Vermeer Global Fund – Comments on Inflation

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We think about inflation from two different perspectives, the first being from a market/macro point of view. This is relevant to how we want to position the portfolio as we think about what inflation will do to both the bond market and longer-term inflation expectations as a combination of both of these factors usually leads to a rising yield environment which may impact the more "growth" parts of the market as duration linked stocks tend to suffer when this occurs. Secondly, we look at inflation from a company specific perspective, and how the various dynamics that are causing the high inflation rates are impacting operational and financial performance of the companies that we own in the Fund. It is our view that inflation will be higher for longer than a lot of people expect/hope but not at the same levels we saw in the October CPI print.

As part of our investment process, we spend a lot of time talking to Washington policy teams and economists at our broker partners. An economist who we speak to regularly and who is very close to the Fed and their current thinking, has been much more cautious on his inflation outlook, believing that inflation will be higher for longer and that the Fed missed the opportunity to begin tapering in the window it had in the summer. He has also written a lot about an area we are keeping a close eye on which is shelter and rental costs. This accounts for around one third of CPI and although they are generally slower moving, these factors are much stickier than other parts of the inflation calculation. Rents normally follow moves in housing prices with a lag and recent Case Shiller house price data showed that home prices increased 19.8% y/y in August with rental prices rising by over 10%, taking the owners' equivalent rent portion of inflation up to over 4.5% on a three-month annualised basis. This is a key factor in our view that inflation will be around for longer and above the Fed's 2% target.

From the more micro, company specific perspective, the first thing we focus on is actually how much of current inflation is being caused by so called "transitory" factors. Whilst we hate using the word transitory given the lack of specificity it conveys in terms of timeline, there are some elements that are hitting inflation that have been caused by COVID and its related dislocations, specifically in the supply chain, that should have a shorter-term impact. We expect the supply chain related dynamics, such as high freight costs, port backlogs and factory shutdowns in Asia, to ease over the course of 2022. However, the degree to how much these ease remains a topic of discussion. Using freight rates as an example, these have risen from broadly around $2,000 per container pre COVID to over $12,000 at the peak, and in some cases nearing $15,000. These have now reduced to around $10,000, a near 20% fall but remain five times higher than pre-COVID levels. The question remains as to whether these rates drop back to $2,000 or settle at levels well above pre-COVID and whether this could lead to structural changes in how companies think about pricing. Forecasting this, and its subsequent impact on company earnings as we head into 2022, is extremely difficult given the complexity and consistently changing nature of the situation across the globe.

The second micro related impact is labour and wage inflation, an area where we are far more cautious. Following the October non-farm payrolls report, the overall number of jobs remains around 4.2million below pre-COVID levels with job openings remaining at near record highs. Following the pandemic, data has shown that a lot of people have opted to take early retirement or have decided to leave the workforce due to COVID. Given the step change in wages over the last six to twelve months, individuals who previously had to work two jobs have been able to reduce this to only one job given the much

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better wage environment enabling them to earn the same amount of money as they did pre-COVID. Despite seeing a decent rebound in October, labour in the leisure and hospitality industry remains chronically undersupplied with huge levels of job openings. The workforce is now in a much stronger bargaining position, switching jobs for better wages with relative ease given the demand for staff by companies. Two examples can be seen by Amazon recently stating that they are now having to pay wages of $18 per hour along with $3,000 sign on bonuses in order to attract and retain staff whilst union workers at Deere felt confident enough to reject an initial 10% wage increase offer as part of a new agreement. We believe that these wage increases will be sticky and continuous high inflation rates will lead to consumers believing that inflation will be around for longer, with expectations that their pay will need to continue to rise as a result. It is also worth remembering that real wage growth in the US remains in negative territory. One of our sell side research partners has indicated that around 6million people are currently sitting outside of the labour force due to COVID or because they are caring for someone who currently has COVID. The speed at which it takes for these people to return to the labour force, and if all this cohort even intend to return to the workforce, remains unknown.

Balanced against the points made above is the long-term themes and trends of factory automation, AI and robotics which are structurally deflationary. Whilst we appreciate that the major impact from this will not be felt in the near term, the current inflation backdrop and labour market dynamics are leading companies to invest heavily in these areas and “de labour” their own industry. This is a key theme within the portfolio which we play via stocks such as Nvidia, Keyence, AVEVA and Jack Henry just to name a few.

So how does all this factor into how we are positioning the portfolio? There have been interesting dynamics of late as we try to balance our views on both the macro and company outlook. Higher inflation should lead to higher yields which in turn has a negative impact on the growthier, higher valued stocks as higher rates impact DCF related driven price targets. Over the course of 2021 we have increased our exposure to financials to play the theme of higher rates and have maintained our position in gold miner Newmont as a traditional inflation hedge. Conversely, the more highly valued companies, such as Microsoft, have far greater pricing power and are more insulated from the supply chain dynamics and raw material/commodity cost inflation. Hence over the last month or so, this trade reasserted itself as pricing power and offsetting dynamics for the space have outweighed concerns over the move in rates. So far this year, rates have not moved as we have anticipated with the view that higher inflation would lead to higher yields yet to play out. Due to this, we are continuing with our balanced portfolio positioning and tailoring position sizes that may have larger exposure to inflation dynamics short term but that we still fundamentally believe in over the long term. For example, we have greatly reduced our position in off price retailer Burlington Stores due to a lack of pricing power limiting its ability to offset wage increases and supply chain cost inflation in the short term. On the other hand, we have maintained our position in Nike, a company which has great brand strength, the ability to drive full price sell through via its own DTC channels and is benefiting from continued strong consumer demand.

In the short term, as mentioned above, the element of inflation that concerns us most is wage pressures and the fact that the rental market inflation is likely to remain stickier. However, in the longer term, pressures in the labour market may be circumvented in our view by areas such as factory automation, robotics and AI which will lead to structural changes in the labour market due to these continued technological advances. As a result, the portfolio remains balanced to take account of the ongoing inflationary environment and the resulting headings along with companies whose progress will help offset these factors over the longer term.

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