COMMENTARY

July 8, 2021

Dear Clients and Colleagues:

As we write this commentary, the first half of the year is behind us and most stock indices are at all-time highs. Earlier in the year, an inflation scare drove the United States (US) 10-year Treasury yield to 1.74% with a small correction in growth assets like those listed on the Nasdaq. It seems the market has decided to follow the cues of the US Federal Reserve (Fed) that inflation will be transitory, once the effects of the pandemic, the pent-up demand and the disruptions to the supply chain are behind us. Since March 5, equity markets have been roaring back and the 10-year Treasury yield is now range-bound at around 1.5%. Inflation numbers, however, continue to rise.

What do we think at Global Alpha? Unfortunately, we do not have a crystal ball, nor have we reached a consensus amongst ourselves. However, we believe the risk that inflation will be sustainably higher than the target of 2% established the Fed and many central banks is high.

The table below shows the prices of various commodities. Many would argue that 2020 was an outlier. That is why we based our comparison on 2019, which was a normal year with a strong economy. The numbers are self-explanatory. In many cases, prices are at multi-year highs. Copper is now at its highest level since 2011, and reached an all-time record this quarter, as did lumber.

Price of (in US$)	June 28, 2019	June 30, 2020	June 30, 2021	% increase over 2019
Oil (Bbl)	58.47	39.27	73.90	26%
Natural Gas (Mcf)	2.31	1.75	3.65	58%
Gasoline (gallon)	1.77	1.26	2.26	27%
Corn (Bushel)	414	373	585	41%
Pork (lb)	0.87	0.75	1.04	20%
CRB Food Index	348	290	488	40%
Copper (MT)	5993	6015	9335	56%
Aluminium (MT)	1820	1620	2552	40%
Lumber (MBF)	379	436	718	89%
CRB Index	408	360	557	37%
Baltic Freight Sea shipping	1381	1799	3418	247%

Sources: USDA, CRB

The broadest measure of commodity prices, the CRB Index, is at its highest since 2011, when it reached an all-time high. Its component, the CRB Food Index, is also at its highest since 2011, near its record high.

Many observers will brush off commodity price inflation, arguing that it is caused by an imbalance between demand and supply that normally reverts within a few quarters. Although true, the supply response can take a lot longer than expected. Oil and gas companies are under enormous pressure and are not increasing exploration. Political uncertainty in South America may slow the supply growth for copper. The effects of weather events seem to have a more permanent effect on the inflation of agricultural commodities. For now, let's assume that supply will come back and prices will come down. The example of lumber, which has recently retreated from above $1700/mbf to just over $700 may prove this point. In our opinion, what may drive a more sustainable inflation will be wage increases, which are driven by inflation expectations.

What we are witnessing currently, particularly in North America, is a wage inflation between 5% and 10% for the lowest earners. Inflation expectations are running close to 4%.[1] There is a risk that the situation becomes a self-feeding mechanism, like in the 70s. Another big component of inflation is rent. The median asking rent in the US has increased almost 18% from the end of March 2020 to the end of March 2021, reaching $1,226 per month. It is up 22% since March 2019.[2]

Many have stated that a big reason for the low-inflation of the last twenty years was the emergence of China and its vast labor pool of migrant workers as the factory of the world. In May of this year, China's producer price index reached 9%, its highest level since the summer of 2008. China will no longer be the deflationary force it has been in the last two decades. Between the aging of its population, its internal needs and increasing trade frictions, we can expect price increases from China.

Inflation numbers will continue to be very high, one might even call them scary for the next twelve months. How the Fed, politicians, unions, consumers and investors will react to these numbers will be important to watch, and our job is to forecast. We are already starting to see some divergence

[1] https://www.newyorkfed.org/microeconomics/sce#/

[2] www.census.gov

between central banks, like those of Norway, New Zealand and Canada, and even within the ranks of the Fed.

How will the market react to increasing signs that inflation will be more than transitory and that rates will rise?

Past episodes have shown that long-duration assets like long-term bonds and high growth stocks will be most affected. US large caps, particularly technology companies, are selling at important premiums versus other markets. They will be most vulnerable. Europe does not have the same labor inflation pressures. That said, inflation in the region may be more contained.

Smaller companies have generally outperformed in periods of inflation. From January 1979 to July 1983, the Russell 2000 Index outperformed the S&P 500 Index by 77%. During this time, inflation rose to as high as 13% and the economy suffered a double-dip recession in 1980 and 1981-82, before staging an extremely strong recovery in 1983 with growth rates as high as 8.5%.[3]

Our portfolio is well positioned for a strong recovery accompanied by higher inflation. With less debt, a rise in interest rates will have a minimal impact. With a more important exposure to the consumer and industrial sectors, economic growth will translate into earnings growth.

As mentioned in last week's commentary, our companies have been able to maintain their margin despite rising input costs through a combination of price increases and efficiency gains.

Have a great day.

The Global Alpha team

[3] http://www.cmegroup.com/