Newsletter

May 2021

INDEX House View

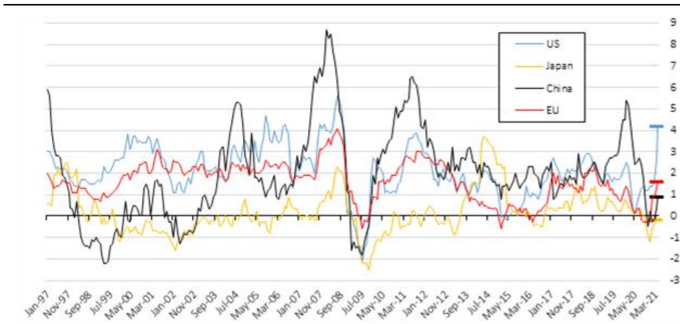
Persistent inflation fears

No matter how clear it is that the present spike in US inflation is only temporary, markets remain still preoccupied by it. And liquidations happen.

The latest numbers are indeed pointing to a bounce back in the US and Europe, but Asian major economies are not experiencing the same magnitude in trends. The average of inflation growth among the major four economic blocs is still well within the long-term average, but of course markets do not consider long-term truths. In absence of major fundamental surprises and in times of expensive valuations, markets remain essentially exposed to the downside coming mainly from negative headline news.

Below are the trends in the largest economic blocs:

Year-on-year inflation growth, in %



Average inflation growth in US, Europe, Japan and China, in %

Source: Bloomberg, Index & Cie calculations

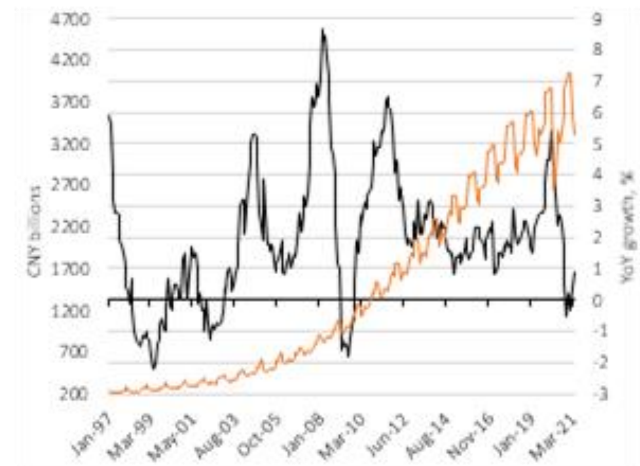
The nature of a consumption stop and its effects on inflation growth should serve as a useful tool to predict the future: on one hand, during a year of lockdown the average household in developed economies did not receive substantially higher payout for job activities (the cash handouts in the US did not materially change the life of anyone), nor was investment income (from crypto, or just equity markets) dramatically higher than average, since the investments do not take a substantial portion of household disposable income in these four blocs. On the other hand, reduced consumption might have increased savings, but again not enough to justify a prolonged higher level of consumption after lockdown. Looked at it differently, it is normal that pent-up demand floods markets all at once in 2021, but it is unlikely that the current level of spending will set new standards from 2022 onwards. This means that any market retracement based on prolonged high inflation is destined to lose strength soon.

The graphs below show exactly what happened to retail consumption in the major economic blocs.

United States

Europe

China



Japan

Source: Bloomberg

The only outlier here is the US, with a much higher spike in domestic retail consumption than its competitors. Such inflation rebound eroded confidence on US stocks deep in bubble territory, i.e. tech. While indeed many tech companies currently have non-terrestrial valuations – which makes them eventually liable to land on earth – we do not believe that the argument for future lower growth in fundamentals due to inflation has much value. The retracement of May comes after the second best year on record for the NASDAQ (+53% year-to-date, +106% in 1999). While we agree tech stocks are valued at least at double their real economic value, it is also true that the year 2020 unexpectedly accelerated a transition from brick & mortar to online that was long in the making. Barring occasional hiccups, the tech section of both American and global indexes has been growing steadily in its EBITDA contribution (now about 11.5% of global EBITDA), which lead to the unprecedented share of the total index market capitalization (now about 30% of global market cap, which reached 60% during the tech bubble of June 2000). The fundamental part of this reasoning is an undeniable reality, from which there is no coming back. The market part will have to normalize at some point, but this adjustment will not affect the capillarity and grip that tech companies have on the present global economic tissue.

We remain unchanged in our portfolio positioning and believe there is much value in being positioned in both the best of traditional stable businesses and in a selection of future possibilities.

Crypto

The inevitable trend in tech penetration is evident also in the renewed hype around cryptocurrencies – fueled by (1) an increasing access through traditional financial institutions, (2) extreme leverage offered at main crypto exchanges and (3) very low returns offered by public markets.

Memories of 2017's winter come to mind, when bitcoin reached USD 20,000, only to irremediably collapse some months after. Back then there weren't any of the improvements or projects of today. In the past four years Ethereum, the second largest cryptoproject by USD market cap, moved to fix weaknesses in its coding, has been working on making transactions cheaper and its expensiveness has given rise to at least three other alternative platforms to develop smart contracts. New decentralized finance (deFi) strategies have mushroomed everywhere, similarly to Initial Coin Offerings of 2018 and 2019. Contemporary art, and a whole lot of stuff that begs to be perceived as such, is being tokenized through NFTs, in a wave of collective madness that saw the digital picture of a flying cat with a rainbow coming out of its rear sold at USD 390,000 price – and considered to be a good investment.

As long-term investors, we are adept at separating the fundamental value of a company or project and its current market valuation, in public markets. In the latter, human emotions play out much faster than in the former, simply because of a lag between daily market valuation and the frequency with which economic results are communicated to the market (quarterly, sometimes semi-annually).

Leverage indeed amplifies emotional swings, especially when there is no financial anchor. Yesterday's almost 50% price collapse in bitcoin and other major currencies shows how quickly leverage can change the price of an asset, especially one that does not generate any cash or return. The underlying reason for such swings is still the same found in public markets: greed, both from retail investors and market exchanges.

If one switches off the noise around price fluctuations, and the constant, clueless and highly time-consuming flow of nonsensical chatter from 100-dollar traders in online forums, it appears that an increasing number of projects are in fact becoming more professional, surely when compared to four years ago. This is true even at a time when bitcoin remains one of the best money laundering tools of present times. What strikes of the current environment is the sophistication of the major initiatives in tackling existing problems and in tightening untested processes to make the whole structure efficient. As we did in 2018, we are currently studying a handful of projects that have strong potential to revolutionize existing industries and to solve existing inefficiencies. The failure of Ripple and its token XRP served as a reminder of the resistance some establishments will present against new technologies, but there are positive signs. More traditional financial institutions are allowing their clients to trade an increasing number of tokens, a fact that increases awareness, liquidity and eventually will serve to discover and consolidate projects with the best future potential. The presence of extreme leverage does pose a risk to the whole system, but it will also serve to bankrupt stupid capital out of the equation.

All these developments are exciting, as they offer a glance of what the future of many industries might look like, especially financial services. At the same time, we remain cautious and investigative in our approach to cryptocurrencies, as the majority of these instruments – including the NFT on the rainbow-sprouting flying cat – are used purely for financial speculation.

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