

Wealth Weekly

Inflation Not an Imminent Threat

WEALTH MANAGEMENT RESEARCH

wmr@forsythbarr.co.nz

+64 4 499 7464

Ultra-low interest rates are underpinning high asset prices. But the combination of super easy monetary policy aimed at keeping rates low, together with large government deficits which stimulate the economy, raises the spectre of a return of inflation. That could bring with it expectations of a firming in interest rates (as we used to see late in economic cycles), which in turn would put downward pressure on valuations of fixed-rate bonds, growth equities and other assets. Consequently, the question of whether inflation will make a comeback is top-of-mind for many investors.

Should investors fear the inflation bogeyman?

This is not a straightforward question to answer. Current levels of monetary policy stimulus are unprecedented in developed economies in recent decades. **Inflation has surprised on the downside since the global financial crisis, despite heavy stimulus including record low interest rates and quantitative easing (QE).** A few years ago a recently retired Fed governor admitted the US Federal Reserve (the most influential financial institution in the world) doesn't have a reliable theory on inflation. We acknowledge, therefore, the outlook is uncertain including the significant (but yet unknown) influence future policymakers will have.

A special report we published last week outlines our current thinking. In summary, **we don't think investors should worry about inflation near-term, because the key drivers of sustained inflation — rising costs which businesses can pass on via price hikes, or an excess of demand over business capacity — seem to be missing**, for a variety of reasons:

- Costs have been dampened by productivity-enhancing effects of technology, global competition and unemployment.
- Meanwhile unemployment, ageing demographics and inequality have suppressed demand growth.
- Given the absence of inflation over the last decade, central banks have indicated they will not hike interest rates at the first signs of inflation.

But we live in unique times and **the longer-term inflation outlook is more uncertain.** Portfolio assets that can provide inflation protection include: well-positioned companies with pricing power, infrastructure, commodities and commodity producers, natural resources such as farmland, precious and industrial metals, real estate, and inflation-linked bonds.

Themes of the week

While equities have had a very good year considering the circumstances, there is no shortage of stocks that still look attractive. Our review of 98 international companies following the recent reporting season threw out 49 that look attractively valued given their quality and growth outlooks. From this group **we have identified a dozen stocks with exposure to themes we like, including Alibaba, Amazon, Baxter International, Merck & Co, Microsoft, Salesforce.com, Takeda Pharmaceutical and Tencent.**

Corporate bond issuance has come to an end for the year with just under NZ\$6b having been raised. Much of it was in the form of senior bonds, with proceeds used to repay bank debt. The big four banks have been notably absent from the issuance since pre-lockdown, as they remain flush with funding — including from the Reserve Bank's new Funding for Lending Programme (FLP).

Looking ahead

Napier Port, Sanford, ANZ Bank and National Australia Bank are among New Zealand and Australian companies holding AGMs this week. **FedEx** will report 2Q21 earnings on Friday morning (NZ time). The **New Zealand Rural Land Company** will start trading on the NZX under the ticker NZL on Friday following its IPO. New Zealand's gross domestic product statistics for the September quarter will be of historical interest on Thursday. Inflation statistics for the Eurozone and the UK are due out on Wednesday and Thursday. The central banks of the US and Eurozone will release their interest rate decisions on Thursday and Friday respectively.

"For more inflation, blow into the mouthpiece" — If only it were so easy!

With ultra-low interest rates a key underpinning of asset prices, what a combination of super easy monetary policy (including quantitative easing or QE) and large government deficits mean for inflation is top of mind for many investors. Our 8-page [Special Report - Should investors fear the inflation bogeyman?](#), published on 8 December, looks at the factors that drive and hinder inflation.

We don't think investors should worry about inflation near-term

- QE has allowed governments to inject money directly into the economy (and therefore the money supply). But, an increase in the money supply alone is not sufficient to drive inflation.
- Inflation is typically driven by higher costs for businesses, or rising demand for goods and services that exceeds an economy's capacity to supply.
- Over the past decade, economies have struggled with low growth and low inflation despite stimulus from ultra-low interest rates, QE and fiscal deficits. These measures failed to fully offset disinflationary/deflationary factors such as demographics, high debt, wealth inequality, technology, and low inflation expectations, which, have collectively dampened demand growth and reduced costs.
- COVID-19 has added to disinflationary pressures by swelling excess capacity in economies, most notably through higher unemployment.
- Greater government spending (fiscal stimulus) is needed to (at least partially) offset declines in the private sector and counter the disinflationary pressures above.
- In the near-term, we could see upward price pressures from factors such as additional COVID-19 related costs and/or global and domestic supply chain constraints. We don't expect central banks to view these as "inflation" – inflation is broad-based and continuous, not specific and short-term. We see little risk of broad-based inflation in the short-term.

The longer-term inflation outlook is more uncertain

- Inflation risks are higher over the medium to longer-term.
- Expansionary monetary (QE, low interest rates) and fiscal (government deficits) policies could lift inflation if they boost demand to a level that exceeds the economy's capacity to supply.
- Outcomes will be significantly influenced by governments' willingness (or not) to maintain sizeable fiscal deficits. The higher the deficits, the greater the inflation risk.
- Rising populism in global politics is consistent with larger government deficits, but recent stalemates on new stimulus packages in the US and Europe highlight the uncertainty in any political decision-making.
- Populism could also drive greater wealth and income redistribution which tends to be inflationary by allocating money to lower income earners with a higher propensity to spend.
- Other factors such as de-globalisation, increased trade barriers, greater regulation, pricing on greenhouse gas emissions, and firmer commodity prices may also add cost-push inflationary pressures.

Central banks will not hike interest rates at the early signs of inflation

- If higher inflation does emerge we expect policymakers' initial response will be to let inflation exceed central bank targets and keep interest rates low (meaning even lower real interest rates). The US Federal Reserve has already announced an "average inflation targeting" regime targeting 2% average inflation over time, and that, given it has tracked below target for more than a decade, a period above target would be accepted.
- Higher inflation would assist with central banks' full employment mandate by (1) reducing the real value of elevated debt, and (2) more easily lowering real interest rates if required.

Options for inflation protection in portfolios

- Assets that are expected to be resilient in the face of higher inflation include: well positioned companies with pricing power, infrastructure, commodities and commodity producers, natural resources such as farmland, precious metals, industrial metals, real estate, and inflation-linked bonds.

Fiscal deficits should help support asset prices

- All-else-equal, fiscal deficits transfer wealth from government to the private sector. A large portion of this wealth finds its way to savers and, therefore, into demand for financial and real assets. Ongoing fiscal deficits would provide a support for asset prices.

Themes of the Week

International Equities

Global Reporting Season – Investment Ideas with Exposure to Themes We Like

We reviewed 98 international companies following the recent reporting season. From this list we then screened for ideas that offer attractive value on an absolute return basis, using our “target 3-year return” investment framework. We identified 49 stocks that in our opinion look to be good investments at today’s prices. From this list of 49, we have highlighted 12 companies that are exposed to themes we are targeting, plus a few stocks in the industrials and consumer staples sectors.

Healthcare

- **Baxter International (BAX), Merck & Co. (MRK), Royal Philips (PHG.AS) & Takeda Pharmaceuticals (4502.T).** We are spoiled for choice across the Healthcare sector, which we believe is set to outperform over CY21. Our favoured companies include cheap “Big Pharma” companies (Merck & Co and Takeda) alongside Royal Philips which is seeking to achieve enduring growth by providing “connected health” benefits, while accelerating productivity benefits from digitalising healthcare data.

Information Technology

- **Fiserv (FISV.O), Microsoft (MSFT.O) & Salesforce (CRM).** Technology and innovation will continue to play an important role in enhancing the productivity and competitiveness of businesses, particularly in the current environment of fast-paced development and industry disruption. Information Technology stocks have been significant beneficiaries of COVID-19 and we continue to like companies enabling digital transformations (Fiserv in payments, Microsoft in cloud and Salesforce in software-as-a-service) and those that offer cyber-security solutions.

Communication Services

- **Activision Blizzard (ATVI.O) & Tencent (700.HK).** Within the Communication Services sector we are targeting companies with exposure to gaming. Industry trends show continued strength in player demand and engagement, as the sector continues to transition from a hit-driven business model where players make a one-off CD-ROM purchase to a subscription/pay-as-you-play model. This new environment provides gaming companies the opportunity to increase monetisation within games by offering additional downloadable content, character personalisation, and digital advertising within games. We see a significant runway for growth, particularly in multi-player games where players socialise within a game’s ecosystem.

Consumer Discretionary

- **Alibaba (BABA.K) & Amazon (AMZN.O).** In the Consumer Discretionary sector we continue to prefer leading ecommerce companies, with COVID-19 accelerating the shift from in-store to online shopping. In our view the runway for growth in ecommerce remains significant. For example, US online sales represent only c.20% of total retail sales.

Financials

- **Allianz (ALVG.DE).** Global financials continue to trade on undemanding valuations and within this sector ALVG caught our attention. ALVG is the largest non-life insurance company globally and provides diversification within European markets. In a sector that has faced ongoing earnings headwinds ALVG has been more resilient than peers and has a more favourable outlook.

Industrials

- **Deere & Co (DE), Siemens (SIEGn.DE).** Within the Industrials sector we continue to like companies that are implementing technology to help transform their businesses and/or produce technology that will help drive productivity and competitive advantages for customers. DE is future proofing its business by incorporating technology such as artificial intelligence (AI) and automation into its products, while SIEGn provides digital and automation solutions to multiple industries including manufacturing, healthcare, construction, and infrastructure.

Consumer Staples

- **Mondelez (MDLZ.O).** MDLZ owns a defensive portfolio of confectionary and snacking brands and trades at an undemanding valuation. In a world where consumers are increasingly time-poor, MDLZ offers convenient, cheap, and tasty snacking options. The company has indicated it is investing in ecommerce-specific pack sizes and products, along with digital marketing to help drive growth through online sales channels.

Fixed Interest

That's all folks...

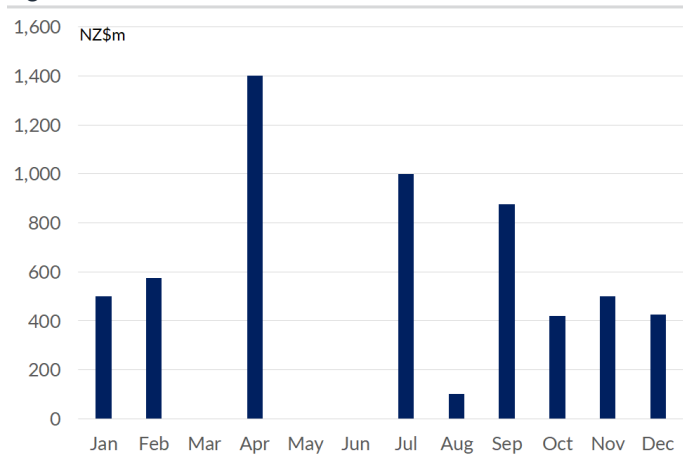
With the completion of the NZ\$150m bond offer from Ryman Healthcare last week, corporate bond issuance for 2020 appears to have come to an end. **Just under NZ\$6b was raised in 2020, predominately in the form of senior bonds, which were used to refinance bank debt.** Notable absentees from the issuance list are the 'big four' banks who are usually regular issuers on the NZDX. The big four have not issued senior bonds since pre-lockdown, as they remain flush with funding and funding options (i.e. the Reserve Bank's Funding for Lending Programme, FLP).

One sector which seems to have embraced the retail debt market is the aged care sector with four issuers now present (Ryman, Summerset, Oceania and Metlifecare), and Arvida has stated that it is also considering a bond offer. This sector follows the property sector, which has become a regular issuer to retail and institutional investors.

The return of a subordinated Tier 2 security from Kiwibank was a good sign in a segment that has been largely paralysed since the RBNZ started its Capital Review in 2017. With the Capital Review completed and the rules around issuance of Capital Securities out for submission, it may be a sector that once again finds its feet in 2021.

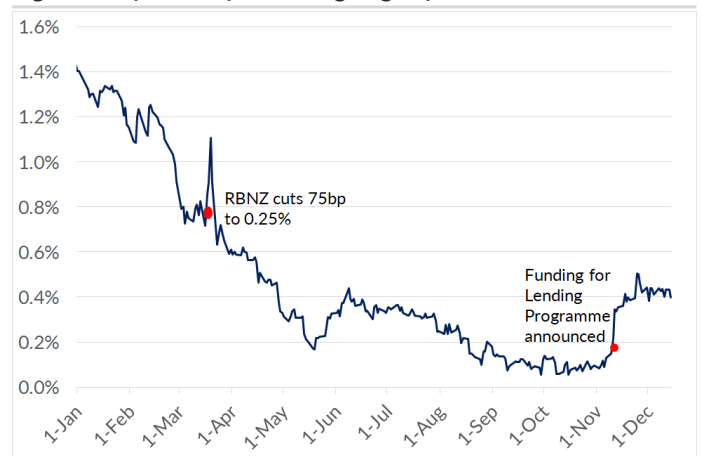
Meanwhile **the market has removed any chance of the Official Cash Rate heading into negative territory in 2021.** Ironically it was the announcement of the FLP on 11 November which seems to have been the catalyst for the change of thinking. This is not what the Reserve Bank had planned – its policymakers will be waiting patiently for the interest rates on lending facilities and retail mortgages to head lower!

Figure 1. New issuance in 2020



Source: Forsyth Barr analysis, Refinitiv

Figure 2. 5-year swap rate not going to plan for the RBNZ



Source: Forsyth Barr analysis, Refinitiv

Research Worth Reading

New Zealand

Genesis Energy (GNE) – Repowering – Investor Day 2020 Take-Outs

GNE's key 2020 Investor Day announcement was its commitment to reducing carbon emissions consistent with limiting warming to 1.5°C, meaning it will ramp up replacement of baseload thermal generation with renewable energy. Whilst the company's coal units will likely still be in use for the next decade, this commitment is a positive step, and along with the sale of Kupe will see GNE's environmental credentials improve. On the earnings front, GNE's FY24 EBITDAF target is ~NZ\$445m, consistent with our pre NZ Aluminium Smelter-closing forecast. GNE offers better value than several of its peers and its intention to reduce carbon emissions will only help. **OUTPERFORM.** (Published by Forsyth Barr)

Infratil (IFT) – Not a Foregone Conclusion

AustralianSuper's bid for IFT at a c.20–25% premium to the undisturbed share price has been unanimously rejected by IFT's board. Ordinarily we would expect the board to consult with its major shareholders to decide whether to engage with the acquirer or not. So far the board has chosen not to. However, we believe this to be more nuanced than a simple question of accepting the offer (or an increased one) or not. AustralianSuper is taking advantage of IFT's discount to NAV, a discount that would be largely unlocked by taking IFT's assets into a private setting; the bid is broadly in-line with our estimate of NAV after allowing for cancellation costs and already earned performance fees. Historically, investors have been unwilling to pay gross NAV for IFT's assets. We believe the bid, even if rejected, could prove to be a trigger for (some of) the discount to be closed. **NEUTRAL.** (Published by Forsyth Barr)

Pacific Edge (PEB) – On the Edge of Glory?

2020 has been a transformational year for PEB, ticking off key milestones leading to a substantial re-rating and a return to the stock being included in the S&P/NZX50 index. There is no short-cut on the path to commercialising the company's liquid biopsy test for bladder cancer and the hard work is far from over, however, we believe PEB is well positioned to deliver a strong long-term growth profile (admittedly off a very low base). It is unlikely to be smooth sailing, but if PEB is even partially successful this should see a strong payoff for investors. We reinstate full coverage with an **OUTPERFORM** rating and NZ\$1.60 target price, which includes a risk adjustment to take into account PEB's life stage and high execution risk. Given the wide range of justifiable outcomes for earnings and valuation, we expect PEB's share price to be driven by news flow in the near-term, which we believe is positively skewed. **OUTPERFORM.** (Published by Forsyth Barr)

Z Energy (ZEL) – Cloudy Period Doesn't Dampen ZEL's Spirits

ZEL's November 2020 sales volumes were softer than in recent months, with ZEL citing the lack of international tourists that would have been arriving for the start of summer, and the wet weather. That said, retail volumes are still tracking ahead of our forecasts. Retail margins have been under pressure in November as a result of a sharp increase in crude oil prices, however, margin pressure should ease in coming weeks assuming the crude oil price rally does not continue. As long as ZEL hits FY21 EBITDAF guidance (which it is on track to do) we expect the stock to continue to positively re-rate over coming months. **OUTPERFORM.** (Published by Forsyth Barr)

Australia

Aristocrat Leisure (ALL.AX) – RAID Doom Tower to drive FY21e earnings growth

Aristocrat's social gaming subsidiary Plarium has released its long-awaited Doom Tower game – the first major new Raid game launched in over a year. The game has been very well received to-date by the Raid player community. This comes after several delays, which had led to frustration from users, who had little incentive to increase spending given the previous state of the game. Prior to this launch, growth in bookings was reliant on attracting and monetising new users. Executing on these major game developments is critical for Raid as it will help to they wind back user acquisition costs and improve monetisation in FY21. **BUY.** (Published by Citi)

Origin Energy (ORG.AX) – Earnings revisions

Wholesale electricity prices remain weak, driven by low fuel costs and the rollout of new renewable supply. In Ord Minnett's view, current prices are unsustainable given few baseload generators are able to make appropriate returns at these levels, although Ord

Minnett believes the market has not accounted fully for the impact of lower electricity prices on ORG's future earnings. BUY. (Published by Ord Minnett.) [Forsyth Barr Wealth Management Research is concerned about the long-term outlook for electricity prices in ORG's Australian market, given the impact of rising renewables supply, and we have removed ORG from our preferred list.]

International

Adobe Systems (ADBE.O) – Better FY21 Margin Guide Offsets Tax Headwinds, But We Still See More Leverage Ahead

ADBE's Q4 results were healthy while FY21 guidance came in better than feared and has room for upside in UBS's view. UBS was particularly impressed by the implied margin expansion, helping offset dilution from the Workfront acquisition and a higher tax rate. Shares lagged as investors picked at a smaller net new annualised recurring revenue (ARR) beat than seen in prior quarters, and the fact that FY21 guidance benefitted from an extra week of revenue due to the timing of the new fiscal year. However, UBS thinks demand drivers remain firmly in place, with a potential pickup in Digital Experience as the environment stabilises in FY21, while the durability of margin gains still looks underappreciated in UBS's view. BUY. (Published by UBS)

Facebook (FB.O) – The Gov't Presents Their Case; Facebook Responds

The Federal Trade Commission (FTC), along with a coalition of 46 state attorney generals, filed a lawsuit against FB alleging the company illegally maintained monopoly power through a years-long course of anticompetitive conduct. Although this comes as another regulatory headwind, UBS believes it would be unusual and difficult to force a sale of Instagram and WhatsApp given their acquisitions were previously approved by the FTC and the businesses are already well integrated. That said, the FTC will more rigorously examine future acquisitions. Two FTC commissioners opposed the action. A federal court lawsuit will likely lead to prolonged litigation. BUY. (Published by UBS)

Ping An Insurance (2318.HK) – Removal from APAC Key Call; investment thesis remains intact

Following significant stock price outperformance, UBS has removed Ping An from its Asia Pacific Key Call list. 2020 has been a challenging year for Chinese insurers. Ping An's share price has outperformed domestic peers by +17% YTD, after another +19% in 2019. UBS believes the investment thesis remains intact and continues to like Ping An in the long term, based on the company's superior agency distribution, health ecosystem and technology. UBS still sees plenty of value in the stock on a price/enterprise value multiple of 1.1x. At this level a recovery in new business and potential synergy between insurance and health ecosystem are not fully priced in. BUY. (Published by UBS)

Walt Disney Co (DIS.N) – Takeaways from Disney's 2020 Investor Day

On 10 December DIS hosted an investor day at which the firm addressed a broad range of topics, with a particular focus on its direct-to-consumer initiatives. Management provided further details around the upcoming launch of its Star general entertainment offering, as well as updated expectations for the growth and profitability of its direct-to-consumer apps. The firm raised its subscriber outlook for Disney+ and ESPN+. BUY. (Published by Citi)

Funds

Fidelity China Special Situations (FCSS.L) – High conviction focus on "New" China

FCSS's interim results showed a net asset value total return of +51.1% in the six months to 30 September, more than double the MSCI China's +24.4% (both in sterling). Consumer-related stocks including China MeiDong Auto (luxury cars) and Yadea Group (e-bike maker) were strong contributors, as was SHSHU Paint Company. FCSS's long-term performance record (+14.6% pa NAV total return since IPO) underpins Investec's confidence in the investment philosophy, process and manager. Investec likes the manager's high conviction focus on companies in China's growth sectors and the fund's small/mid cap exposure. BUY. (Published by Investec)

Polar Capital Technology (PCT.L) – Interim Results: Rotates away from stay-at-home beneficiaries

In the six months to 31 October the NAV of PCT was up +28.1% in sterling, outperforming its benchmark by over +4%. PCT's manager has taken profits in 'stay-at-home beneficiaries' and other stocks where valuations appeared full, and recycled the cash into sectors which could benefit from a recovery phase such as online travel, electric vehicles, industrial automation and 5G. The manager has noted the risk posed by greater regulatory scrutiny of the mega-cap technology companies, and has reduced exposure to Chinese internet names following China's last-minute introduction of regulations that halted the hotly anticipated IPO of fintech company Ant Group. Numis believes PCT's recent c.-5.9% discount to NAV offers an attractive entry point to the trust. (Published by Numis)

Calendar

Figure 3. Calendar

| Date | New Zealand | Australia | International |
|--------|--|--|---|
| 14-Dec | Westpac Consumer Sentiment (4Q) External Migration & Visitors (Oct) | | JP: Tankan Large Manufacturers Index (4Q) JP: Tankan Large Non-Manufacturers Index (4Q) |
| 15-Dec | RBNZ Accounts (Nov) | RBA Meeting Minutes | UK: Average Earnings Index +Bonus (Oct) UK: Claimant Count Change (Nov) CN: Industrial Production |
| 16-Dec | Global Dairy Trade Price Index Balance of Payments (3Q) Sanford AGM Geo Limited AGM | Manufacturing PMI Services PMI Melbourne Institute Leading Index HIA New Home Sales ANZ Bank AGM | UK: CPI (Nov) UK: Composite (PMI) UK: Manufacturing (PMI) UK: Services (PMI) EU: German Manufacturing PMI (Dec) |
| 17-Dec | GDP (3Q) Marlborough Wine Estates AGM | Employment Change (Nov) Participation Rate (Nov) Unemployment Rate (Nov) | US: Retail & Core Retail Sales (Nov) US: Crude Oil Inventories US: FOMC Statement US: Fed Interest Rate Decision EU: CPI (Nov) |
| 18-Dec | ANZ Business Confidence Trade Balance (Nov) Napier Port AGM NZ Rural Land Company listing | Incitec Pivot AGM National Australia Bank AGM Nufarm AGM Sydney Airport November Traffic | US: Building Permits (Nov) US: Initial Jobless Claims US: Philadelphia Fed Manufacturing Index (Dec) UK: BoE Interest Rate Decision (Dec) UK: Retail Sales (Nov) EU: German ifo Business Climate Index (Dec) JP: BoJ Monetary Policy Statement FedEx 2Q21 Earnings |
| 19-Dec | CFTC NZD Speculative Net Positions | CFTC AUD Speculative Net Positions | |

Source: Forsyth Barr analysis

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