On the Road Again...

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I recently spent time in Spain visiting with CEOs, CIOs and leading macro thinkers discussing the current state of play in the global economy. Upon arrival in Madrid, as I went through customs, I was reminded of my last international trip, one that entailed my essentially fleeing London to return to New York at the onset of the pandemic. While I will likely never travel again as much as I did pre-COVID, my Spain trip did reinforce that there is real value in face-to-face connectivity. In particular, these types of meetings can inform and improve one's views on a variety of investments and/or thematic trends.

My big picture *Thoughts from the Road* are as follows:

1. **Europe's economy is on track to recover nicely.** Despite higher fuel prices, expect the consumer to shine, including fashion purchases, cosmetics, and nesting items. If there are economic hiccups, they are likely to be supply driven.
2. **Europe has less of a wage problem than the U.S., but rising input costs are favoring price makers.** What is a price maker? They are companies that can leverage competitive advantages, including technological prowess, proprietary processes, and speed to market, to adjust prices in ways that keep pace with soaring input costs. Price makers often offer goods or services that are critical and have inflation-linked pricing embedded into long-term contract terms. In our view, we believe this cycle will be remembered for the valuation differential between price makers and price takers.
3. **China's growth will continue to slow and the impact of its slowdown will soon bleed into Europe, including Germany.** Bigger picture, until China somehow gets better vaccines and stabilizes its housing market (something we think is several quarters off), its economy will continue to struggle — and these struggles will reverberate in Europe and globally.
4. **When we think about 10-year yields in the United States, we need to consider the 10-year yield of the German bund too.** Importantly, we left Europe still thinking yields are not poised to surge, despite break-evens moving up in recent months.
5. **Having a global but local approach in Europe is a prerequisite for success in the investment management industry, particularly when striving for truly differentiated deal sourcing.** Ongoing supply chain issues, as an example, will remain a key challenge, as this is a global phenomenon that must be managed carefully across all types of portfolios to prevent disruptions.

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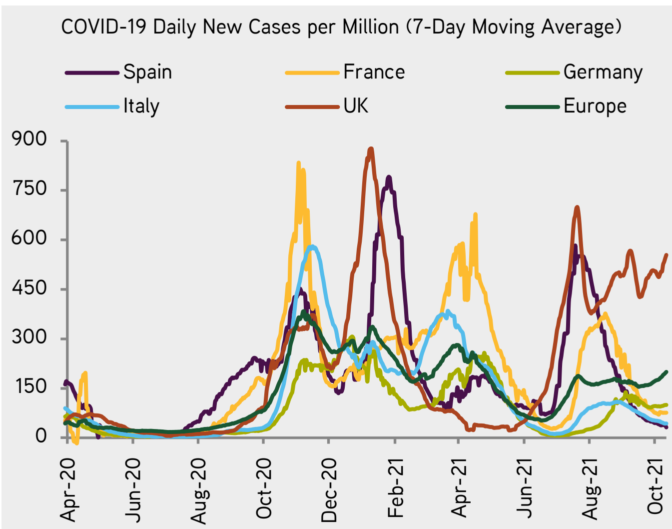
DETAILS: My colleague Aidan Corcoran expects growth in Europe to outpace that of the U.S. in 2022. Thereafter, top line growth comparisons will be more challenging (i.e., our rate of change thesis will play out), particularly amidst surging input costs. If there is good news for Europe, it is that the government's handling of the labor force during the pandemic (i.e., giving government transfers to companies rather than individuals) has led to much less dislocation in the labor market. This seemingly small nuance is actually a big deal, particularly given that Europe's economy is still largely consumer-driven.

Exhibit 1

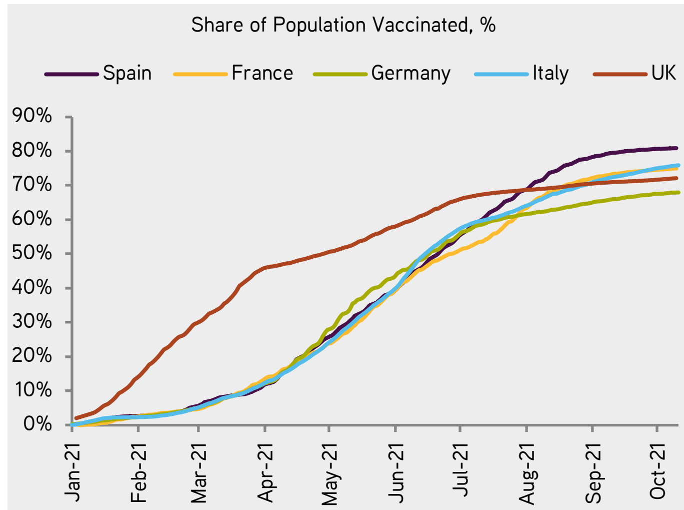
Spain Currently Has a Manageable Number of New COVID Cases



Source: Data from Our World in Data, as of 12th October 2021.

Exhibit 2

Spain Has the Highest Share of People Vaccinated Compared to Its Key Peers



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Every conversation during my trip started and ended with the risk of inflation. As everything looks expensive these days unless one believes that rates are not going up, having a strong view on inflation is the key macro variable on which to focus, we believe. Across the board, global CEOs are seeing rising input costs, and as a result, they are raising prices. However, it likely will not be enough.

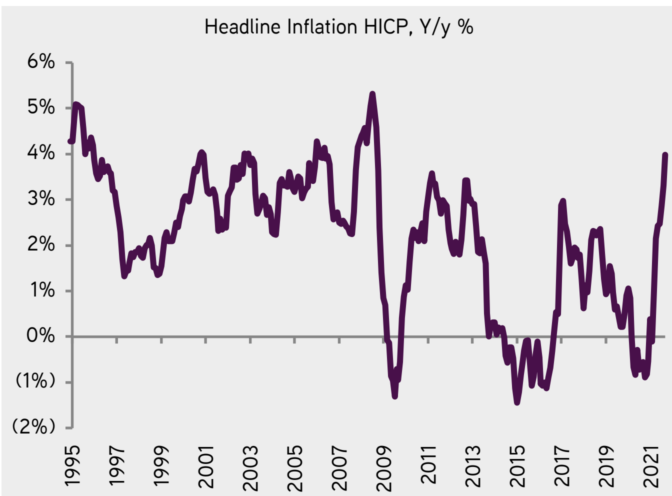
The greening of the energy industry is also leading to a surge in demand in commodities that are required to fund spending in renewables. As a result, copper, aluminum, and other input costs required in the transition from 'old economy' energy towards renewables are likely to remain well bid. This backdrop has important implications for other industries, including our positive view on global housing.

Supply chains are of course messy, and most with whom we spoke only see improvement occurring in the second half of 2022, not the first half. On-again, off-again activity from the Asian ports, particularly China, is shifting 'just in time' to 'just in case' when it comes to inventory levels.

While all that sounds like bad news, comparisons for inflation on the goods side should start to ease by late 2022. However, services, including rental income, are likely to prove stickier than in prior cycles. Therefore, our basic take is that we now have a higher resting heart rate for global inflation versus the prior cycles, which supports why we have been pounding the table on Real Assets, including Infrastructure, Real Estate, and Asset-Based Finance of late. Thus, a potentially more permanent reflationary backdrop suggests that the long-lasting spell of pessimism surrounding Eurozone inflation may now finally have been broken.

Exhibit 3

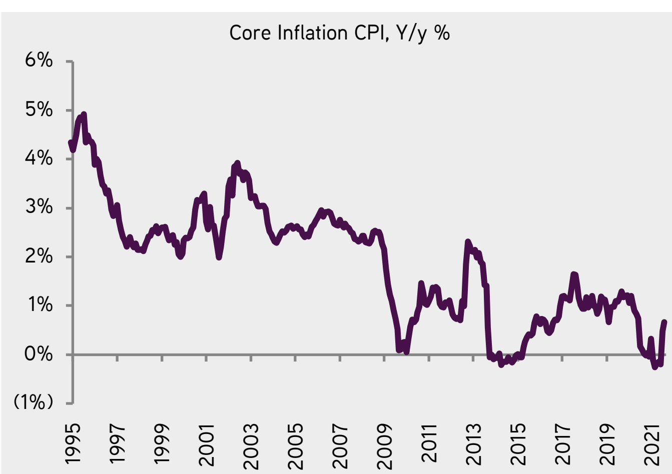
Headline Inflation Has Spiked...



Source: Data from the Statistical Office of the European Communities, as of 01 October 2021.

Exhibit 4

...But There Is Little Evidence of Core Inflation Becoming Unhinged



Source: Data from Statistical Office of the European Communities, as of 17 September 2021.

We also left Spain with the impression that this economic cycle will truly be different from the GFC. This recovery is more akin to a post-war environment than a post-financial crisis one. There is not much consumer deleveraging that needs to occur, wages are rising across most countries, and while consumer confidence on some big-ticket items like cars has waned, shoppers want to venture out, spend, and be seen. Fashion, beauty, and general consumer discretionary all feel poised to do well.

Second, the huge fiscal surge that accompanied the early stages of this recovery has not yet fully made its way through the system. In the U.S., for example, we estimate that north of $1 trillion of fiscal stimulus is still sitting in local and state coffers. In Europe, the €673 billion Recovery and Resilience Facility (RRF) is off to a good start, with most key countries having received their initial disbursements over the summer. Most importantly, the RRF is targeting those countries most in need of support, including Italy and Spain.

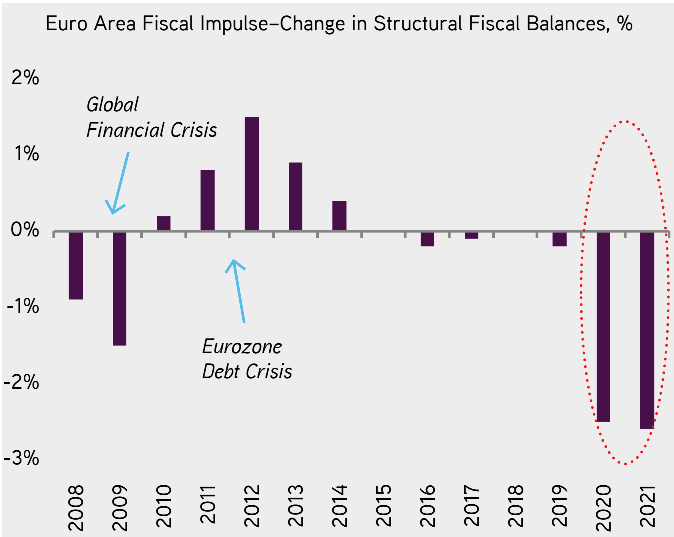
Third, the energy transition is actually inflationary, as expenditures essential to bolstering commodity output in key markets such as oil and copper are being diverted to pursue alternative energy sources at a time when we need lower commodity prices.

Fourth, there was no mention of austerity. Remember that Mario Draghi, as head of the European Central Bank last cycle, was talking about narrowing deficits in a post-GFC environment. Moreover, even before he came on the scene, Jean-Claude Trichet actually raised rates not once but twice to 1.5% from 1.0% in 2011.

Our conversations in Europe confirmed our belief that the ECB will remain much more dovish for much longer than the Fed and other global central bankers. We believe this is because there is less structural inflation in Europe on both an absolute and relative basis.

Exhibit 5

This European Recovery Cycle Is About Accommodation, Not Austerity

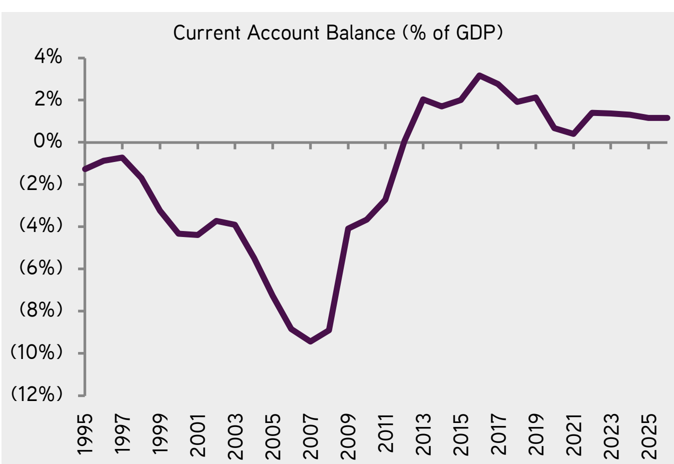


Note: Based on EC Spring Forecast. Data as at June 28, 2021.
Source: European Commission.

Fifth, while Europe is carrying more debt, it is also more competitive. *Exhibit 6* shows that Spain is running a healthy current account surplus. In the aftermath of the GFC, both its banks' capital bases and the country's exporting competitiveness were woeful.

Exhibit 6

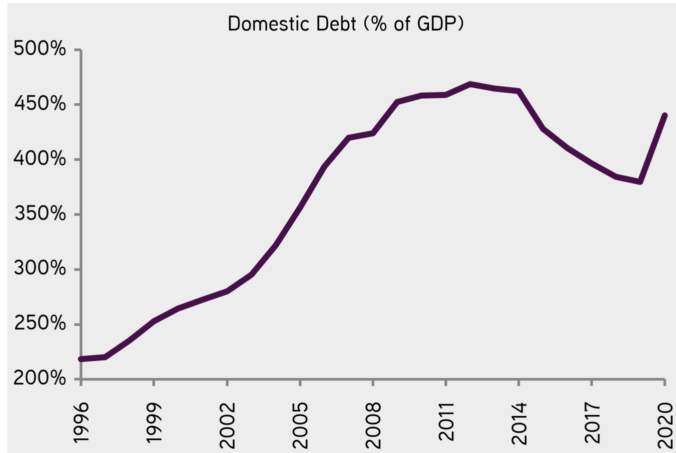
Spain Regained its Current Account Surplus During the Eurozone Debt Crisis and Never Looked Back



Source: Data from the International Monetary Fund, as of 12 October 2021.

Exhibit 7

Unfortunately, Most of the Deleveraging Achieved Since the GFC Was Reversed During COVID-19



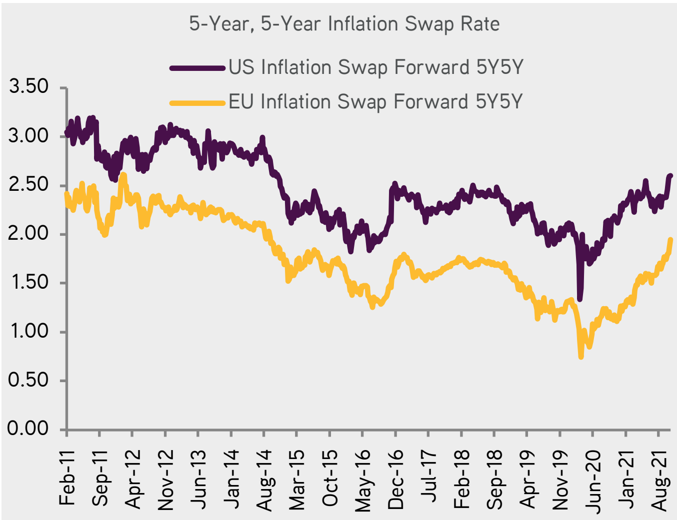
Source: Data from Instituto Nacional de Estadística, as of 11 October 2021.

Finally, this recovery will be driven by the West, not the East. China's growth will sputter for some time, as it looks to 'fix' its housing issues. Somewhat ironically, my conversations in Spain reminded me that Spanish economists have plenty of experience forecasting housing downturns, and all of them believe China will stumble more than the sell-side consensus now thinks.

In addition to inflation and China, the other big topic du jour was interest rates. Despite our conviction about a higher resting heart rate for inflation, we don't see nominal yields surging. As our insurance survey suggested, global insurers are still overweight Cash and underweight acceptable yield. Demographics also suggest both in the U.S. as well as in countries like Spain *(Exhibit 9)* that income-oriented baby boomers still want yield. Further, our conversations in Europe confirmed our belief that the ECB will remain much more dovish for much longer than the Fed and other global central bankers. We believe this is because there is less structural inflation in Europe on both an absolute and relative basis. If we are right, then this backdrop means that the yield on German bunds does not increase much over the next few years. Thus, U.S. Treasuries are likely to offer good relative value, as we show in *Exhibit 9*, with the U.S. 10-year rarely trading 200-250 basis points above the bund.

Exhibit 8

Inflation Concerns Typically Have a Self-Fulfilling Prophesy Component

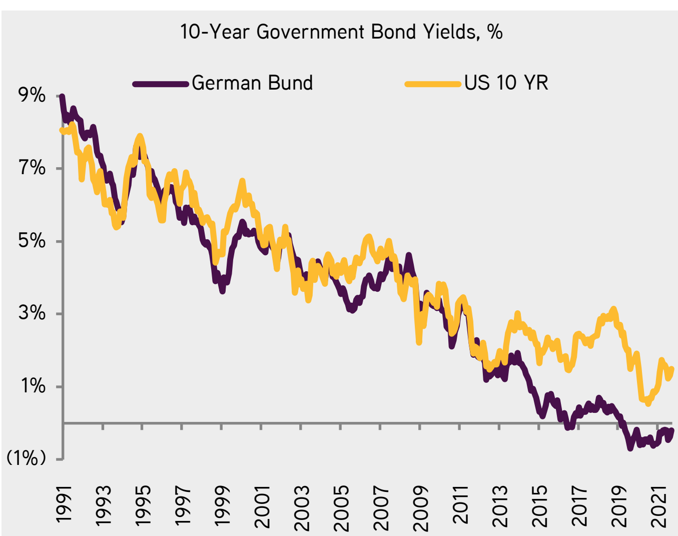


Source: Data from United Nations, as of 19 June 2019.

Moreover, for those who worry that tapering in the U.S. will break the historical relationship between the treasury and the bund, we would remind folks that the Fed's balance sheet did not contract for fully five years after it announced tapering in 2013 (i.e., tapering is not tightening).

Exhibit 9

U.S. Treasuries Likely Can't Go Too High If the German Bund Remains Well Bid Behind Significant ECB Purchases



Source: Data from Bloomberg as of 19 October 2021.

What does all this mean for investing? We firmly expect the definition of Infrastructure to expand well beyond traditional infra to include meters, data centers, bus contracts, etc.

Meanwhile, we have more conviction in our reflation thesis, including pricing power. If we simplify the big calls during the last two decades, it was to fade China's fixed investment boom and get long rates in the 2000-2010 period; and to buy growth stocks and get long rates (again) in the 2010-2019 period. Now we think this cycle the 'winners' will have a pricing moat around their franchises to protect against higher input costs, more regulation, and an increase in labor benefits. Margins, in aggregate, have likely peaked on a secular basis. Therefore, 'winning' in today's environment is about determining the companies able to successfully navigate this huge tailwind becoming a headwind.

While Europe is ahead on the 'green movement,' we need to be eyes wide open that there could be some unintended consequences. The faster the push by government officials for expedited transitions towards carbon neutral sources, the higher the potential for a short-term economic snafu or rise in social discontent caused by surging commodity prices.

Finally, we have entered an era where every investment must be viewed through the prism of data security, monopolistic pricing, and income equality. In Europe, for example, it is clear that political coalitions will replace strong individual leaders, and as such, grounds for agreement on all sides of the debate will need to satisfy these three criteria.

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Important Information

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