ISSUE
96

Pitcher Partners

Investment news

Pitcher Partners Investment Services Pty Ltd

Kellie Davidson – Partner

Let's check our 2021 bingo cards for the quarter; tornado in NSW, NSW Premier resigns, earthquake in VIC, further lockdowns and record covid cases. Who has fire and brimstone next?

If we throw in a reporting season, surge in energy prices, rising inflation, global trade tensions, Taiwan, other commodity price volatility prompted by Chinese regulatory controls, peaking global growth momentum, amongst other issues – it was an eventful 3 months to say the least!

The performance of Equity markets were varied. Despite extended lockdowns in NSW, VIC and the ACT, our local market rose 1.7% on the back of a solid reporting season. Most major markets finished in the black with the exception of China & Hong Kong. China's clampdown has impacted some of its largest companies including Tencent and the quite spectacular crisis facing its second largest property developer, Evergrande. The reverberations were felt keenly across the globe, including the price of iron ore which at one stage had fallen more than 50% from its intra quarter peak.

Energy shortages, especially within pockets of Europe and China, resulted in sharp increases in the price of natural gas and thermal coal. Coupled with ongoing supply chain disruptions, this has stoked inflationary concerns, resulting in sharp sell offs across bond markets, with the US 10-year Treasury yields hitting 1.55% while Australian 10-year yields fluctuated between a low of 1.06% to 1.48%. The $AUD has dropped against the $US benefitting offshore unhedged returns over the quarter.

In our reports this quarter, we take a deeper look at inflation and discuss the case for whether these pressures are just transitory or are we on the verge on a structural regime change, one we haven't experienced in the developed world for close to 40 years.

Investment market performance summary – 30 September 2021

Indices	Current	3 months	1 year
ASX 200	7,332.2	0.3%	26.07%
ASX 200 (Acc)	84,351.6	1.7%	30.56%
US S&P 500	4,307.5	0.2%	28.09%
Japan Nikkei	29,452.7	2.3%	27.03%
UK FTSE 100	7,086.4	0.7%	20.80%
MSCI World (AUD)	14,035.5	3.9%	27.82%
German Dax	15,260.7	-1.7%	19.59%
French CAC	6,520.0	0.2%	35.74%
HK Hang Seng	24,575.6	-14.8%	4.76%
Shanghai Comp	3,568.2	-0.6%	10.88%
ASX 200 Prop (Acc)	63,366.4	4.2%	29.85%
Global Prop	2,988.4	-0.2%	29.14%
Australian Bonds	10,545.2	0.3%	-1.54%
International Bonds	1,094.9	0.1%	-0.79%
Commodities			
Gold (oz)	1,757.0	-0.7%	-6.83%
Oil (Barrel)	75.0	2.1%	86.55%
Iron Ore (Tonne)	116.8	-44.7%	-2.83%
Aluminium	2,858.5	13.3%	61.95%
Copper	8,936.5	-4.7%	33.94%
Lead	2,092.5	-8.0%	14.69%
CRB Index	228.9	7.3%	54.15%
Currencies			
AUD/USD	0.7227	-3.6%	0.91%
AUD/EUR	0.6241	-1.3%	2.13%
AUD/GBP	0.5364	-1.1%	-3.25%
AUD/JPY	80.4230	-3.5%	6.46%
AUD/RMB	4.6704	-3.5%	-4.06%

Source: Bloomberg

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We also discuss BHP's transformational announcement at its annual results in August, which highlighted a distinct pivot away from fossil fuels and into one of the three essential macronutrients for plant health and growth, Potash, which we believe will underpin attractive rates of return for BHP over the very long term.

Last but not least, we truly hope you, your family and friends are keeping well in these challenging times and very much look forward to meeting with you over the months ahead.

Potash – embracing a mega trend

Alistair Francis – Senior Investment Analyst

The FY21 result for BHP Group Limited (BHP) proved to be a monumental day in the history of the company. For the newly appointed CEO – Mike Henry (Jan. 2020), the exceptionally strong result and record final dividend coincided with a trifecta of announcements that are company transformational. The announcements included:

1. Woodside Petroleum (WPL) and BHP are combining their respective oil and gas portfolios in an all-stock merger. BHP shareholders will be issued new WPL equity and will own 48% of the new combined group. The deal completion is expected in 2Q CY22.
2. Unification of the cumbersome Dual Listed Company (DLC) structure with the main listing going forward to be on the ASX. The existing BHP PLC shareholders will receive one BHP Ltd share in exchange for one BHP Plc share. BHP will maintain secondary listings on the LSE (London), JSE (Johannesburg) and its NYSE (New York) ADR offering. The unification process is expected to be completed in 1H CY22.
3. The US$5.7bn Jansen Stage 1 potash project was approved. First ore is expected in CY27.

The all-stock merger of the BHP Petroleum business and WPL is expected to be completed after the planned DLC unification. BHP have indicated that the merger is however not contingent on the DLC unification.

From a long-term perspective, the three proposals (subject to various shareholder meeting approvals) will all add value to the newly structured BHP Group Ltd. It's expected that by removing fossil fuels from the portfolio mix, it will enable BHP to focus capital and management attention on those commodities that are required to facilitate electrification and decarbonisation. Just as importantly, the entry into the Potash market pushes BHP further into the future facing commodities that it craves, albeit the returns will be lower in the medium term.

After nitrogen and phosphorous, potassium (a chemical in potash) is the third essential macronutrient for plant growth and health. Over the years, modern intensive agricultural practices have led to a significant decline in soil potassium levels. Thus, having adequate potassium levels through the application of potash will help to reduce crop stress thereby supporting a growing global population. Currently, potash deposits are concentrated in Canada, Russia, and Belarus, with the highest import demand from China, Brazil, the United States and India.

The 100% BHP owned Jansen project (located in Saskatchewan, Canada) has been one of their discrete growth options for over a decade and now has the potential to become the largest and lowest-cost potash mine globally, with a mine life of approximately 100 years. Accordingly, Jansen offers BHP exposure to a mega trend by not only replacing the essential crop nutrients thereby creating higher yielding outcomes, but it helps to reduce the temptation for farmers to convert more of the world's forests into paddocks in the search for more fertile land. For the newly structured BHP portfolio, it importantly also provides greater diversification by commodity, customer base and operating footprint.

Further supporting the attractiveness of the investment is the Jansen potash project, which is expected to have materially lower carbon emissions released during production versus other major chemical fertilisers. In addition, underground mining and support fleet will be more than 80% battery electric vehicles by consumption and will ultimately pursue 100% electrification.

The global potash market has come alive in 2021 as rising demand, surging crop prices and margins along with supply-side risks have combined to drive regional potash prices up 2–3 times. Over the past few months in particular, it has been the supply risk concerns from the increased sanctions implemented by both the European Union and the United States against the Belarus Potash Company. It is worth noting that the Belarus Potash company, accounts for around 20% of global potash supply. However, contract prices have remained subdued, and it is expected that the spike in regional spot prices will likely normalise as the market rebalances over time as the Belarus' volumes are repurposed to other locations.

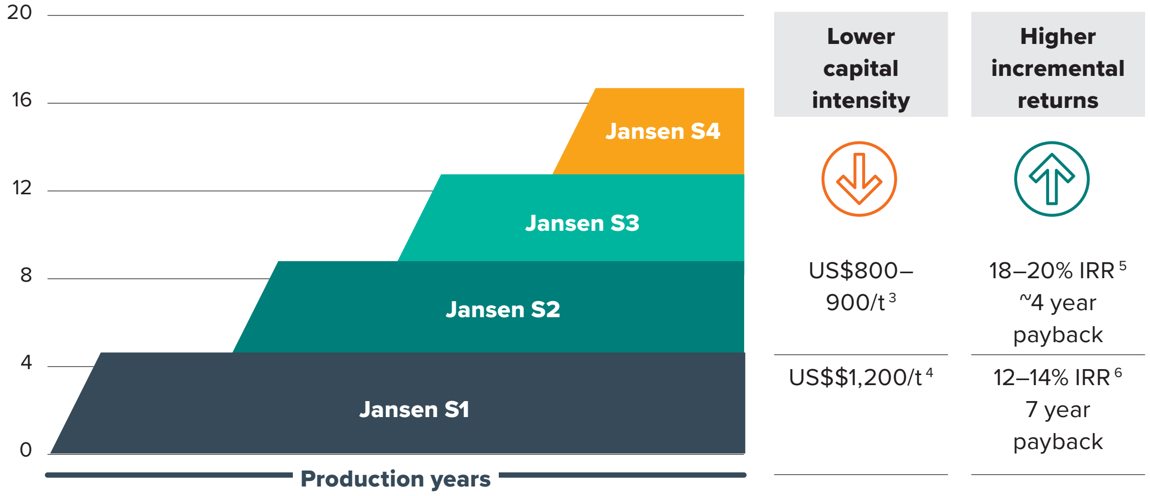
Per the recent BHP investor briefing, the initial development (stage 1 of a proposed 4 stage plan) aims to deliver an underground mine with a production capacity of 4.35mtpa. Subject to further feasibility work, the market anticipates that the decision to develop the Jansen deposit is part of a much larger strategic commitment by BHP to the potash market with additional staged developments up to approximately 16mtpa incorporated into their plans.

BHP – Jansen briefing 15 September 2021

Janson S1 provides a platform for growth

***Stage 2–4 would make Jansen one of the world's largest potash operations*[1]**

Estimated production from potential incremental stages beyond Jansen[2]



Source: BHP Jansen briefing, 15 September 2021. You can access a copy of the report on BHP's website www.bhp.com.

Notes

1. World's largest statement is on a production basis.
2. Production targets for Stage 1 is based on reported Ore Reserves. Potential incremental stages 2–4 are based on Measured Resources. Mineral Resources and Ore Reserves are included in the news release published on 17th August 2021, available to view at www.bhp.com. The execution of future stages would be subject to our review of supply and demand fundamentals and successful competition for capital under our Capital Allocation Framework.
3. Expected Capital Intensity Jansen S2-4, US$/product tonne, Real 1 Jul 2020.
4. Expected Capital Intensity Jansen S1, US$/product tonne, Real 1 Jul 2020.
5. Expected Jansen S2-S4 IRR of investment decision across ~100-year mine life analysis was conducted on consensus prices. Jansen S2-S4 IRR is post tax and nominal.
6. Expected Jansen S1 IRR of investment decision across ~100-year mine life analysis was conducted based on the range of the average CRU and Argus prices in 2027–2037. Jansen S1 IRR is post tax and nominal and excludes remaining funded investment of ~US$0.35 billion for completion of the shafts and installation of essential service infrastructure and utilities.

From a global perspective, potash demand growth is expected to sustain a 2.5% CAGR going forward which is underpinned by population growth, diet mix change, and shrinking arable land. Analysts forecast that this steady demand growth should see the potash market move into balance by CY26 and experience a deficit from CY27 onwards.

Given the dominance of the iron ore earnings along with the customer concentration risk for BHP, it's pleasing to see another future facing commodity in the form of potash finally being commercialised. Although a number of years until it makes a meaningful earnings contribution, the long-life potash investment also critically provides BHP's portfolio further diversification benefits from the other more cyclically orientated exposures.

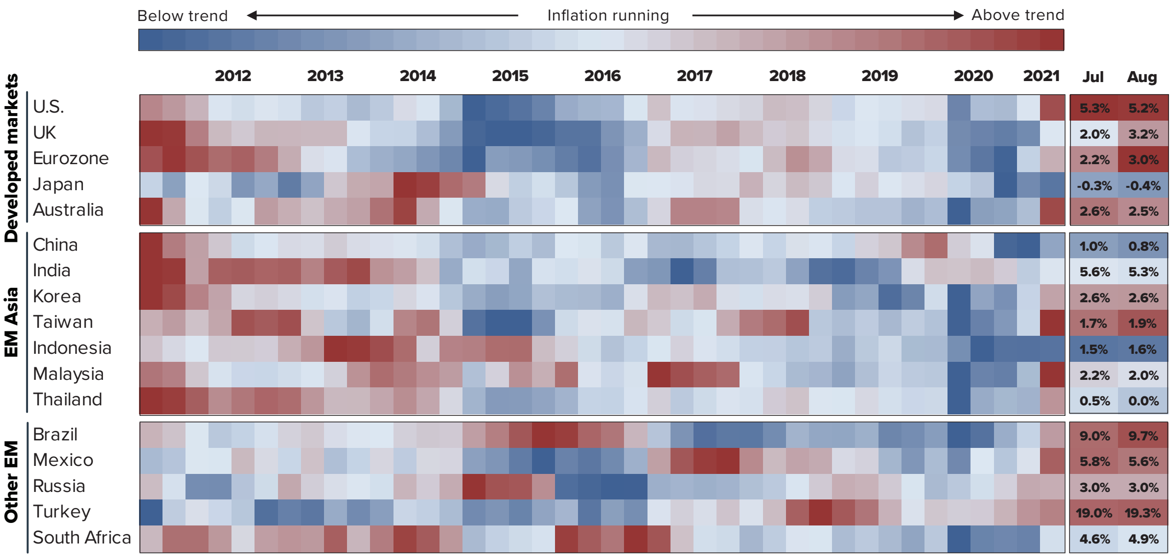
Inflation – Where do we stand?

Duncan Niven – Director of Research

The recent surge in energy prices amid shortages particularly in areas of Europe and China, coupled with ongoing supply chain disruptions, have refuelled the debate around the likely persistence of the inflationary pressures currently being experienced around the globe.

Headline consumer prices

Year-over-year change, quarterly



Source: Department of Statistics Malaysia, DGBAS, Eurostat, FactSet, Goskomstat of Russia, IBGE, India Ministry of Statistics & Programme Implementation, INEGI, J.P. Morgan Economic Research, Korean National Statistical Office, Melbourne Institute, Ministry of Commerce Thailand, Ministry of Internal Affairs & Communications Japan, National Bureau of Statistics China, Office for National Statistics UK, Statistics Indonesia, Statistics Institute Turkey, Statistics South Africa, U.S. Department of Labor, J.P. Morgan Asset Management. Quarterly averages, with the exception of the two most recent figures, which are single month readings, are shown. Colours are based on z-score of year-over-year inflation rate relative to each country's own 10-year history where red (blue) indicates inflation above (below) long-run trend.
EM represents emerging markets.
Guide to the Markets – Australia. Data as of 30 September 2021.

For many of us, this issue is a relatively unusual environment. In looking back over time both here and overseas, if you're under 50 years old and have lived in developed markets, it's very likely you haven't experienced much in the way of inflation. If you're under 60, you likely have not experienced high, disruptive inflation.

The debate has two primary sides – will we see the pressures abate or are we on the verge of a change in regime?

- **Camp Transitory** makes the case that recent inflation is due to a combination of temporary factors such as base-level effects as we roll off different time periods, the pandemic recovery and supply chain disruptions.
- **Camp Structural** argues that recent inflation is the starting point of a self-sustaining spiral of rolling price increases that will end with inflation running materially higher than its pre-pandemic level.

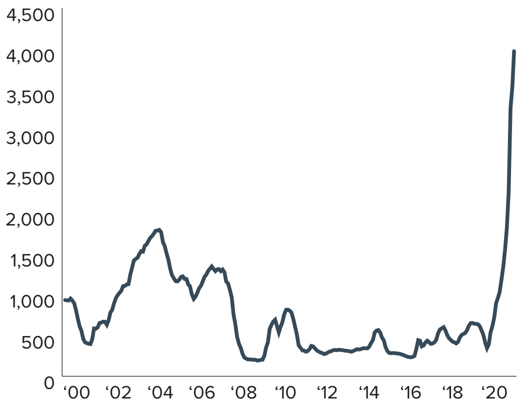
Both camps have genuine cause to state their case. To further complicate matters, official measures and interpretations of inflation do differ from country to country – with varying allocations given to specific goods and services. Making generalisations involving multiple countries can be futile, however the broad globalised pressures at play currently make this an issue for all of us.

Currently, the inflationary pressures building within the U.S and potentially within Europe and China are more pronounced than those witnessed here in Australia (particularly when looking at the core "trimmed mean" measure the RBA prefers to focus on). This reflects the different composition of our CPI basket, differing policy settings and relatively lower wage pressures. Our comments immediately below speak to these current pressures.

Camp Transitory

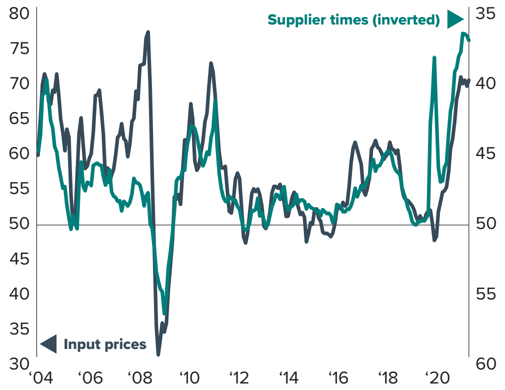
Shipping costs

HARPEX Index



Global input prices and delivery times

Manufacturing PMI sub-indices

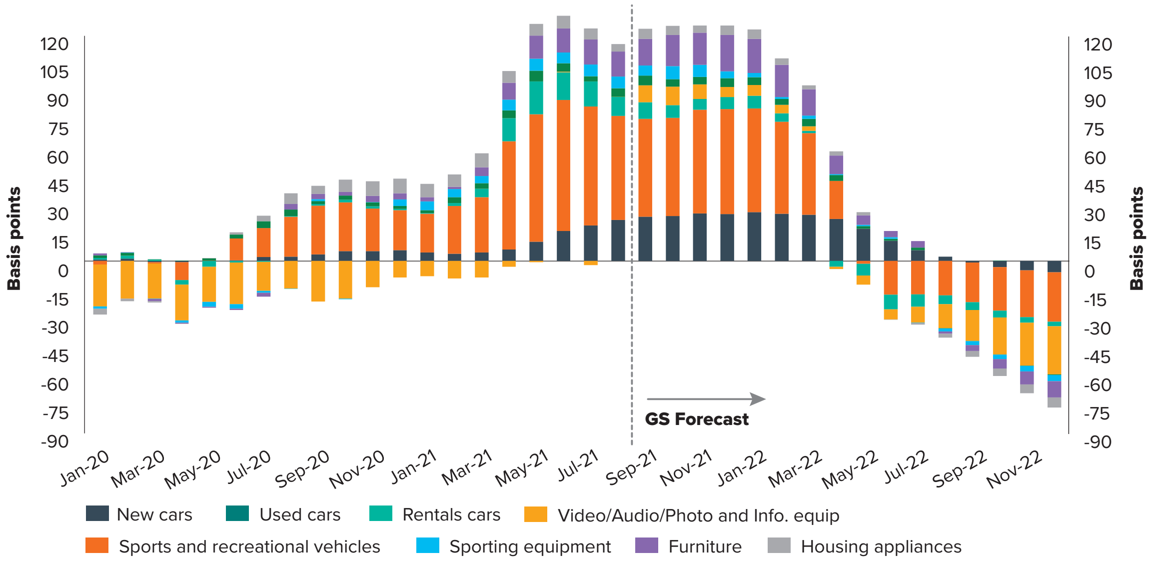


Source: J.P. Morgan Asset Management, Harper Peterson Institute (LHS), Markit (RHS)
HARPEX measures the global price for container ship contracts. *PMIs are a diffusion index around 50; a supplier delivery time under 50 indicates it is taking longer to receive inputs into the manufacturing process.
Guide to the Markets – Australia. Data as of 30 September 2021.

The recent spike in inflation has lasted longer than many first expected, indeed Fed Chair Powell acknowledged as such in a testimony to the U.S Senate in late September. But how long is transitory? Whilst this can be quoted in a measure of time, another way to think of this is instead to think of transitory being defined as the underlying supply/demand conditions that can be "fixed" on their own or will take outside forces (such as central banks raising rates to temper demand).

The cost of transportation is a big part of the debate – prices of transit-oriented goods, which in conjunction with dwelling costs represent ~60% of U.S CPI, have increased due to a combination of surging pandemic recovery demand and insufficient supply. This is naturally assumed to dissipate as production resumes and ports clear their backlogs. Goldman Sachs estimate that the rising impact on inflation from supply-constrained industries will swing from +1.2% by calendar year end, to -0.7% by the end of 2022.

Contributions to year-on-year core PCE inflation from supply-constrained categories



Source: Department of Commerce, Goldman Sachs Global Investment Research

The well reported semi-conductor shortages have plagued automobile production (as well as other goods). It is reported that it will likely take well into 2022 before that problem is close to being fully resolved, but many goods markets have already started to correct – used car prices have retraced slightly in the last few months after a sharp spike earlier in the year. Lastly, by the nature of "base effects", i.e if the high prices we are experiencing now stay at current levels, next years inflation will be 0%. In addition, consumers still retain the ability to substitute goods or delay purchases if prices are too high. This is why the market majority remains pitched in Camp Transitory.

It's also critical highlighting that this is where the central banks such as the RBA and the Federal Reserve sit as well.

Camp Structural – What if we are on the verge of a new regime?

A number of financial market commentators believe the market is being too complacent in its view of transitory pressures. Temporary price spikes have occurred regularly in developed markets over the last 20–30 years. Whilst we are always cautious when seeing the words "This time it's different", it's worth assessing what the contrarian views are and what could happen if we experience a change in inflation regimes. We credit some insightful commentaries we have read from firms such as Neuberger Berman and Amundi in recent weeks on this topic.

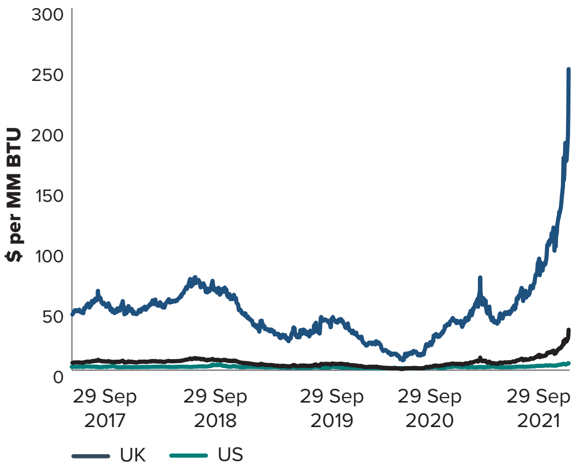
Energy prices

Natural gas prices spike, especially in Europe

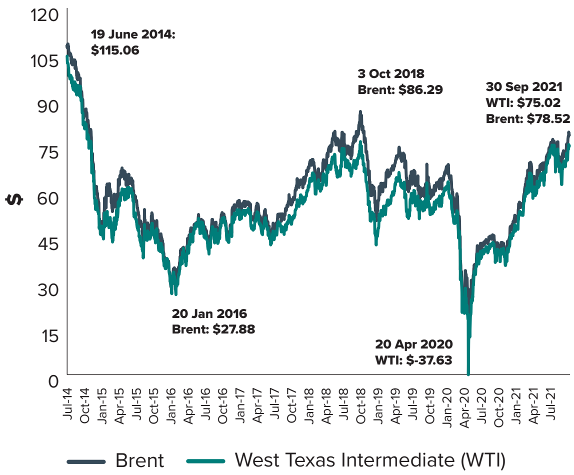
In the UK,the natural gas price rose 93% in September

Natural gas prices

(Generic 1st Futures contract price)



Oil price



Source: LaSalle Investment Management

The transition to a low-carbon economy will involve cost and disruption, with perhaps a taste of things to come evident from current events in some areas of Europe and China – natural gas prices hit double their levels from a year ago. In the transition to a low-carbon economy, it is expected that energy costs for industry and consumers are likely to rise structurally – especially given the urgency/acceleration from many economies here. While some energy costs have been constrained through innovation and new technology, this deflationary force is not expected to persist.

That adjustment need not be disruptive though. If governments tax carbon appropriately, incentivise renewable energy and allow free markets to do their work, the transition to moderately higher costs can be smooth. We highlight that in the U.S, one of the ways high inflation in the 1980's was contained was not just rate hikes, but deregulating and allowing free market forces do their thing in global energy markets.

China’s shifting priorities

China is likely to cease being an exporter of disinflation to the rest of the world.

China is battling an aging population, which is barely growing and peaking in terms of urbanisation growth rates. It’s labour force is not expanding. That is why its recent announcements on social and business regulation are able to prioritise things like equality, good health, the environment and the automation of the economy over jobs generating growth. China is slowly re-engineering itself away from the worlds low-cost workshop, to a high-tech workshop for itself. The deterioration of its relationship with several major global economies only adds impetus to this trend.

Structural Shift In Supply Chain Management

Whilst the supply chain disruptions we are seeing are likely to be transitory, there are potential longer term effects. Stories of a ten-fold increase in the cost of shipping containers, sharp increases in the cost of raw materials – these are material enough for management of companies to take action to prevent them from happening again – or at least moderate the impacts. A localisation and/or diversification of supply chains could easily evolve into a structural, marginal increase in costs.

What happens into the future?

So if we aggregate these structural considerations – more resilient supply chains, a low carbon economy, a more sustainable Chinese economy, de-globalisation – these are all very different from the governing priorities of the past 40 years or so.

Currently, cashed up consumers and strong corporate balance sheets, coupled with pent up demand have an ability to absorb the passing through of higher costs. But this can’t be done indefinitely.

Investment implications

Camp transitory is by far the most investor friendly scenario. Major central banks will maintain current accommodative policy settings until their goal of full employment and resulting wage growth pushes inflation sustainably into their target band ranges. Bond investors will continue to price yield curves closely to central bank guidance and equity investors will benefit from a lower rate environment for potentially the next 12–24 months.

Temporary shifting inflationary expectations, as witnessed recently, will likely result in some sharper spikes in volatility given the fully valued nature of equity and bond markets, but this will moderate.

Camp structural is not investor friendly. Central banks will be behind the 8-ball and forced to abandon full employment policy objectives as they hike rates aggressively to combat any sustained outbreak in pricing. The lack of central bank credibility will see bond investors hurt and equities, at the very least, will likely suffer a sharp initial downturn as earnings expectations are recalibrated and valuation multiples contract.

Conclusion

So we are at a very interesting juncture at this point in time, however we will still need to wait until well into 2022 to get a clearer picture of where inflation, particularly in the U.S, will settle. Despite Australia’s dormant wage growth, which the RBA believe won’t accelerate sufficiently for it to be able to lift interest rates higher until 2024, all eyes will be on the U.S and what occurs with energy prices as a major driver of market sentiment between now and the end of the year.

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