INTUITION
10 MARCH 2023

What if inflation stays higher for a bit longer?

A lot has been said and written about inflation over the last year or two. For years global inflation fluctuated around 2 percent. Last year it accelerated to 40-year highs. Initially, we all thought it would be a short transition – quickly up and then quickly down. Central banks declared war by hiking rates in quick succession. Now that the initial impact of fighting this inflation dragon is reaping rewards the debate has shifted to either how low can we go on inflation or will it ever be back at the previous average levels.

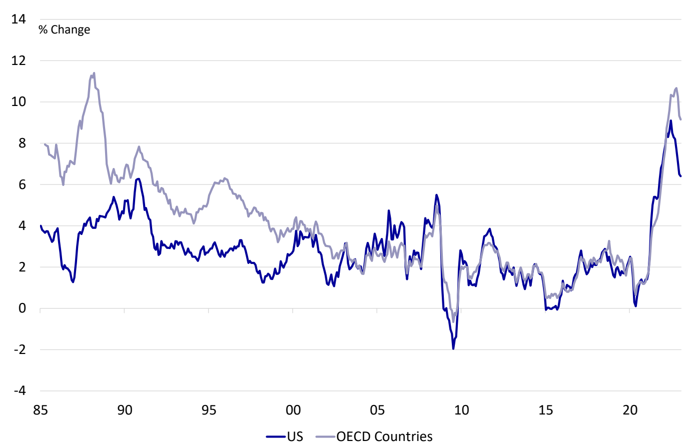
Willie Pelser

I don't believe that the average person on the street makes a calculated decision to read about inflation. However, something we can all confirm is everything has become more expensive. Even your cup of coffee at your favorite coffee bar is more expensive, as Lebogang wrote in last week's Intuition. It is not just the cost of doing business, but also the commodity, coffee, that is up in price. Over the last eighteen months inflation became the buzzword as global inflation suddenly rocketed to 40-year highs across the world. Despite the moderation in inflation over the past few months, it is still well above previous averages.

During our monthly discussion session between the asset management and financial consultant teams at Harvard House, the question was raised whether inflation will get back to the "pre-runaway" levels? For example, in the US average inflation over the last 20 years (before the acceleration) was about 2%. The most recent data point was 6.4%, a long way from the 20-year average, so the question is whether it will get back to that level? (The same argument applies to other major economies.) I was reminded of an article from the Economic Research Groups of Standard Bank and JP Morgan, arguing this exact point.

What if inflation does not come down to the 2% level that most central banks target on a sustained basis? When looking at inflation in the major industrialized nations it seems that the main question amongst investors is now

GLOBAL INFLATION



Inflation has been tamed for so long that many have forgotten what higher inflation actually feels like. The past year has seen inflation rise at the fastest pace in almost 40 years.

SPEED READ

- **Two years ago the debate was whether inflation was "dead". Now it has changed to arguing if we will ever see the lows of 2% that have prevailed over the past two decades.**
- **Regardless of whether the outcome is for interest rates to remain higher for longer or inflation takes a bit longer to settle back at a new level, the Harvard House Investment team will remain focused on seeking out those companies that have stood the test of time and are expected to continue to do so even under this new scenario.**
- **Examples of companies rewarding investors with good dividend distributions despite bad economic growth and inflationary forces do stand out. Two such companies are Coca-Cola and AECI.**

not whether inflation has turned down in annual terms, but whether it will fall to the 2% level that most central banks target and whether it will hold there? Achieving that level will allow central banks to start lowering interest rates. So it is an important question.

In the US, the economy is proving quite robust, particularly the labour market. Other countries too might just avoid recession but is this a good or a bad thing? It's good in the sense that recessions are best avoided, but bad if the absence of a recession means the persistence of inflation above the 2% target. Both the economic research units argued that they can certainly see a danger of persistent inflation, especially in the US. The US Federal Reserve however, does not seem to think so as it forecasts inflation falling to 2.1% by 2025. An international poll of economists has the same median forecast. But what if they are wrong? What if inflation in the US, and other major nations, remains higher, for argument's sake between 3% - 4%?

In this case, they argue that policymakers have three options. The first is to accept higher inflation and even validate it by lifting inflation targets – and ultimately cutting interest rates. That would not be well received by markets. The second argument is to raise rates significantly more than the market is currently expecting to get demand destruction (i.e. a curb in spending by consumers) that will tip economies into recession and ultimately get inflation back to 2%. The third option is not to lift rates much more but instead to maintain higher interest rate levels for longer which should have the same impact on spending patterns. It is this third option that we believe is starting to be priced in by global financial markets.

The research units conclude that their arguments over the last couple of months weren't so much that inflation will lift off again but that structural long-term factors such as demographics (aging population) and deglobalization (the re-direction of supply chains, for instance, and higher imported inflation) will prevent inflation from sustainably falling to the 2% target over the next year or two. If this does happen, we think the third option of holding rates at the terminal rate for longer will be the Central Banks' preferred strategy as they continue to fight the inflation battle, whilst remaining cognizant of the political risks of a deep recession.

"The second argument is to raise rates significantly more than the market is currently expecting to get demand destruction."

Clients will appreciate that stock markets gyrate as the mood changes around these forecasts and debates. Markets have rallied hard over the past few months of the promise of a peak in interest rates. Over the past 2 weeks, that view has been undermined by better data, especially labour markets, and consequent comments from the US Federal Reserve that the hiking cycle is not yet over. Where does that leave your portfolio?

Sadly, inflation, globally, is a reality whether we like it or not and policy makers need to deal with it.

Regardless of debates and changing sentiment such as the inflation debate, Harvard House's investment philosophy or the way we think about money will remain unchanged, just as it did when inflation accelerated sharply. The crux of the matter is to remain focused on the variables such as those discussed above and ask the following questions?

1. Will the business models of those companies we have in portfolios survive the impact of the economic changes brought about by such factors?
2. How will they reward investors? Will the dividend be paid or withheld, and if withheld, for how long? Furthermore, will the dividend grow faster than inflation or not?

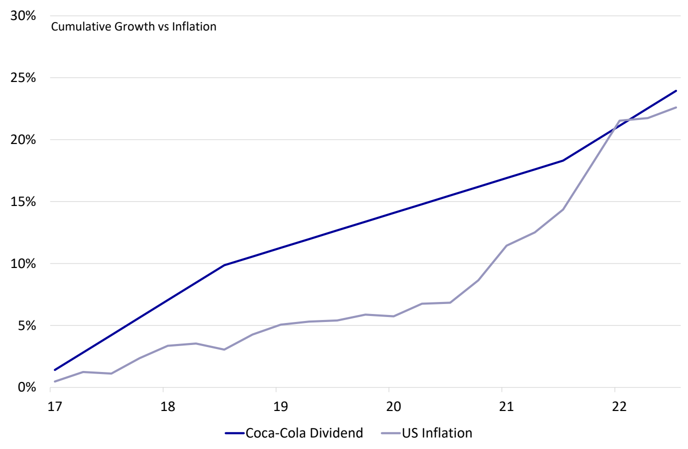
We don't discard the impact of high interest rates, or that inflation might not decelerate as quickly as previously anticipated, or that economic growth might be more muted, etc. Depending on our forecasts we would adjust our exposure to various companies depending on how we see them being impacted by future economic and market developments.

Regarding the inflation debate, I draw your attention back to our Insight presentation at the end of 2022, in which we highlighted two examples – Microsoft and Afrimat – of companies who have been successful in navigating the economic cycle, whilst still consistently rewarding shareholders through inflation-beating dividend growth. To drive home the point on inflation I would like to add two further companies to that analysis, specifically comparing dividend growth to inflation.

Coca-Cola

This is a great example as it demonstrates quite clearly how inflation (specifically in the US) accelerated over the last 18 months. Coca-Cola is a global conglomerate deriving 60% of sales from non-USA markets. Like most companies, sales were impacted by Covid and the subsequent slow economic recovery. Furthermore, high inflation saw consumers adjusting their spending patterns and higher interest rates impacted the net interest expense line negatively. Consequently, margins came under pressure as not all cost pressures could be pushed through to raise the price of a can of coke. Despite this impact, companies like Coke were able to raise dividends (the latest increase is 4.5%) to reward investors albeit more aligned with the current business environment. Importantly, over the past five years, Coca-Cola has grown its dividend at least in line with inflation.

COCA-COLA DIVIDEND GROWTH VS INFLATION



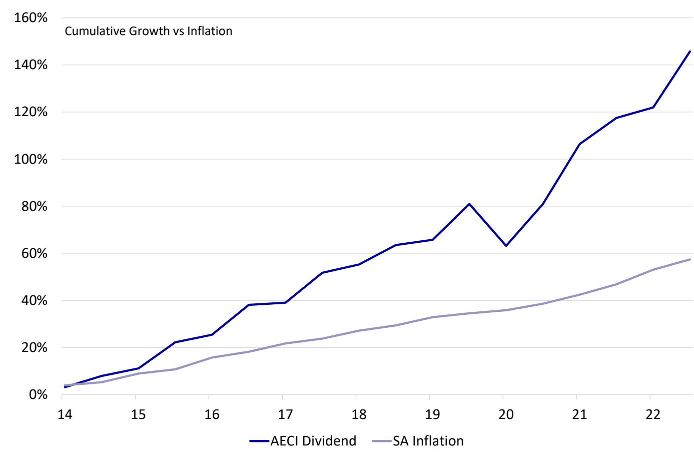
The impact of the sharp increase in US inflation is quite noticeable, but the company continues to reward investors. The dividend is as refreshing as adding some ice to your glass of Coca-Cola.

AECI

Despite it have been listed for decades, AECI had fallen off our radar but we have recently re-added it back into our investment universe. AECI's revenue is derived from four major segments spanning not just South Africa. Their divisions span the mining industry (50% of revenue), the agricultural industry (20%), chemicals (20%) and the rest from water treatment. The process here is storing and purifying water to ensure it is potable for various uses amongst their client base. The areas AECI operates in are cyclical by nature and sometimes unplanned (for example the agricultural sector) events do play a part. For the 2022 financial year, AECI delivered solid results with revenue up 37%, despite this being a period of high inflation, subdued global growth and high commodity prices. Unfortunately, profit was only marginally up from the previous year due to a loss in one of the chemical businesses in Germany. Such is the risk of large, diversified businesses. Yet cash generated was strong, rising by 17% so investors were rewarded with a 15% increase in the dividend. The dividend chart does tell a story of solid management and prudent capital allocation and rewarding shareholders with the income they deserve. Everyone can agree that doing business in SA over the past eight years has been challenging, but backing a strong management team that can navigate its way through the challenges is usually a rewarding one for shreholders.

This is a water treatment plant owned by AECI that is designed for processing mining explosives.

AECI DIVIDEND GROWTH VS INFLATION



Despite the cyclical nature of its core operations, AECI has successfully navigated the challenges to deliver solid inflation-beating growth in their dividend.

Our next Insight seminar will delve into the mechanics behind markets, why share prices sometimes react the way that they do, and how changing valuations can exaggerate those moves.

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Topic: **The Mechanics of Markets**

Natal Midlands	
Date:	Thursday, 16th of March
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	Tuesday, 14th of March
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

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