GVC Gaesco Gestión

The Catch-up effect

When the global lock down was just beginning, towards mid-March 2020, and the markets were trading strongly for COVID-19 at what would be the minimum levels for the year, the expectation of the future inflation rate was very low. Thus, in the United States, it stood at just over 0.2% per year for the next five years. Therefore, it was considered that there would be no inflation in the coming years, anticipating that covid-19 would have serious and lasting effects on the economy. Since then, **everything has changed a lot** and this inflation expectation has not stopped rising, simultaneously with that of a progressive economic normalization. Just before the first of the covid-19 vaccines was announced, on November 9, the same estimate of annualized inflation for the next five years had already risen to 1.6%. This trend accelerated with vaccines, in a type of directly proportional relationship between the percentage of the population at risk vaccinated and inflation, and currently exceeds 2.6%. Just to put this in context, this inflation forecast was not that high since July 2008, just before Lehman Brothers.

It should be mentioned that this inflation expectation is not calculated by any study center, but rather an inflation rate quoted by the financial markets themselves. This is called the breakeven inflation rate, which compares the price of bonds linked to inflation, which are those that pay a coupon based on the inflation rate of the moment, with the price of normal bonds, which pay a permanent coupon. Comparing the two prices, it is easy to extrapolate the inflation rate that is expected within each time period.

Recently, we have witnessed debates in the financial sector about whether we are facing a 90s type inflation, that is, positive but relatively controlled or simply normalized, or a 70s type inflation, that is, a de facto hyperinflation. For the moment, the first thesis prevails, with many arguments in favor, while the main argument for the second is practically limited to the fact of the high level of public debt over current GDP, which has accumulated debt over debt. A debt generated by covid-19 that has been added to the debt generated by the real estate crisis of recent date more than a decade and that, on paper, is inflationary. We are therefore faced with a situation where the anomaly lies more in real interest rates, which continue to be negative, than in inflation itself.

A controlled inflation

Let's look at the arguments in favor of a normalization of inflation. First, **commodity prices have skyrocketed**. The CRB BLS / US Spot All Commodities Index, which takes into account the price of all commodities, is currently at 510 level. At its worst, in early April 2020, it traded at 347 and just before the pandemic was at level 400. In other words, the price of all raw materials is, right now, 27.5% higher than before the virus appeared on the scene. It is not, therefore, only a recovery in prices prior to the pandemic distortion, but rather a strong increase over the previous situation. In fact, these commodity prices were not that high for a decade. It should be added that, throughout history, the prices of all raw materials have only been higher than the current ones in the 10 months that go from December 2010 to October 2011.

Second, you must delve into **business reality**. In this first quarter of the year, we have held meetings with 46 listed companies from around the world, although the majority belonging to different European countries. They all operate in very diverse sectors of activity. Many of these companies have experienced raw material price rises on their own skin, as we have been told. Well, when we asked them about their management of the rise in the price of raw materials, all the companies contacted, without exception, told us that they were raising the sale prices of their products and that they would still raise them more in the future next. In other words, companies are passing on the rise in raw materials to their customers. We have experienced similar situations in the past and we remember how, very often, companies expressed their inability to pass it on to sales prices, to the detriment of their margin. Nothing comparable with the current situation: the impact on prices is being and will be massive.

One of the keys lies in what we could call the **catch-up effect**. In a conventional economic crisis, the different agents suffer a well-known crisis of confidence that takes time to be resolved, a type of period of mourning that must necessarily go through. In all the exits from these crises it is essential to regain the confidence of the agents so that, despite having savings, they want to dedicate them to consumption. In this health crisis, on the other hand, and fewer people who work in the sectors directly affected, the vast majority of the population has saved more than usual, they couldn't have a normal consumption, not because they did not want to, rather because they weren't allowed. The data at the aggregate level are devastating in this regard. What has slowed consumption, then, are the restrictions imposed, and not the lack of confidence. In this context, when the green light is turned on and the fence is raised, it will be necessary to assume a return to the previous consumption patterns quite quickly. In economics it is known that the consumer will want to make up for lost time, he will want to do what is called a catch-up. This effect is not the same for all sectors of activity and there are even certain sectors where there will not be or where it will be slightly negative (the sale of computers in 2021, for example, will be lower than last year, since, for obvious reasons, many were bought in 2020). On the other hand, in many other sectors, such as tourism, this phenomenon will not only exist, but will have a significant magnitude that can be quantified by up to 20%. That is, for a few years, people can travel up to 20% more than they did before the pandemic. This translates into concrete acts as small as they can be, for example, taking 12 days of vacation on a trip that would previously have been done in 10 days. After a certain time, of course, it is foreseeable that everything will normalize.

I can come to understand that, for many people, the strong rise that the stock markets of the whole world have had in the last year can seem something almost esoteric. It is not at all. The stock markets are trading a strong increase in sales figures and a simultaneous increase in business margin, which by definition multiplies EBITDA. Many of the operating cost reductions - called opex in industry jargon - that companies implemented last year will persist over time. One of our essential tasks these days is to determine what is the structural increase in the margin that each company will have due to covid-19. Believe me when we tell you, it is surprisingly high. For all this, the stock markets are, in general and despite the great performance they have had, very far from achieving the levels that correspond to them. It should be noted, however, that this statement is not true for all types of listed companies, but for certain stock market segments, such as the so-called value or the already mentioned tourism sector. All of them, quite spacious, however, to be able to choose with ease.

Jaume Puig, *CEO & CIO de GVC Gaesco Gestión S.G.I.I.C y de GVC Gaesco Pensiones SGFP*