

*Jacques Berghmans*

### 1. Economic and Market Environment

After a great start of the year, world equity markets continued their upward trajectory driven by a rebound in cyclical stocks, like mining, shipping and steel. Recently though, a number of economists and investors started to worry about inflation risks, especially in the US<sup>1</sup>, where a rapid economic rebound saw prices increasing 5% year on year in May. Investors rightly fear inflation as it can quickly erode the purchasing power of savings and affects the valuation levels of assets. After ten years of annual inflation of 5%, cash loses close to 40% of its purchasing power, long term bonds even more and valuation multiples for stocks tend to compress. It is very important though to note the difference between a temporary bout of inflation, which is not really problematic, and structurally high inflation, which can create a range of issues.

*Inflation is the parent of unemployment and the unseen robber of those who have saved (Margaret Thatcher, former Prime Minister of Great-Britain)*

There is no consensus on what causes inflation, with monetary economists attributing it exclusively to excessive money supply, and others attributing inflation to a mismatch of aggregate supply and demand for goods & services. One of the unfortunate consequences of the pandemic is that it caused both an exponential growth of money supply, especially in the United States, and some services & goods supply disruptions. There is plenty of anecdotal evidence for recent supply bottlenecks, like increasing shipping costs from Asia<sup>2</sup>, higher prices for second-hand cars<sup>3</sup> and increasing commodity prices - mainly copper, iron ore and oil. The good thing is that a lot of these supply bottlenecks are likely to be temporary and the commodity price increase is more a rebound to normal levels after the depressed levels of 2020. We are already seeing signs of some commodities coming back to more normal levels, like US lumber plunging 40% in recent weeks since its peak.



Table 1 Major Commodity Prices since 2010 - Source: Bloomberg

<sup>1</sup> <https://www.economist.com/the-economist-explains/2021/06/03/what-underlies-fear-of-inflation-in-america-and-europe>

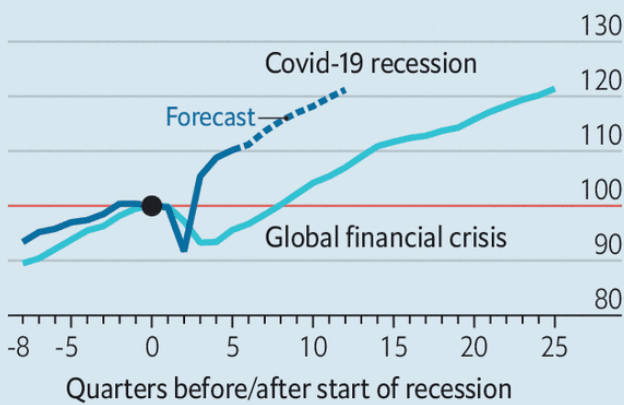
<sup>2</sup> <https://www.cnbc.com/2021/01/22/shipping-container-shortage-is-causing-shipping-costs-to-rise.html>

<sup>3</sup> <https://www.economist.com/graphic-detail/2021/06/15/why-the-used-car-market-is-sending-american-inflation-soaring>

## On a spending spree

Global real investment\*

Quarter before start of recession=100



Sources: Haver Analytics;  
Morgan Stanley Research  
forecasts; national statistics

\*Average weighted by  
purchasing-power parity

The Economist

Higher prices could also spur investment by companies. In a recent article, *The Economist* explained that we are seeing the emerging signs of an investment boom by companies, which should add capacity and reduce long term price pressure<sup>4</sup>. One of the major issues of the global financial crisis in 2009 is that it took 7 quarters for global real investment to come back to pre-crisis levels. Some inflation appears to be a reasonable price to pay if it leads to more investment, better productivity and higher growth.

Other than recent supply disruptions, another potential cause of inflation could be the aggressive balance sheet expansion by central banks. Monetary economists claim that excessive money supply is the main cause of higher inflation. They tend to be very critical of central banks bond buying programs (also called quantitative easing or QE) and think much higher inflation could be around the corner following the recent central banks action. We know that 'extreme' monetary easing tends to end up badly and a lot of us have heard about the unfortunate experience of the

German Weimar Republic in the early twenties, or more recently hyperinflation in Brazil in the nineties. Monetary theory makes sense intuitively as more money chasing the same amounts of goods should lead to higher prices, but the theory could not explain the low inflation of the last fifteen years despite the aggressive quantitative easing of the ECB and the FED. In practice, no theory is sound enough to grasp the complexity of the global dollar and euro systems and are more rough guides for potential scenarios.

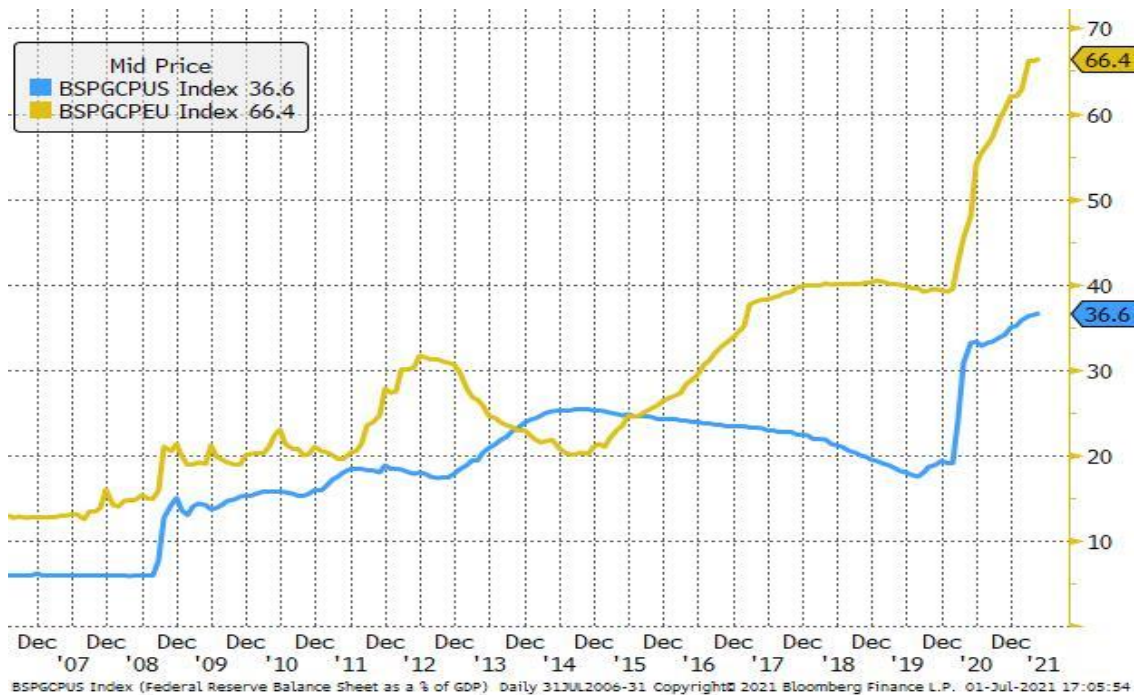


Table 2 ECB total balance sheet % of GDP (yellow) and FED total balance sheet as % of GDP (blue) – Source: Bloomberg

One scenario most economists agree on is that inflation can sometimes be stopped or can turn into an out-of-control inflationary spiral if the appropriate measures are not taken. The most recent case of inflationary spiral in a developed economy is the crisis in Great Britain in the seventies. Like all Western economies, Great Britain suffered from the oil

<sup>4</sup> <https://www.economist.com/finance-and-economics/2021/05/25/an-investment-bonanza-is-coming>

shock<sup>5</sup> which caused inflation to soar above 20% in 1974. While this shock created a number of issues in all industrialized economies, the US and especially Japan managed the aftermath of the crisis much better than Great Britain. As we can see on the graph below, Japan, the United States and Great Britain all faced an important inflation shock in 1974, but Japan successfully tamed inflation quickly, the US continued to face high inflation until the early eighties, while the economic situation in Great Britain went from bad to worse. When confronted with the oil shock, the Japanese government and companies tried to find new oil supply and invested to be more efficient. A number of Japanese companies eventually benefitted from the crisis. Toyota & Nissan, for example, invested significantly in better engine technology and grabbed market share in Western Markets. The partial demise of traditional Japanese industries like shipbuilding and petro-chemicals also left more expansion room for new industries like electronics. In the UK, on the contrary, the oil crisis led to massive strikes as the government and trade unions could not agree on a wage policy. Mining strikes resulted in lower coal production, electricity blackouts and the infamous three day work week, which eventually resulted in a collapse of production, pressure on the currency and more inflation<sup>6</sup>.

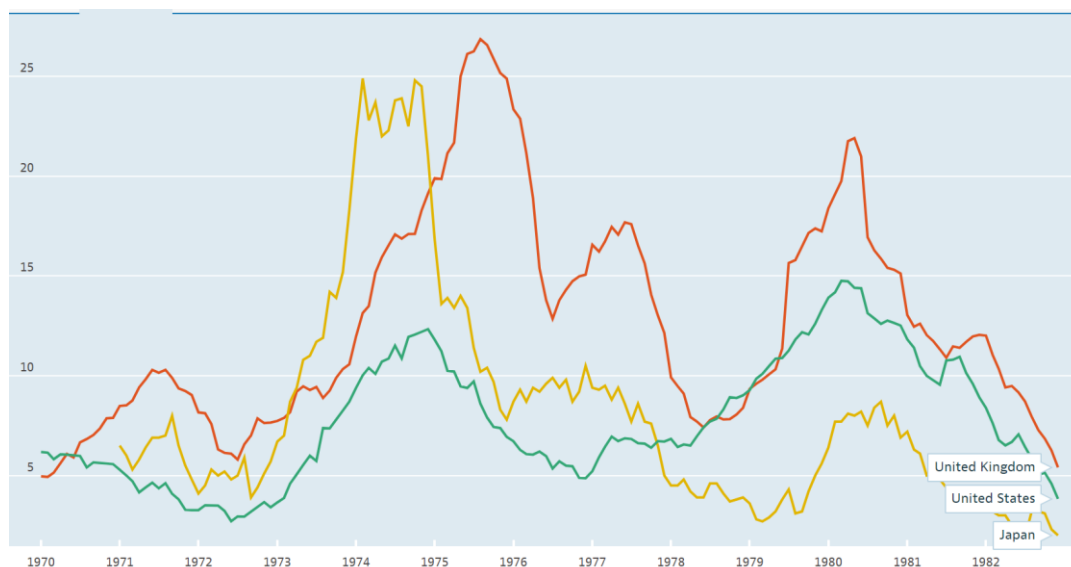


Table 3 Seventies Inflation Rate in the UK (red), the US (green) and Japan (yellow) – Source: Bloomberg

In the short term, the recent inflation spike is much lower than what happened in the early seventies and does not appear to be a significant cause for concern. If the situation deteriorates and governments and central banks don't take the appropriate measures, there are ways for the investor to protect their savings. Long-term fixed income instruments (government & investment grade corporate bonds) tend to perform very poorly in a high inflation environment, as central banks are forced to raise interest rates<sup>7</sup>. Few investors in Belgium buy bonds directly but they should be careful about supposedly 'conservative' portfolios offered by some banks, which might hold supposedly 'safe' bonds. One of the oldest bond funds I could find, the 'Fidelity Investment Grade Bond Fund' was launched in September 1971 and marketed to retail investors. It launched with a NAV of USD9.36/share, bottomed at USD5.7/share in September 1981 and still trades today below its launch at USD8.43/share fifty years later!

Fortunately, over the long term, equity markets tend to provide a decent protection against inflation, certainly much better than bonds. Even in the case of the UK, which faced a near collapse of its economy the FTSE all-shares (in blue on the graph below) provided some protection and even outperformed the S&P500 in US-dollars. The Japanese index performed much better and an investor holding the index through the oil crisis doubled their money by 1981. All that during the most difficult economic period since World War II.

<sup>5</sup> <https://www.theguardian.com/environment/2011/mar/03/1970s-oil-price-shock>

<sup>6</sup> <https://www.theblackoutreport.co.uk/2021/01/06/three-day-week-1974/>

<sup>7</sup> <https://www.pimco.co.uk/en-gb/resources/education/understanding-inflation/>

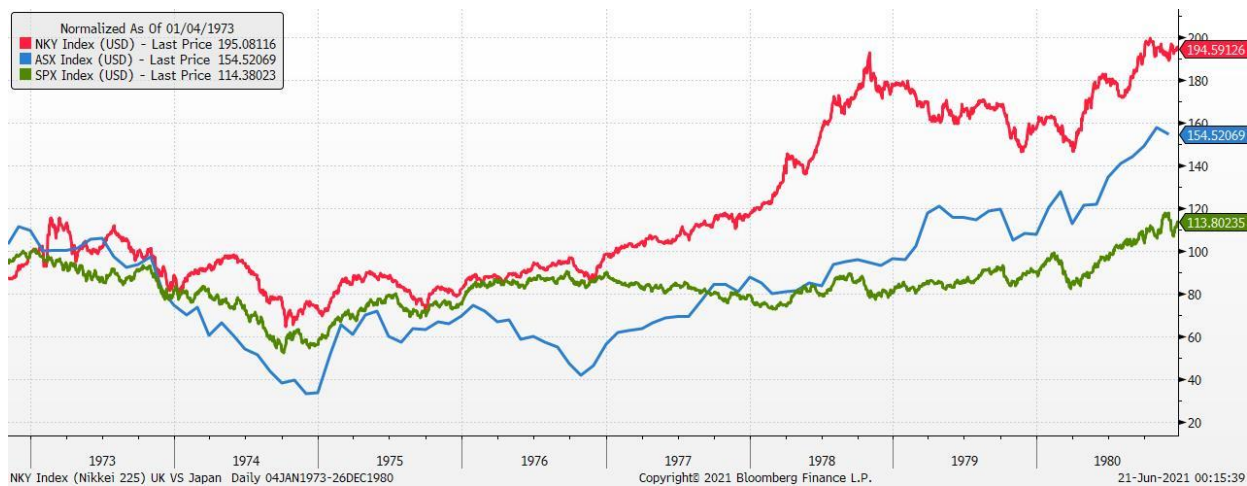
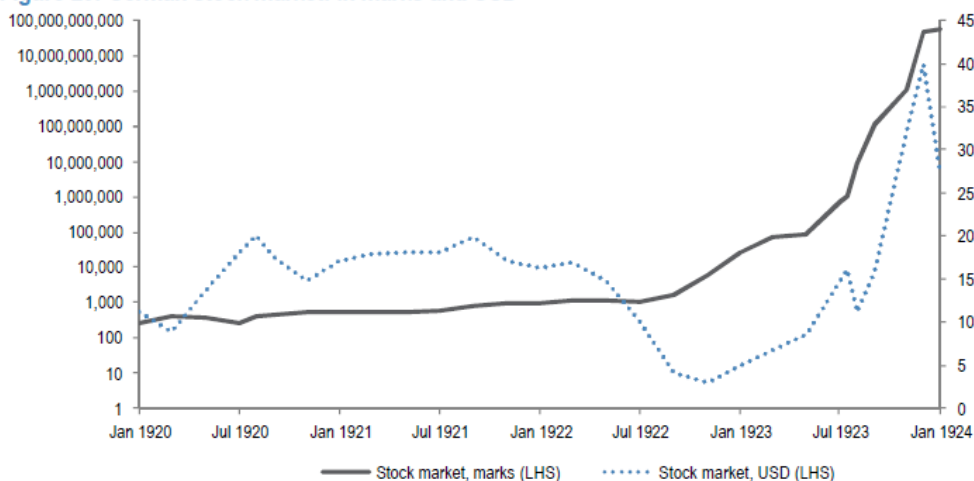


Table 4 Major stock market indexes in the 70ties- Nikkei (red), FTSE-all share (blue), SP500 (green) – Source: Bloomberg

The stock market can even protect you during periods of hyper-inflation. JP Morgan analyzed some of the consequences of hyperinflation during the Weimar Republic on investments in a report in 2011 and surprisingly, a German investor holding on to their shares actually made money in US-dollars during that dark period of history.

Figure 20: German stock market: in marks and USD



Source: J.P. Morgan estimates, "The Economics of Inflation", by Constantino Bresciani-Turroni

In conclusion, high inflation is definitively an issue investors should pay attention to. The recent bout of price increases appears to be temporary though and if inflation became structurally higher, the global stock market would continue to be a decent long-term hedge.

At TreeTop, we also work hard to find the best opportunities wherever they are. As we have seen with COVID, some countries fare better than others when faced with a crisis and this will continue to be the case whatever the crisis is (financial, economic, sanitary...).

## 2. Our convictions

Our strategy continued to deliver decent results in 2Q21, though not as impressive as in the first few months of the year. One difficulty in recent weeks has been the market rotation to more cyclical, beaten-down names, which suffered heavily from the pandemic. As the world economies progressively re-opened and commodity prices rocketed up, oil companies, traditional financial businesses and heavy industrials like steel rebounded very strongly. Our strategy is to buy structural growth at reasonable valuation and some of our investments benefitted from this trend, but we had no exposure to oil, traditional car OEM’s or steel. There are good companies active in these sectors, but the long-term

growth picture is murky and competitive intensity high, so we feel this could be more a short-term market move than a structural trend.

So far this year, some of our highest contributors to performance were equipment rental companies, **ASSTEAD** and **UNITED RENTALS**, a leading Internet consumer finance company, **NORWEGIAN FINANS HOLDING**, and an Indian agricultural technology business, **UPL Limited**. The largest detractors to our performance were **VIPSHOP HOLDING** and **FUFENG**. US equipment rental companies continued to benefit from strong structural growth trends, mainly a move away from equipment ownership to rental, and the potential to consolidate the market. Performance was also boosted by a strong recovery post-COVID and excitement about the huge infrastructure bill prepared by the Biden administration. Despite its excellent performance, the stock of **UNITED RENTALS** remains reasonably priced and trades on a forward price earnings of 14x.

**UPLL** is a leading pesticide and herbicide business based in India, with most of its sales coming from South & North America and Europe. We have been an investor for a few years, as the Company was transformed by the second-generation promoter into a global leader in herbicides & pesticides, thanks to a few acquisitions and a clever use of its low-cost Indian manufacturing and research base. At the end of last year, the Company completed its biggest acquisition ever, buying the American agricultural technology company Arysta for USD4.2bn. The idea behind this important acquisition is to be able to compete with the heavyweights of the industry, like Bayer-Monsanto, capitalizing on the distribution capabilities of Arysta and bringing more efficiency and synergies. While the strategy made sense, investors were concerned about the debt required for the acquisition. In recent months, the Company delivered better revenue and earnings growth than expected and reduced its net debt load by more than USD600mn to approximately USD2.7bn, leading to a re-rating of the stock.

The two most disappointing investments over the last few weeks were **FUFENG**, a leading amino-acid producer in China, and **VIPSHOP HOLDING**, the largest online apparel discount platform in China. **FUFENG**'s fundamentals remain strong, and we expect the Company to be able to generate the equivalent of 70% of its market capitalisation in cash over the next three years. The major issue there is that the founder, who is in his late sixties, has struggled to build a good succession plan and has lost some key managers over the last 18 months. We are currently working with the Company to solve these problems and hopefully have the stock reflect the strong fundamentals of the business. **VIPSHOP HOLDING** was an excellent performer until the implosion of an American hedge fund, Archegos Capital, earlier this year. The fund was an important investor in **VIPSHOP HOLDING** as well as in other Chinese Internet companies and its closure resulted in a fire sale of a high number of stocks. While this poor performance is unfortunate, **VIPSHOP HOLDING** has delivered excellent earnings over the last few years, it still has a large addressable market and the stock trades on the reasonable forward price earnings of 12x.

As the pandemic progressively fades away and the economy rebounds strongly, we are seeing a rapid re-rating of some traditional financial firms and the re-emergence of acquisitions by private equity funds and strategic buyers. Some of our investments are benefiting strongly from these two trends. **INDIABULLS HOUSING FINANCE**, a leading mortgage provider in India, has been able to form strategic relationships with the two largest banks in India and the leading credit rating agency in the country has upgraded its rating from AA with negative outlook to AA with stable outlook. This combined with a stabilization of the economy in India has led to better fundamental and stock performance. Two of our investments have received either formal acquisition offers or are rumoured to be analysed by potential bidders. **NORWEGIAN FINANS HOLDING** recently received an acquisition offer from Nordax and there are rumours that private equity funds are looking at **IWG**, the world's largest network of serviced offices and an investment we have had for a number of years.

Overall, while the stock market has re-rated, we continue to find pockets of value. We continue to believe that low interest rates and a very fast economic rebound post pandemic makes stocks more attractive than most alternative investments.

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