October 2021
Issue No. 21

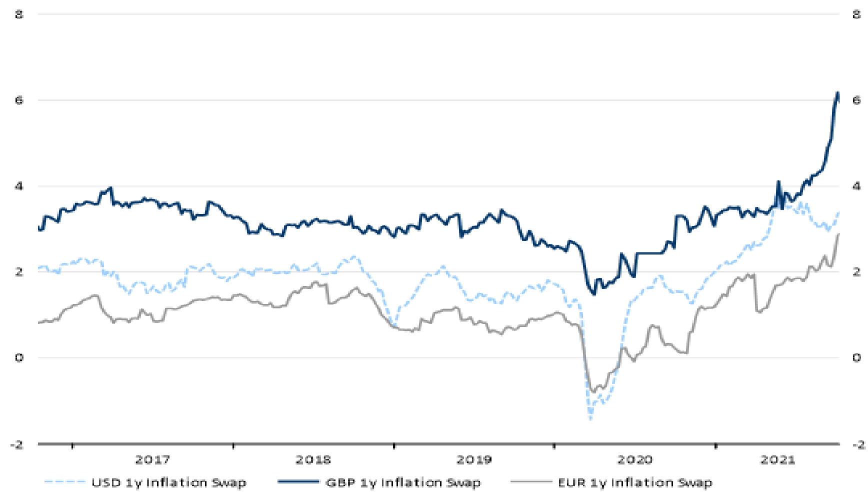
HOTTINGER GROUP

GLOBAL INSIGHT

Overview

- In our Macro View we look at the expansion in economic activity since economies have started to re-open, as well as recent changes in the policy outlook for developed market central banks.
- Surging energy prices have seemingly reached the point at which they may begin to impede future economic growth.
- In our Investment Outlook we take a deeper look at recent shifts in market pricing and articulate our views as to how the future might evolve for markets and client portfolios.
- Inflationary pressures continue to build globally and we walk through our perspective on some of the key challenges this brings for investors today.
- Longstanding relationships between major asset classes are being bought into question and we highlight the need for a rethink of traditional portfolio diversification methods.
- In our guest article, Adrian Courtenay, Portfolio Manager, Odey Asset Management, provides an overview of the mergers and acquisitions landscape and some of the opportunities therein.
- While seemingly a niche strategy a young Warren Buffett allocated almost half of his portfolio to such situations in the mid-50's.
- Adrian outlines why current increases in the level of ongoing inflation may help drive a growing number of competitive bid situations.

Inflation expectations have been rising around the world



Source: *Hottinger Investment Management / Refinitiv Datastream*

Inside this issue

Economic Highlights

- UK GDP Growth looks set to end this year at c.6.5% before falling back slightly in 2022.
- Increases in UK inflation have led to the MPC suggesting policy action much sooner than markets had anticipated.
- The US Federal Reserve have all but confirmed their intention to begin tapering asset purchases before year-end.
- China's heavy-handed approach toward wealth redistribution is estimated to have reduced growth by some 30bps over the 3rd Quarter.

Contact Details

Hottinger & Co. Limited

4 Carlton Gardens
London SW1Y 5AA

+44 (0) 20 7227 3400

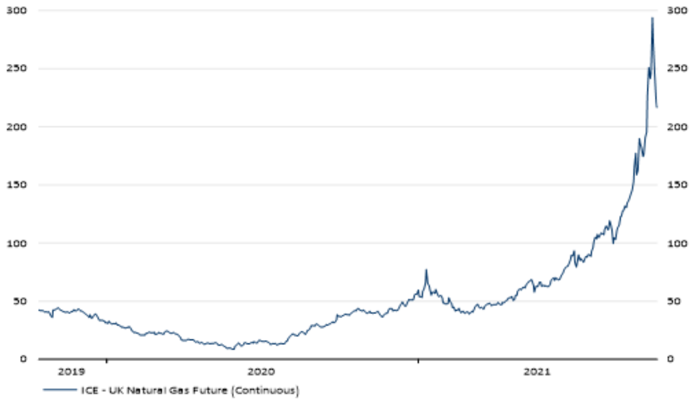
info@hottinger.co.uk

www.hottinger.co.uk

Based upon information available up to and including
16th October 2021

Key Issues in Charts

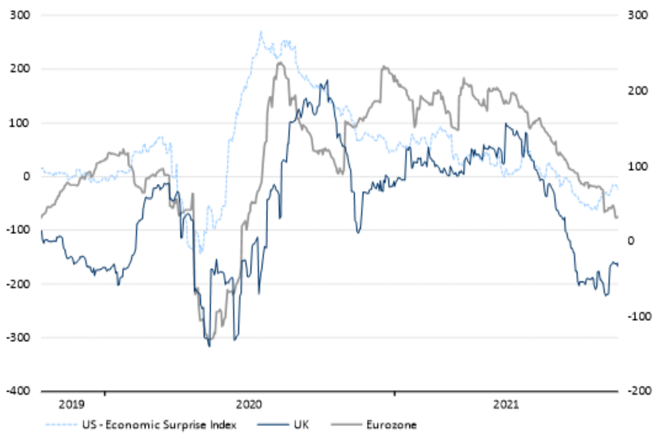
UK Natural Gas Prices



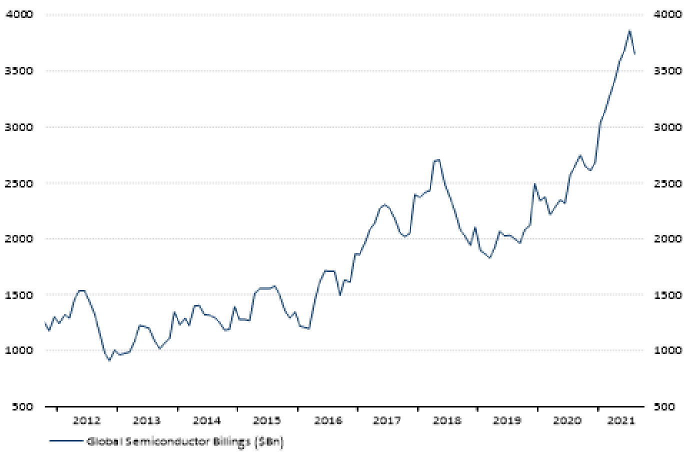
- The price of natural gas has risen exponentially over the third quarter.
- Causes include a muted response to higher prices from key suppliers (namely Russia), an unusually low contribution from wind-generated power and the competitive nature of the UK gas market.
- Government caps on energy pricing have driven a number of UK suppliers out of business.
- Higher prices can, at least in part, be blamed for higher expected inflation in the UK relative to other parts of the world.

Global Economic Surprise Indices

- An economic surprise index shows the evolution of actual economic growth data relative to market expectations.
- On this measure conditions have been deteriorating since the beginning of the second half 2021.
- The UK has seen the most significant decline in growth relative to expectations.
- We see tentative signs that expectations have now caught up with reality and could be entering a period of consolidation or directional change.



Global Semiconductor Billings



- Semiconductors are found in almost every type of electronic device in the world.
- The significant rise in digital demand throughout the pandemic has led to persistent shortages in the available supply of these materials.
- These shortages have resulted in severe delays to the delivery and shipment of cars, printers, televisions, personal computers and mobile phones among many other items.
- The chart depicts the scale of the increase in global demand for these products.

Macro View

For probably the first time since 2005 the word "stagflation" has been used by economists and commentators alike as the transitory nature of the current inflationary pressure is increasingly looking more persistent. Central banks also seem to be proving more hawkish than market sentiment expected, and over the past few weeks Norway, New Zealand, Russia, Peru, Poland, Czech Republic and Brazil have all tightened rates, and the US Federal Reserve is expected to start tapering bond purchases from November. As with 2004-05 one of the most noticeable features of the current environment is rising energy prices putting pressure on growth already slowing because of the Covid Delta variant, and the effects of other supply shocks emanating from the uneven reopening of economies. It could be argued that we may have seen the peak in global growth during the summer as the two main growth engines post-Covid of China and the USA start to slow, suggesting that much of the early gains from the V-shaped recovery have been had. Vaccine programmes are now in full flow globally, including early strugglers such as India, so we enter the winter months with the extra pressures felt by health systems from Covid cases seemingly under control as the world gets used to living with the virus.

For probably the first time since 2005 the word "stagflation" has been used by economists and commentators alike as the transitory nature of the current inflationary pressure is increasingly looking more persistent.

UK

Data released over the summer would suggest that the recovery in the UK was strong as the government relaxed much Covid-related guidance allowing the hospitality sector, in particular, to rebound strongly. The UK economy had largely closed the gap on other regions caused by an initial sluggish start to reopening, and by the end of the second quarter was only 4.4% below fourth quarter 2019 levels[i]. However, the leisure sectors are a significant part of the service sector-led UK economy and businesses remain vulnerable to Covid setbacks. Despite shortages in labour, many companies still seemed to have significant numbers on furlough when the scheme ended in September suggesting the economy may still take longer to recover[ii]. Absolute Strategy Research (ASR) expect GDP growth to end this year at 6.50% before falling back to 5.50% in 2022[iii] as supply side disruptions, labour shortages, surging energy prices, and Delta variant effects keep the recovery process volatile.

Data released over the summer would suggest that the recovery in the UK was strong as the government relaxed much Covid-related guidance allowing the hospitality sector, in particular, to rebound strongly.

Inflation remains a hot topic as the Bank of England writes a letter to the Treasury to explain the inflation pressures being felt within the UK, however, we would argue that many items on the above list of current pressures will prove to be temporary. Inflation is likely to end 2021 at 3.25% and potentially remain strong into 2022 but is expected to be around target rate by the end of next year. September's Monetary Policy Committee minutes emphasised that the inflation target always applied, but the committee would focus on the medium term and not on short term shocks. It also highlighted that an increase in rates could be implemented even if the asset purchase programme was ongoing, and market expectations are that the first rate hike could be as early as December 2021[iv].

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United States

The patchier vaccination roll-out on a state by state basis left the US economy vulnerable to the rising concerns of the Delta variant reducing the pace of hiring in labour markets and activity in the housing sector[i]. Supply side disruptions

Following the Federal Open Market Committee meeting in September Chair Powell indicated that barring surprisingly bad economic data over the next month, it can be assumed that the tapering process will be initiated at the November meeting and will reduce its purchasing of Treasury Securities to conclude around the middle of next year.

and pricing pressures seem to have constrained activity causing many to reduce growth expectations in the fourth quarter. ASR now predict fourth quarter GDP growth of 5.75% with consensus having peaked around 6.6% in May[v]. This also suggests that we may have seen peak growth as the combined effects of labour shortages, wage pressures, supply side disruption, and diminishing government support weigh on the economic rebound. While congress wrestles with the raising of the debt ceiling, the path forward for future stimulus packages such as the $1.2tn bipartisan infrastructure package, and the $3tn Democrat budget reconciliation package looks unclear at this stage.

Following the Federal Open Market Committee meeting in September Chair Powell indicated that barring surprisingly bad economic data over the next month, it can be assumed that the tapering process will be initiated at the November meeting and will reduce its purchasing of Treasury Securities to conclude around the middle of next year. This translates as a reduction of $10bn per month from November until June which arguably is a much more aggressive taper than the market had expected[vi]. However, Powell also stressed that no inference should be made regarding the path for rate hikes[vii] which have a clear higher hurdle.

There is a clear indication that the FOMC has grown more hawkish than it was at the June meeting. The swifter pace of interest rate hikes from policymakers' last set of projections in June comes amid robust debate at the Fed about balancing its maximum employment and 2% average inflation goals. The FOMC projections for PCE inflation see inflation ending the year at 4.2% before falling to 2.2% in 2022 and 2023, getting back to 2.1% in 2024. This underscores the belief that the current high levels will be transitory and shows less confidence in GDP growth being maintained. Real GDP growth is forecast to be 5.9% at year-end (7% in June), falling to 3.8% by the end of next year, and 2.5% in 2023[viii].

Europe

Economic activity rebounded 2.2% quarter on quarter in the second quarter led by consumer spending while export growth remains depressed not helped by the slowdown in China. Household demand looks set to continue in the third quarter as the Covid restrictions are lifted in the tourist industry with manufacturing and construction above pre-crisis levels. Barclays expect growth to peak at 2.3% qoq in the third quarter before decelerating to 1.1% qoq in the fourth quarter[i]. At a country level the pickup in activity in France, Italy and Spain has surprised on the upside whereas Germany has seen downward revision.

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The German elections in September saw the Social Democrats (SPD) take the largest share of the vote from the CDU/CSU marking the end of the Markel era. Negotiations to form a government now start with the so-called Traffic Light coalition of the SPD, Greens and Liberal Free Democrats (LFD) the most likely outcome providing a moment of relief that a more left leaning coalition has most likely been averted. There is still likely to be a different approach to fiscal policy with a new finance ministry, while the green agenda will be more prominent emulating the direction of the EU generally. Furthermore, with Angela Merkel no longer dominating the EU arena there could form a power vacuum until other EU leaders, such as Macron, attempt to fill it potentially weakening

Germany's position in the EU in the short term[ix].

As third quarter service sector activity strengthens as well as supply side pressures grow, as elsewhere, inflation has been ticking up, likely to end the year at 3.25% qoq in the fourth quarter[iii]. We feel stronger wage growth could create further upside potential in the short term, but ASR forecast Eurozone inflation to average 1.75% in 2022[iii].

Japan

An extended state of emergency to combat rising Delta variant cases has created strong headwinds for the economy. The vaccination roll-out over the last few months encouraged by the staging of the Olympics has now seen more than 50% of the population fully vaccinated which should see a pickup in economic activity in the fourth quarter. The election of Fumio Kashida as leader of the LDP and most likely prime minister, was a surprise as the polls favoured Taro Kono, and is considered to be a more fiscal conservative[ix]. However, in the short term he has promised fiscal support for the economy as it begins reopening through the fourth quarter and first quarter of 2022. ASR see fourth quarter GDP growth of 0.75% qoq and estimate 2022 GDP growth to average 2.75%[iii].

The vaccination roll-out over the last few months encouraged by the staging of the Olympics has now seen more than 50% of the population fully vaccinated which should see a pickup in economic activity in the fourth quarter.

The supply side constraints and a surge in energy prices as Japan is a net importer, may well create short term inflationary pressures leading to a positive inflation rate of 1% in the fourth quarter[iii]. However, underlying inflation is expected to remain weak in 2022 once the short-term effects have dissipated.

China

The aggressive government stance to containing Delta variant outbreaks caused a growth slump in August which looks to have rebounded in September as social distancing guidance lifts, but spending levels remain below pre-Covid levels. Supply chain disruptions coupled by the government's ongoing attempts to limit output of high-polluting industries saw industrial production fall to a twelve-month low in July[i]. Power shortages have seen black outs in many regions during the summer due to government policies which seem to be quietly lifting in October[ix]. GDP growth is expected to recover to 4.25% qoq in the fourth quarter leaving 2021 GDP growth averaging 8.25%[iii].

The headline making policy stance towards technology, private education and entertainment sectors has caused ructions in the stock markets but seems to have had little impact on broader economic activity.

ASR also expect fiscal policy to become more supportive with an acceleration of project approvals translating into a sharp pickup in infrastructure construction in the fourth quarter and first quarter of 2022 if power shortages do not hamper activity[ix].

The headline making policy stance towards technology, private education and entertainment sectors has caused ructions in the stock markets but seems to have had little impact on broader economic activity. Barclays estimate the drag to GDP growth will be approximately 0.30% in the third quarter and 0.1-0.2% in the fourth quarter[i].

Supply side disruptions and the rise of Delta variant cases has caused growth for the fourth quarter to be revised downward suggesting that we have passed peak growth from the resumption of economic activity.

Conclusion

Surging energy prices have caused major disruption globally as Brent Crude rises above $80 per barrel, up nearly 60% year-to-date, China coal prices have nearly doubled, and natural gas prices in Europe and Asia are up over four times, doubling in the last month. Europe and the UK have a high reliance on natural gas as an energy source so this will affect growth and inflation during the first quarter of 2022. However, globally ASR point out that the causes are both supply and demand driven which will probably limit the overall effect on global growth[xi]. Supply side disruptions and the rise of Delta variant cases has caused growth for the fourth quarter to be revised downward suggesting that we have passed peak growth from the resumption of economic activity. Inflation pressures will likely prove temporary in many cases but the underlying trend in inflation is expected to be higher going forward which could explain the more hawkish stance of many central bankers.

[i] Barclays - Economic Outlook – September 16, 2021

[ii] Absolute Strategy Research – Furlough comes to a close – October 1, 2021

[iii] Absolute Strategy Research – Investment Committee Briefing – October 1, 2021

[iv] https://www.ft.com/content/1c0d0da5-2db8-4ec2-a577-0542317426c3

[v] Lazard Asset Management – Outlook on the United States – October 5, 2021

[vi] Bloomberg – Points of Return: The Tapir Cometh – John Authers – September 23, 2021

[vii] Morgan Stanley – FOMC Reaction: A Tidy Taper – Ellen Zentner - September 23, 2021

[viii] FOMC Summary of Economic Projections – September 22, 2021

[ix] Absolute Strategy Research – Why the German election matters for markets – September 24, 2021

[x] Absolute strategy Research – Chinese fiscal support is coming through – October 6, 2021

[xi] Absolute Strategy research – How much will higher energy process hurt – October 8, 2021

Investment Outlook

As ever we find it useful to start our outlook with a review of the past quarter in markets and, for the sake of posterity, to cross-reference some of what was said in our previous quarterly note. Following a short burst of volatility in mid-July (sparked by concern around yet another increase in Delta-variant cases) global equity and bond markets sailed through the 3rd quarter largely uninterrupted.

It wasn't until late September that things became a little more interesting as global bond yields began to rise, led by UK Gilts. At their meeting on the 23rd the Bank of England's Monetary Policy Committee disclosed that it may be prepared to hike interest rates as soon as Q1'22 and, perhaps even more surprisingly, that the committee felt comfortable doing so before completing the existing programme of QE[i].

At their meeting on the 23rd the Bank of England's Monetary Policy Committee disclosed that it may be prepared to hike interest rates as soon as Q1'22.

September also saw the US Federal Open Markets Committee release their economic projections in which they raised the average level of expected core inflation over the forecast horizon. The Norges Bank became the first Central Bank in the developed world to raise interest rates and Brazil joined a growing number of Emerging Market central banks who have already responded to higher inflation via rate increases. The breadth of these policy moves and the overall change in tone triggered a broader reassessment of the outlook for global interest rates and growth, leading to a period of elevated volatility as the quarter drew to a close.

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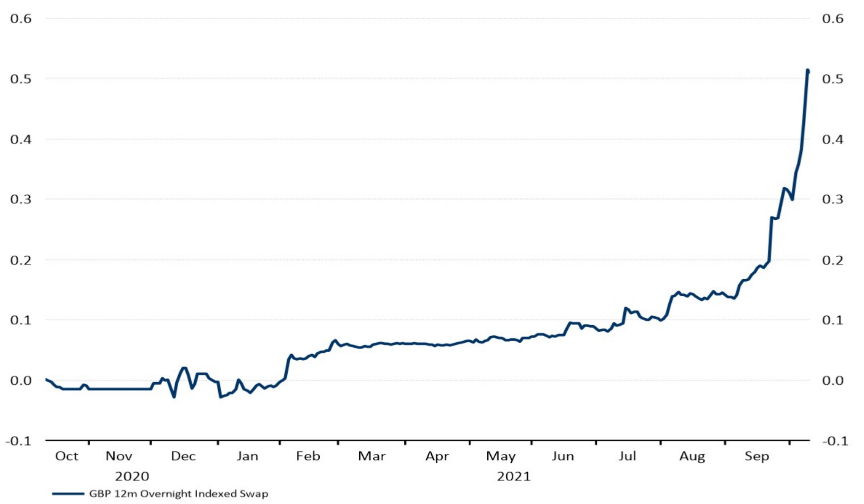
Expectations of future interest rates have been rising, led by the UK



Source: *Hottinger Investment Management / Refinitiv Datastream.*

To us these shifts provide clear evidence that policy makers within Central Banks have 'tipped-their-hand' with respect to their previously held conviction in the transitory nature of inflation. We are reminded of Carnegie's famous quote;

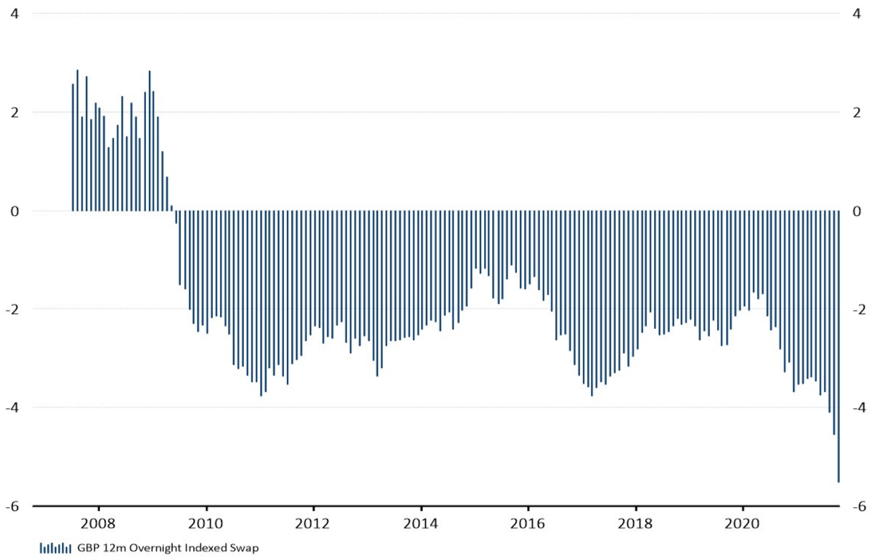
These shifts provide clear evidence that policy makers within Central Banks have 'tipped-their-hand' with respect to their previously held conviction in the transitory nature of inflation.

"As I grow older, I pay less attention to what men say. I just watch what they do"

The greatest challenge facing policy makers today is the ongoing persistence of inflation coupled with decelerating growth and an unpredictable labour market.

As we wrote in our monthly blog 'Peak Growth, Peak Liquidity' the greatest challenge facing policy makers today is the ongoing persistence of inflation coupled with decelerating growth and an unpredictable labour market. In this environment any further tightening of monetary conditions could easily upset an already fragile and slowing recovery. This toxic combination of high inflation and low interest rates imposes a painful cost on the real value of nominal assets such as cash and conventional government bonds.

Real interest rates are deeply negative...



Source: *Hottinger Investment Management / Refinitiv Datastream*

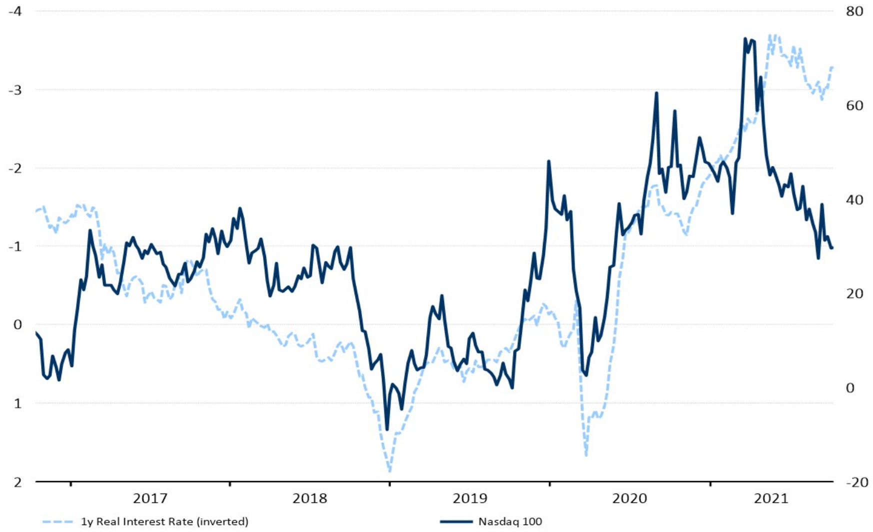
Technology stocks have been the primary beneficiary of these flows and thus we see a very clear correlation between the returns generated by these securities and the prevailing level of real (i.e. after-inflation) interest rates.

One consequence of this relentless pressure is an observable shift into assets which provide exposure to long-term revenue growth but, in so doing, inherently exhibit a high degree of sensitivity to interest rates. Equity prices should, after all, represent the net present value of their future cash-flows discounted by an appropriate rate of interest.

Technology stocks have been the primary beneficiary of these flows and thus we see a very clear correlation between the returns generated by these securities and the prevailing level of real (i.e. after-inflation) interest rates. The big question moving forward is whether real rates will be allowed to rise as Central Banks begin the process of warding off inflation via higher rates and/or supply-side inflationary pressures begin to cool.

Either scenario could prove negative for the (already elevated) valuation of these assets and as a result we maintain an approach focused, first and foremost, on maximising the utility of our expertise in diversifying risk.

Technology stocks have ben the main beneficiaries of greater financial repression...



Source: *Hottinger Investment Management / Refinitiv Datastream*

Achieving diversification becomes a far more difficult challenge in a world where long-standing asset-class relationships are brought into question.

Achieving diversification becomes a far more difficult challenge in a world where long-standing asset-class relationships are brought into question. There is one particularly dangerous assumption that is inherent to almost all quantitatively orientated risk models; the idea that fixed income securities diversify equity risk during periods of volatility. What is interesting to us is that, whilst this assumption has certainly been true over the past two decades, we know it to be ***categorically untrue*** during periods of higher inflation.

We closely monitor the correlation between government bonds and equities so as to assess the suitability of the asset class as a tool for diversification. We have found the relationship to be breaking down more consistently of late as inflation has taken hold (a level above zero in the chart below shows periods in which bond and equity prices are moving more in tandem) and, as a result, have taken a number of proactive steps within client portfolios to help protect against this risk.

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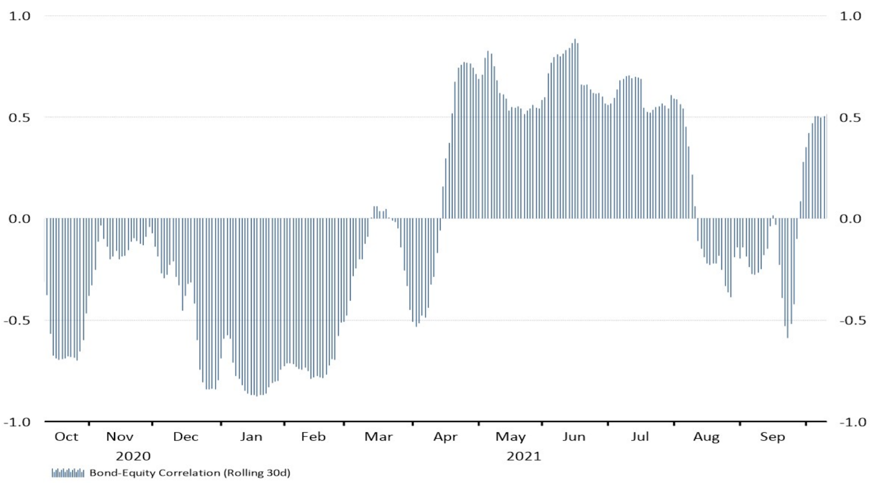
Defender caught offside...



Source: *Hottinger Investment Management / Refinitiv Datastream*

So, given that we know the probability of central banks raising interest rates is already rising, what are our views on growth and inflation moving forward?

We feel increasingly confident that 2022 should be a positive year for economic growth.

Firstly, we feel increasingly confident that 2022 should be a positive year for economic growth. While employment data continues to be volatile the ongoing decline in the unemployment rate suggests to us that a greater emphasis should be placed on the available supply of labour as opposed to underlying demand, which is clearly present and increasingly strong. Our belief is that labour markets could well be tighter than is currently appreciated.

A closer look at household balance sheets highlights the US consumer as being in particularly rude health. The upper panel in the chart below shows the level of household net worth relative to total household liabilities, which currently sits at its highest level in decades. A similar picture emerges from total homeowner equity (lower panel) following a significant increase in house prices over the past year. Personal savings rates remain elevated and leave plenty of scope for additional increases in expenditure.

While the distribution of wealth and its concentration no doubt skew these numbers, we still believe economic conditions to be very favourable for the average consumer.

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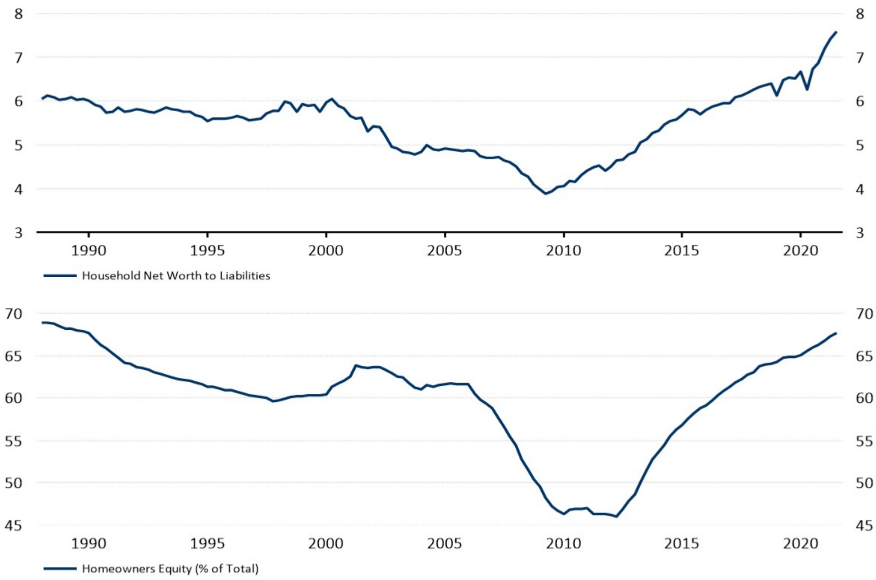
The US consumer is in rude health...



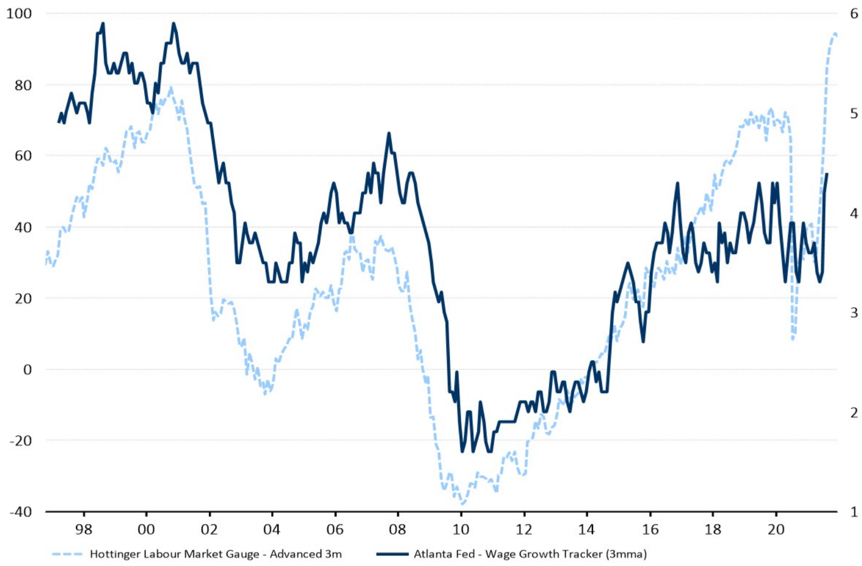
Source: *Hottinger Investment Management / Refinitiv Datastream*

We also see compelling evidence that upward pressure is now being exerted on wages as a result of the dynamics referred to above.

While the debate over the bargaining power of labour relative to capital will no doubt continue, we also see compelling evidence that upward pressure is now being exerted on wages as a result of the dynamics referred to above. In an attempt to 'take the temperature' of labour markets we have developed a proprietary measure which combines and weights data from a number of survey-based metrics relating to the demand for, and availability of, employment.

The resulting indicator has a solid history of leading underlying wage growth by a period of 3-6 months and currently implies wages should be growing at an annualised rate somewhere north of 5%.

Our own gauge of labour market conditions points to continued upward pressure on wages...



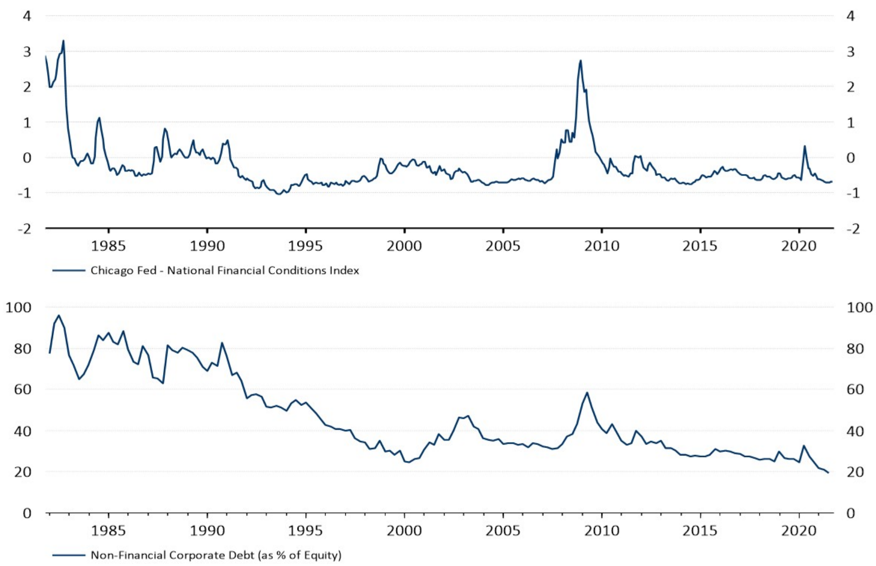
Source: *Hottinger Investment Management / Refinitiv Datastream*

Financial conditions remain at incredibly low levels while total non-financial corporate debt as a percentage of equity value recently reached the lowest level in its recorded history.

So, with the consumer in a relatively comfortable spot we turned our attentions to corporations where we see a very similar picture emerge. Financial conditions (a broad measure comprised of interest rates, equity valuations, credit spreads and more) remain at incredibly low levels while total non-financial corporate debt (when measured as a percentage of equity value) recently reached the lowest level in its recorded history.

With these supports in place our outlook for future capital expenditure and the potential for increased corporate activity (mergers & acquisitions) remain particularly positive.

Financial conditions & Debt-to-Equity Ratios paint similar picture for the US corporate sector...



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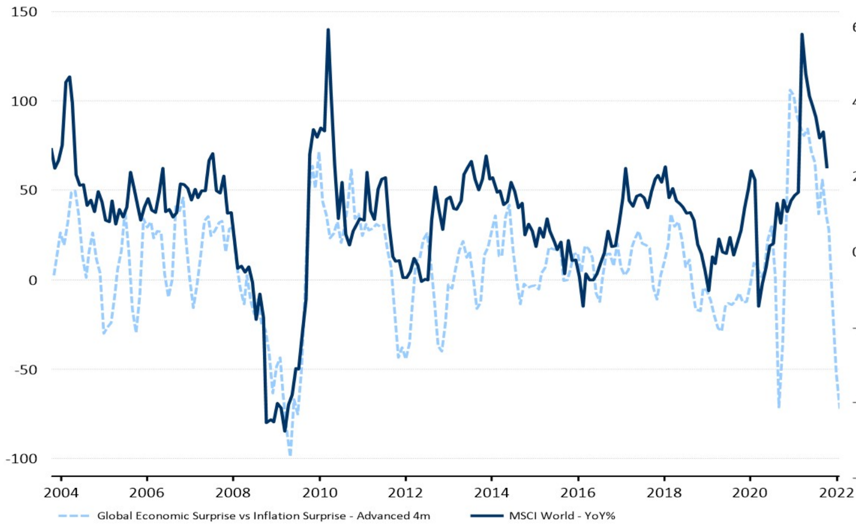
To our minds the most significant impediment to future economic growth is the potential for a period in which inflation exceeds growth.

To our minds the most significant impediment to future economic growth is the potential for a period in which inflation exceeds growth. One of the more worrying indicators we monitor here is the rate at which inflation is being reported at higher levels than expected *relative* to the rate at which economic growth is coming in at higher levels than expected. This has historically provided a useful steer on year-over-year equity return expectations several months ahead. As you will note below this does not give us any comfort at all in our short-term outlook for risk assets.

Inflation vs Growth surprises imply a difficult period for global equities...



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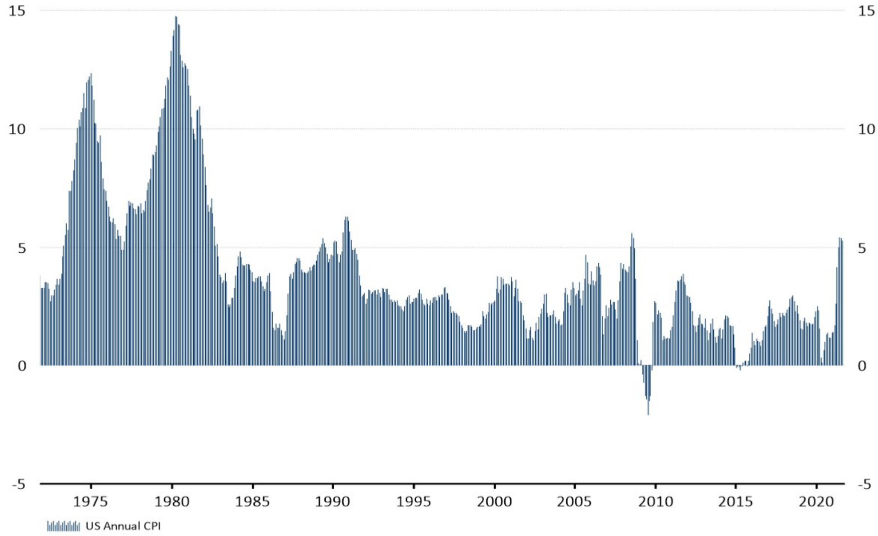
This new, inflationary world is a difficult one for many investors to imagine given the persistent trends of lower inflation and lower interest rates which began back in the 1980's.

This new, more inflationary world is a difficult one for many investors to imagine given the persistent trends of lower inflation (+ its volatility) and lower interest rates which began back in the 1980's. This period has since become known as 'The Great Moderation' and reflects a variety of factors including globalisation, digitisation, mobility, demographics, the opening up of the global labour force and the dawn of modern central banking among others.

The great moderation...



Source: *Hottinger Investment Management / Refinitiv Datastream*

In seeking to answer the question 'why might catalyse a change in prevailing inflation dynamics?' we feel able to point to a number of significant structural developments that are both unique and, perhaps more importantly, occurring in unison. These broadly fall into the following camps;

The energy revolution. Decarbonisation and 'ESG Investing' are increasingly popular and pervasive trends, however their implications from a macroeconomic perspective do not appear to have been given anything like sufficient thought in the context of near-term targets (particularly in the case of Europe whose leaders have committed to carbon neutrality by 2050[ii]). Achieving 'net-zero' implies significant relative price changes, an accelerated obsolescence of the existing capital stock, reallocation of labour resources and a tremendous increase in ongoing investment. This subject could (and probably will) be covered in a separate letter but, for now, the overarching principle is that the reduction of price is no longer the primary objective of global markets and there are very real costs to be dealt with as a result. This is inherently inflationary.

Achieving 'net-zero' implies significant relative price changes, an accelerated obsolescence of the existing capital stock, reallocation of labour resources and a tremendous increase in ongoing investment.

Politics. It has become clear that decades of building inequality are resulting in shifting patterns among voters and resulting political agendas (witness the election of Donald Trump, Biden's 'Build Back Better' campaign and China's recent disruption of its business world as primary examples). Populism has arrived. Also, with central banks having largely exhausted their arsenal the arrival of Covid accelerated, and in many ways facilitated, the idea of fiscal expenditure as being the next great hope for economic stimulus. The crisis also laid bare the fragilities of relying on a globalised supply chain in a world where borders close (albeit temporarily). These themes threaten the ignition a more prolonged period of 'de-globalisation'.

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Labour & Demographics. Increases in the global supply of labour over the past three decades have combined with ageing populations (whose marginal propensity to consume has been lower) to apply downward pressure on both wages and inflation[iii]. There are very good reasons to believe these trends may begin to reverse in the coming years as divisions in global labour costs narrow, economies turn increasingly inward and aggregate life-expectancy increases alongside the cost of care.

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Capacity underinvestment. Somewhat related to the energy revolution we are aware of a more and more businesses in the commodities space practicing an exceptionally high level of capital discipline[iv]. Firms that were caught out in the last commodity cycle have been focused intently on rebuilding balance sheets and increasing shareholder returns as opposed to investing in new projects. The post-Covid spike in commodity prices is being considered by these management teams as being purely transitory (whether it is or not) and has led to the availability of significant free-cashflow-yields at the individual equity level. Demand for energy and commodities remains robust and our belief is that many of the largest players in this space (most notably Oil & Gas) will form a significant part of the response to the climate crisis mentioned above. These businesses trade at very low valuations and investors are imposing high costs of capital which will only serve to widen the existing gap between supply and demand.

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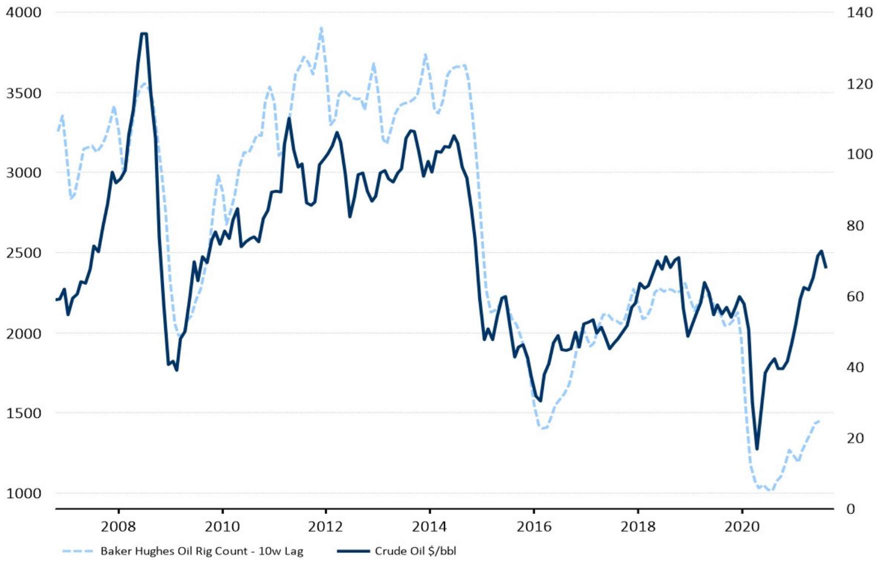
From a more immediate perspective we are seeing the consequences of these ideas playing out before us. Inflationary pressures look to be building from both energy prices (natural gas and oil) and the significant recent increase in house prices. The chart below shows the reluctance of Oil & Gas companies to bring new supply on-stream over the past few months given some of the constraints outlined above. The number of oil rigs deployed has historically tracked the price of oil closely as producers seek to capitalise on higher pricing environments. Not so this time. Or, at the very least, not yet. This provides ongoing support to current price levels and in our view further increases the relative attractions of Energy as an investable sector.

The number of oil rigs deployed has historically tracked the price of oil closely as producers seek to capitalise on higher pricing environments. Not so this time.

Oil— A muted supply response...



Source: *Hottinger Investment Management / Refinitiv Datastream*

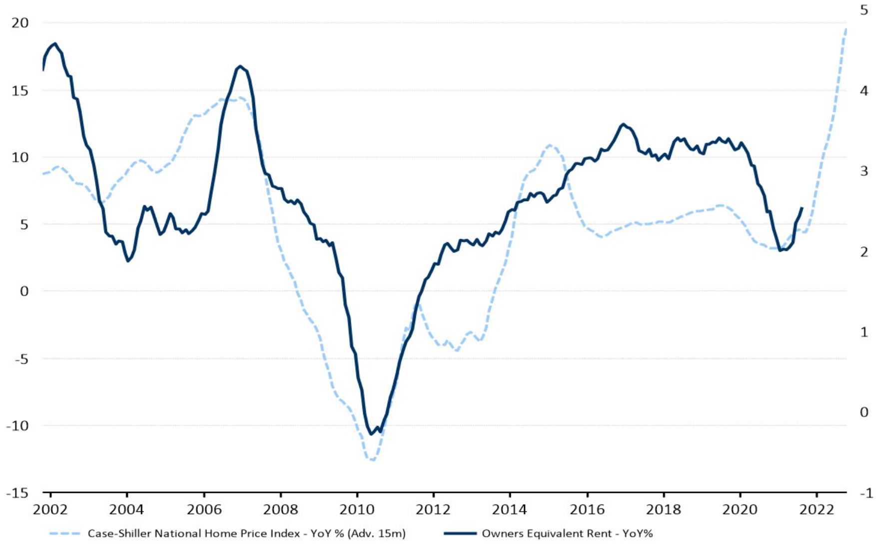
While energy represents a relatively low weighting in the overall CPI basket (c.7.3%) it tends to exert a disproportionate impact on the overall level of inflation because of its high relative volatility. Housing and shelter has historically been a far less volatile component but represents a much higher weighting at almost one-third of the entire basket. It is here that we see additional cause for concern.

Housing looks likely to exert significant pressure on both core and headline inflation throughout the next year at least.

Owners equivalent rent (a measure of how much money a property owner would have to pay in rent in order to be equivalent to their cost of ownership) tends to correlate highly with house prices but does so on a lagged basis. This is particularly useful as it means we are able to get a feel for how this variable might evolve some 15 months into the future. As you will see from the chart below housing looks likely to exert significant pressure on both core and headline inflation throughout the next year at least.

While there will undoubtedly be some offset from more transitory variables such as used car prices we still believe these ideas at least warrant greater caution on the outlook for inflation.

In terms of market pricing we are seeing some interesting divergences that point toward a greater appreciation of these risks. As the outlook for inflation

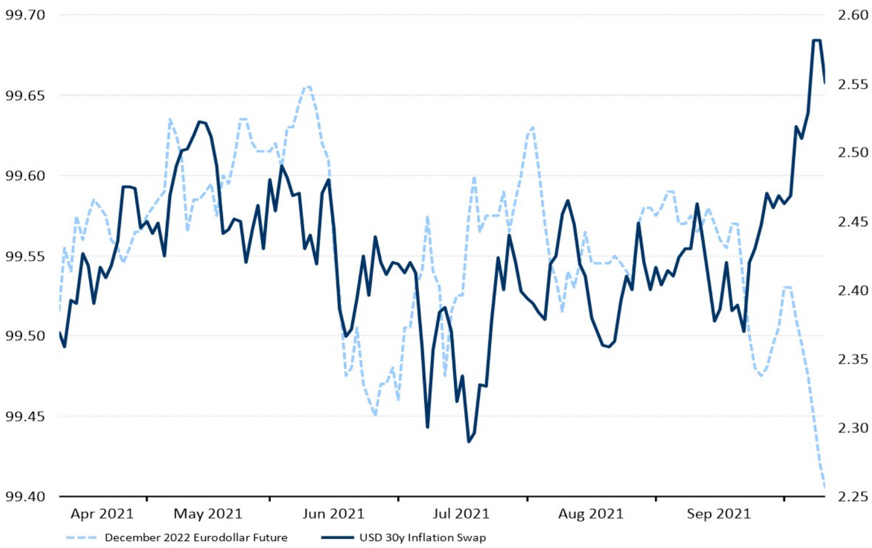


Source: *Hottinger Investment Management / Refinitiv Datastream*

has changed so too has the outlook for interest rates. As mentioned at the beginning of this note markets have recently bought forward their expectation that Central Banks will begin to hike interest rates. The Eurodollar futures market is one of the deepest and most liquid ways to for investors to express a view on the outlook for short term interest rates and, as can be seen below, these have been falling in price of late (similarly to a bond, a lower price indicates a higher expected interest rate).

Historically the expectation of higher short term rates has exerted a dampening effect on the market's outlook for longer-term inflation; at present these two indicators are diverging.

Historically the expectation of higher short term rates has exerted a dampening effect on the market's outlook for longer-term inflation (higher financing costs reduce the likelihood of inflation taking hold on a persistent basis). The dark blue line below represents the market's long term view on inflation (30y inflation swaps) and at present these two indicators are diverging. This suggests that the markets belief in the longer-term inflation story is rising.



Source: *Hottinger Investment Management / Refinitiv Datastream*

*Given our role as stewards of client capital whose overriding objective is the preservation of wealth in 'real' (often inter-generational) terms, the possibility of such an outcome is something we **must** be prepared for.*

While it is difficult to gain too much confidence in the idea of inflation proving persistent (given decades of evidence to the contrary), as investors we must think in terms of probabilities. From this perspective we then have great confidence in saying that the probability of higher inflation has increased markedly.

Given our role as stewards of client capital our overriding objective is the preservation of wealth in 'real' (often inter-generational) terms, the possibility of such an outcome is something we ***must*** be prepared for. In future letters we will discuss exactly how we are doing so in more detail.

[i] Bank Rate maintained at 0.1% - September 2021 | Bank of England
[ii] EU carbon neutrality: Leaders agree 2050 target without Poland - BBC News
[iii] Demographics will reverse three multi-decade global trends (bis.org)
[iv] US shale drillers cannot contain oil price rise, Pioneer boss says | Financial Times (ft.com)

The unique investment opportunities created by the current landscape in mergers and acquisitions

By Adrian Courtenay**, Portfolio Manager at **Odey Asset Management

Arbitrage opportunities, identified from mergers and acquisitions situations, can deliver asymmetrical outcomes with attractive annualised returns

In 1956, when a young Warren Buffett launched his first investment fund, his investor letters highlighted that around one half of his allocations were in "workout" situations, or in modern parlance, merger arbitrages. Today, an investor might reasonably ask therefore, if a focus on merger arbitrage strategies was good enough for Buffett in 1956, how attractive are the merits of this strategy in the current markets?

The arbitrage opportunity set arises from corporate activity – mergers, but also sell-outs, reorganisations, or spin-offs – and offers allocators two crucial differentiations from non-arbitrage investments. Firstly, arbitrage situations in their base case have a fixed price outcome from the existence of a binding takeover offer. Secondly, these situations have a timetable. And, whilst the gross profits in arbitrage opportunities often appear quite small, their predictability coupled with a short holding period can produce attractive levels of annualised return, an outcome that also can be significantly accreted if new bidders emerge to "gazump" the initial binding offer.

From the perspective of an investor allocating to arbitrage constructs, these opportunities can also allow a more asymmetrical outcome than non-arbitrage investments. In the current market environment this is a particularly advantageous feature – because today's stock market has properties indicative of some risk of an equity market correction. It is notable in this regard that the equity market is trading at an above average earnings multiple. However, this risk has recently become exacerbated by the co-incident emergence of factors that can also provide a headwind to corporate earnings: rising energy costs, a rising cost of interest, and a rising cost of wages. A scenario therefore has become possible of a contraction in the market's earnings multiple at the same time as a decline in the market's earnings number, and therefore the relative attraction of arbitrage opportunities has increased.

Yet is it straightforward to find arbitrage deployments for an investor today? The answer is that the number of arbitrages is a function of the total deal count of mergers and acquisitions or "M&A" activity. From an industrial perspective, M&A is conducted when the need exists to restructure companies for business advantage, for example, during periods of technological change. Another driver of M&A is low financing costs, which enhances the profit incentive of the takeover protagonist. Both of these pre-conditions continue to be features of the current market environment, and likewise therefore, the concurrent volume of arbitrage opportunities also remains reasonable.

The current inflationary environment may increase the frequency of one of the most profitable types of arbitrage opportunity – the competitive bidding situation

It is only a rare number of arbitrages, however, that will produce unusually attractive results, and this category is captured when an allocator succeeds in the early identification of the “competitive bidding situation” – when new interlopers compete with existing offerors in an escalating auction for a company. This scenario significantly increases the arbitrageur’s profit with each successive bid.

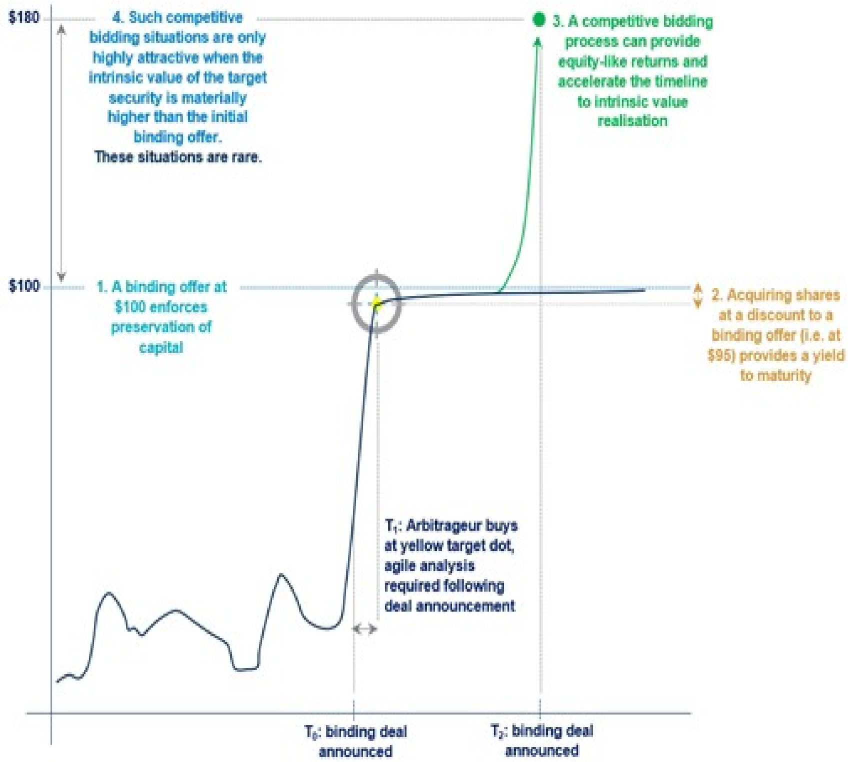
In an inflationary environment, such as that faced today, there is rationale for the frequency of competitive bidding situations to increase. This is because for those asset classes where a steeper gradient of inflation is observed (for example mining resource deposits, or land and property holdings), net asset values can rise in some instances as to high as or even above the market capitalisation of the corporate equity that owns them. This then can result in some takeover situations being so prospectively profitable for a takeover practitioner that competing bidders become the most probable outcome. And these dynamics mean that a focused approach in arbitrage that is highly alert to signs of a competitive bidding trajectory emerging can still permit an ambitious and rewarding path even when a cautious approach is also taken with regard to overall equity index levels.

The attractiveness of competitive bidding arbitrages in an inflationary environment can be further enhanced because higher inflation also correlates with increased yields on government bonds, and increased yields on government bonds tends to correlate with lower P/E ratios. Therefore, not only may a number of asset-rich securities possess real assets whose inflating value is beginning to exceed their market capitalisations, but in addition the share prices of such securities may also de-rate because the market environment may become one of deflation in the P/E multiple.

This means that the magnitude of share price change during a competitive bidding process can be that much larger because of a start point valuation that is that much lower (and the first bidder, not recognising yet that the process will become competitive, may start off with a bid at only a modest premium). This then can lead to a “golden period” opportunity for competitive bidding arbitrage allocations.

A particular attraction of this opportunity set is also that it allows a “conservative aggressive” approach to capital allocation. This is because an experienced practitioner, using agility to achieve situation identification early, can often make deployments to competitive arbitrages at a discount to an existing binding offer. As such, competitive bidding situations can offer both preservation of capital and a yield to maturity. Importantly, however, competitive bidding situations also offer meaningful equity-like returns on top, so long as they have been identified as also possessing an intrinsic value, likely to be reached by the conclusion of the auction process, that is significantly higher than the value of the prevailing bid.

Agile allocation to arbitrage situations that are enticing enticing competitive bidders can offer all three of: preservation of capital, yield, and equity-like returns at the same time



Source: *Odey Asset Management*

Allocation to constructs with these three coincident qualities of competitive bidding situations: preservation of capital, yield, and equity-like returns at the same time, is a fortuitous mix. Convertible bonds, which are the only standardised instruments offering all three of these attributes, are by comparison rarely priced inefficiently in the securities markets due to the homogeneous nature of their valuation inputs attracting quantitative funds into this market area. And strip away the fixed income element from a convertible bond (because it is fully priced already), and the resulting equity exposure does not offer preservation of capital. Or, strip away the equity option from a convertible bond, and the fixed income element remaining does not offer equity-like returns.

A key challenge to identifying competitive bidding situations is however that the practitioner must leverage their fundamental value skillset in a short duration timeline to determine whether the auction target remains deeply undervalued. This requirement is crucial because takeover situations by their nature normally already include some premium, and so to find the uncommon situation where there is already some premium, and yet which also remains deeply undervalued, is an often-demanding task.

However, the often work-intensive requirement brings with it a final pleasing advantage: the concept of acceleration to intrinsic value – because each situation is timeline-driven. Timeline acceleration to intrinsic value, in situations at deep discount to intrinsic value, is a highly attractive performance accretion to an investment strategy and absent from most other investment approaches.

These dynamics within the arbitrage opportunity set, correctly anticipated and captured, and particularly in the area of competitive bidding situations, offer highly attractive return opportunities. Importantly, however, they also offer the defensive qualities that Warren Buffett became well known for and that continue to be prudently necessary in the high earnings multiple equity markets today that investors correspondingly must navigate.

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