FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

02 December 2022
Volume 1164

Getting a jump on the Bogeyman

Author: Hubert Weyers, Global REIT Analyst at Reitway Global

Inflation has, for a long time, been the dormant passenger in the trunk of most investors' risk factor vehicles. The last time it had the wheel was back in the Volker era of the late 70s and early 80s, when Paul Volker brought down the hammer and snapped the back of inflation to around 2%. Since then, inflation has been kept in its cage, only out on occasions on a very tight leash.

Shortly after the pandemic struck in March 2020, the Fed opened its dam wall and flooded the system with liquidity that, unbeknown to them, would roughly coincide with several other forces nourishing the feral inflation and radically altering the economic landscape. Now the Fed sits with the problem of 6.28% core inflation and investors are dealing with a new type of regime which is considered a novelty by those that only entered the game in the last three decades.

There is a scenario where inflation can be found in the driver seats of the upcoming three cars on the investor's highway: the short-term, the medium-term, and the long-term.

The short-term has very little need for explanation beyond the current level of inflation in the US, fuelled by structural deficiencies in the supply of shelter and labour for which there is no easy and quick fix. The medium- to long-term can see a myriad of factors play out, all of which seem to be back in the trunk of the investor's risk factor vehicle, with the five-year US breakeven inflation rate at 2.35% and the 10-year, at 2.28%.

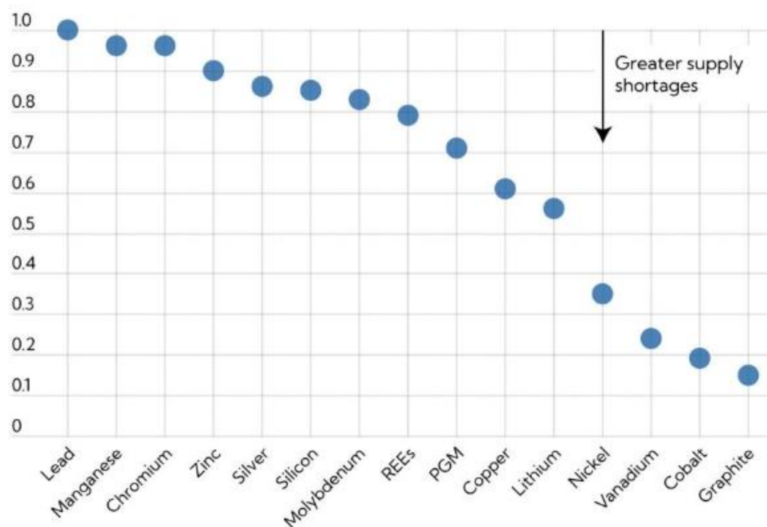
Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be dependable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness, or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

Prospective inflationary forces

The world is on the cusp of a great infrastructure overhaul which will require an unprecedented amount of spending and resource utilisation. To keep global warming at no more than a critical 1.5°C, emissions need to be reduced by 45% by 2030 and reach net zero by 2050. The degree of such a trajectory leaves a jumbo question mark hanging over its achievability in a world where many of the necessary natural resources are set to come under pressure.

Exhibit 1: Metals in a net zero scenario



Source: International Energy Agency, US Geological Survey 2021, and IMF staff calculations.
Note: PGM = Platinum-group metals. REEs = Rare-earth elements. Supply-demand ratio is the ratio of supply to demand. Supply = cumulative production volume for 2021-2050, fixed at 2020 output level. Demand = total metal demand 2021-2050 for renewable energy and other uses.

IMF

The inevitable acceleration of the clean energy transition could lead to several supply crunches that are highly inflationary, especially in the subterranean metals group, where there is a significant lag between demand and supply owing to large investment requirements, and long periods between exploration and production.

The International Energy Agency's *Net Zero by 2050* Roadmap calls for up to sixfold increases in the demand for certain natural resources such as lithium and cobalt. The pace required to meet the 2050 target could result in a derailment of the transition itself. The longer it takes the world to complete the transition to net zero, the more damage the earth's atmosphere will take, resulting in further expansion of climate extremes and weather events disrupting crop yields—phenomena which will cascade through into the global economy as food inflation.

Many of the necessary natural resources for the transition are concentrated in the hands of only a few nations. Centralised resources don't help the issue. It can cause supply security issues and in the worst of cases, an abuse and weaponisation of resources—Russia's natural gas to Europe being a prime example of this.

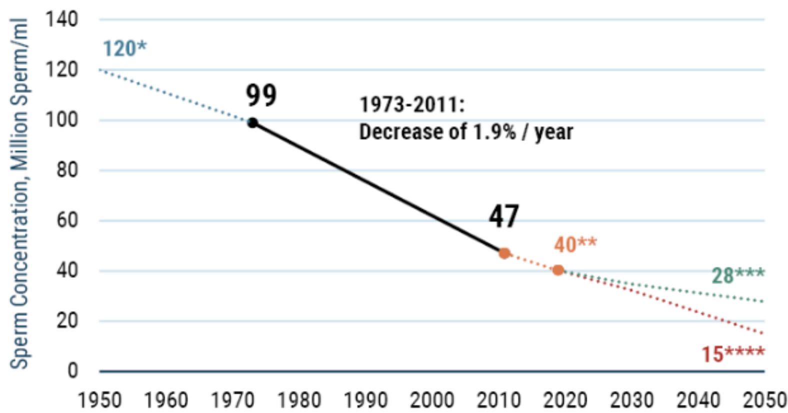
The *baby bust* is another risk yet to be given its rightful attention. It works in two channels:

1. women deferring pregnancy to less fertile years owing to their evolution in the workplace, and
2. the toxicity of food and certain consumer products which significantly curtails sperm count (to roughly two-thirds of pre-industrial levels) and damages chromosomes of the fetus in utero.

These drivers have sent current fertility levels below replacement level in most of the developed world. The inter-generational effect of compounding, where damaged chromosomes are carried over from offspring to offspring, is exacerbating the problem. Jørgensen et al. (2017) found that from 1973 to 2011, the loss of sperm count compounded at 1.9% per year.

Exhibit 2: Sperm concentration in the Western world

Actual Data For 1973-2011; Projected Backwards And Forwards



Source: Hagai Levine, Niels Jørgensen, Shanna Swan, et al. (2017). Temporal trends in sperm concentration: a systematic review and meta-analysis. Human Reproduction Update, 23(6), 646-659
*1950-1973: Assuming decrease of 0.8% / year
**2011-2019: Assuming continued decrease of 1.9% / year continues
***2019-2050: Assuming 'improvement' to 0.8% decline / year
****2019-2050: Assuming continued 1.9% / year

Fertility phenomena of this kind are set to augment the aging of the global population, putting severe pressure on resources and systems, and resulting in inflationary supply-demand imbalances.

Inflation prospects hardly end with resource crunches and labour shortages. Heightened rhetoric among companies to restore production from cheap labour economies like China as a response to the events of recent years could lead to increasing manufacturing costs. New Chinese policies like dual circulation paired with common prosperity signals, the end of cheap Chinese goods flooding the global market.

Any escalations in geo-political tensions in an increasingly polarised world between autocracies and democracies through wars, the prospect of war, countries forced to pick sides (and condemned when they don't), dollar weaponisation and subsequent de-dollarisation, could all lead to the loosening or cutting of trade ties and thereby…more inflation.

Real estate haven

It is important for investors to start thinking about these inflationary prospects. There is no surety on how or if they will develop, but they are important considerations in a world of accumulating risks for which it is sapient to build portfolios best able to absorb as much of the prospective impacts as possible and preserve wealth by, at the very least, matching inflation.

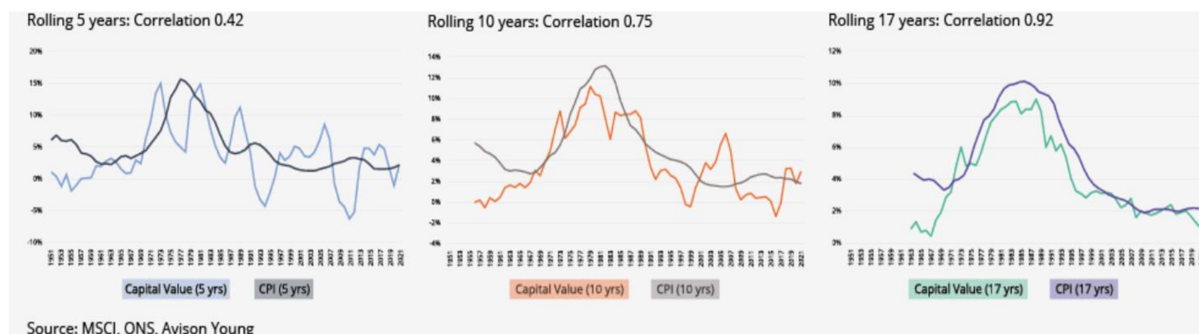
One of the most effective inflation hedges is real estate. It sits at the unique intersection of inflation pass-through (through rental contracts) and inflation cultivar (land and building materials)—making it an asset class with the ability to capture a great deal of the inflation that permeates an economy. Other assets have shortfalls in hedging inflation that real estate circumvents, such as return being capped at inflation—as is the case with treasury inflation-protected securities when held to maturity—or running the risk of being used as the wrong inflation hedge,

which can be the case with commodities, and the risk of staying relevant and competitive which are prime considerations for equities. In essence, real estate can be seen as the asset class that comes the closest to being structurally linked to inflation with still the potential for outsized returns.

Real estate's ability to hedge against inflation is buoyed by its relative scarcity which makes it a viable store of value. Its scarcity is magnified when rising building costs and interest rates result in certain construction becoming financially infeasible, putting a damper on supply. However, its store of value aspect only really comes to the fore when in a desired location for which there is a finite amount of land available.

Real estate correlates strongly with inflation and GDP over the long-term—interrupted by market forces, interest rates, and real estate idiosyncrasies over the short to medium term.

Exhibit 3: Changes in Real Estate Value and Consumer Prices 1951-2021



Long criticized implications of real estate investment such as illiquidity, management intensity, and large initial capital investment have been eradicated by the advent of real estate investment trusts (REITs) that provide investors with a seamless way of bootstrapping into and out of real estate. However, not all REITs are of equal merit and still require the right analysis to separate the winners from the losers. Although still a relatively niche practice, fund managers that provide these services, have emerged in recent years.

Conclusion

Whether inflation will persist in the short term and continue into the medium and long term is almost an aside. There is rarely any certainty around something as uncertain as inflation, but there does seem to be a current underappreciation by the market for certain future inflation carriers.

The best way around uncertainty is building a resilient portfolio that is ready for anything, not least of all inflation. And while real estate is not the only way to hedge against inflation, it is one of the most effective.

References

Ananthakrishnan, P., Seneviratne, D., Stuermer, M. & Valckx, N. (2021, December 8). *Metals demand from energy transition may top current global supply.* IMF BLOG. https://www.imf.org/en/Blogs/Articles/2021/12/08/metals-demand-from-energy-transition-may-top-current-global-supply

Is real estate an inflation hedge? Avison Young. https://www.avisonyoung.com/is-real-estate-an-inflation-hedge

Jørgensen, N., Levine, H., Martino-Andrade, A., Mendiola, J., Mindlis, I., Pinotti, R., Swan, S. & Weksler-Derri, D. (2017) Temporal trends in sperm count: a systematic review and meta-regression analysis. *Human Reproduction Update,* (6), 646-659.

Net Zero by 2050: a roadmap for the global energy sector. IEA. https://www.iea.org/reports/net-zero-by-2050

Glacier Research would like to thank Hubert Weyers for his contribution to this week's *Funds on Friday*

Hubert Weyers

Global REIT Analyst

Reitway Global

Hubert holds an honours degree in financial analysis which he obtained from the University of Stellenbosch in 2019. He has passed all three CFA examinations on his first attempt and scored in the top 10% of all participants in the CFA level II examination. He is currently adding to his work experience in the field to become a CFA charter holder.

From September 2020 to December 2021, he worked for The Burgiss Group where he quickly made his way up the ranks from junior analyst to auditor and then to building and co-leading the hedge fund transparency team.

For three months he wrote about financial topics for The Urban Writers before joining Reitway Global in September 2022.

Hubert is responsible for covering all REIT sectors in the American market.