JOHCM Funds

July 2021

Global Value and Income Dispatch

Inflation Now; Deflation Later?
And Aligning capital with Labor

2nd Quarter Update

- We see risk still skewed to higher rates and inflation but are on alert
- We have pulled back a touch from cyclical equities and saw value in convertible bonds
- With income inequality in focus, is it time to **align your capital with labor?**

Portfolio Executive Summary

The reflationary regime hit a speed bump as the June 16th FOMC meeting triggered hawkish policy concerns. Despite this, policy is likely to remain easy for years while strong growth and a surge in capital investment could create an echo of the 2000s. We see risk still skewed to higher rates and inflation but are on alert.

1. **Not all FOMC comments are created equal**
    - Regional reserve bank heads may grab headlines by railing against inflation and moving their dots, but policy is driven by the "Big-3"
    - Powell, Williams and Clarida will likely continue to be firmly committed to "Maximum Employment" and a broad-based and inclusive recovery
2. **The market may underestimate the Fed's commitment to Forward average inflation targets (FAITs)**
    - Markets fixated on recent strong inflation readings, however key drivers (such as used car, car rental and hotel & airline prices) should ebb
    - Inflation expectations moved down sharply in June. There may come a time when Fed will actually need to **talk inflation expectations back up!**
3. **The next decade's growth could be both real AND virtual**
    - We have barely reached base-camp on the journey to de-carbonize global supply chains. This will require massive investment of tangible capital.
    - De-globalization and de-densification (away from cities) can further support a future that features investments in both the cloud and in concrete

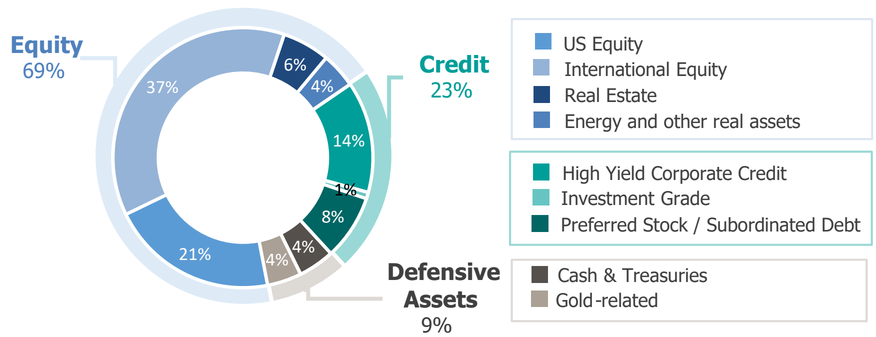
Current positioning and the competition for capital

With real interest rates still significantly negative and credit spreads tight, **traditional fixed income continues to struggle to compete for capital.** Instead, we see opportunities in event-driven credits and convertibles.

The portfolio remains skewed to equities, where we continue to have the chance to preserve and grow purchasing power should interest rates normalize further and inflation persist. We have pulled back a touch from cyclicals, as we saw value in some higher growth businesses (both in the form of equity and convertible debt investments) earlier in the quarter.

Current Allocation (as of 06/30/2021)

Subject to change without notice.

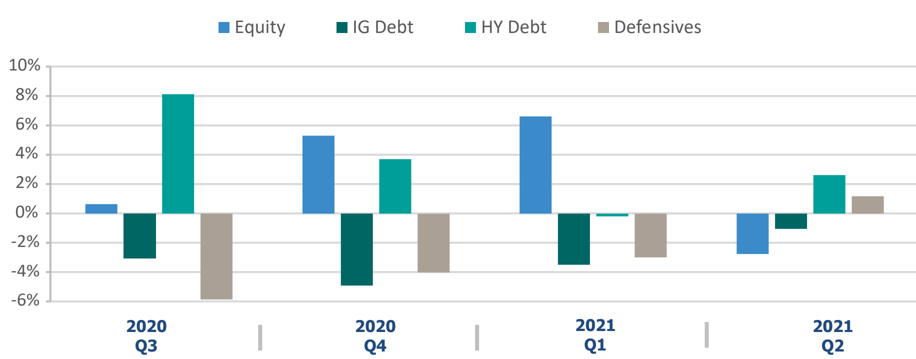


Source: JOHCM, as of June 30, 2021.

It is only once we are through the transitory inflation period that we will see how much underlying inflation exists

Regarding convertibles, a number of technology companies issued them earlier this year to take advantage of **elevated implied volatility levels**. The term **"0-up-50"** entered new-issue parlance to describe a convertible bond with a 0% coupon, but where the implied volatility was so high that the strike price at which the convertible would be in-the-money was still 50% (!) above the current share price.

Since then in various cases, **both** the implied volatility **and** the share price of the issuer have declined leading these converts to have a modestly positive yields for businesses that often have nearly enough cash on their balance sheets to pay off their debt entirely. These securities are near what we think are their "bond floor" values (the price where they would trade if they did not come with a call option) but still offer some upside participation should they underlying share prices increase. While these are not quite free options they are certainly cheap ones.



Source: JOHCM, as of June 30, 2021.

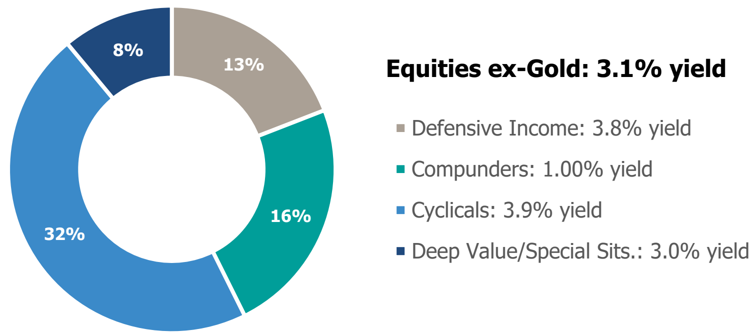
Stylistic positioning

At quarter end, stylistic exposure of equities remained pro-cyclical.

While the peak of Covid-19 recovery growth rates and inflation may indeed be behind us, the recent pullback in cyclicals and interest rates makes us feel there is still value here. As long as the MRNA-vaccine firewall holds (it seems to continue to do so largely, even against the Delta-variant), the recurring variant scares have proved to be buying opportunities in the broader recovery trend.

It is only once we are through the transitory inflation period that we will see how much underlying inflation exists and how committed the Fed is to keeping inflation **higher** than 2%, as they have indicated.

Equity holdings and LTM yield grouped by style



Sources Bloomberg, JOHCM as June 30, 2021.

Are we heading "back to the future" of Disinflation?

With the exception of years of Chinese-stimulus driven growth early in the past decade, post-Global Financial Crisis markets have featured a strong disinflationary trend. Productivity improvements and technological innovation created a climate where capital was rewarded, labor had limited sway and falling interest rates drove asset value for stable earnings streams ever higher. Inflation has consistently undershot the 2% target used by the ECB and the US Fed.

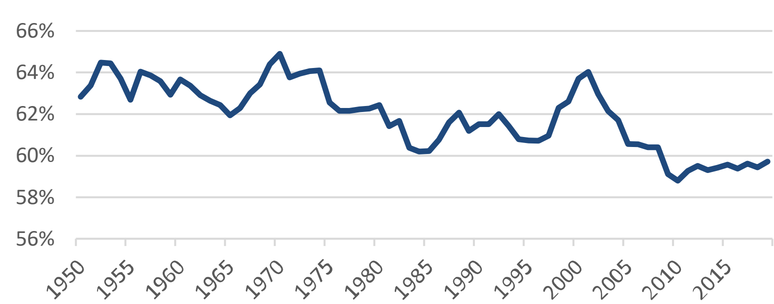
To paraphrase Newton's first law, unless there is a new force to be reckoned with, it is reasonable to assume that the long term dis-inflationary trend may reassert itself. Technology and automation continue to improve and there are still many benefits to reap from AI, data science and the transition to the cloud.

The 3Ds of de-carbonization, de-globalization and de-densification could provide the force that nudges up inflation

However, the 3Ds of de-carbonization, de-globalization and de-densification could provide the force that nudges up inflation, especially when paired with pro-inflationary Central Bank policies such as average inflation targeting now from both the US Fed and the ECB.

The themes of employment and income inequality cut across virtually all of the inflationary pulses we see. Whether it is the US Fed's target of "Maximum Employment" or the stimulus implications of Europe's Green Deal or the 10 million green jobs heralded by President Biden's Build Back Better initiatives. The goal of many current fiscal and monetary policies seems to be to redress labor's loss of economic share during the past few decades as shown in the chart below.

Labor Share of GDP



Source: JOHCM, St. Louis Fed.

Align your capital with labor?

We believe in fair wages, but we are also stewards of capital and it is our charge to seek to preserve and grow purchasing power over the long term and across different economic regimes.

We are finding that – in order to achieve these goals in the current environment – we are increasingly aligning capital with these pro-labor policies.

Whether it is copper or semi-conductors that will enable de-carbonization, the cement and aggregates that will build infrastructure or the financial businesses that can benefit from the steepening yield curve that could ensue should the Fed's FAIT indeed lead the economy to run persistently a bit hotter in the years to come, we are seeing this theme in many incarnations.

Should this policy-driven, reflationary environment persist, capital may need to shake hands with labor

Closing thoughts

#1 Risks for rates, growth and inflation still skew positive in our view

- While, deflation and Delta Variant fears could certainly have contributed to the recent decline in bond yields, technical factors and lack of net supply may also have fueled the bond rally
- Fed policy remains accommodative and the jury is still out on whether there have been shifts in the reaction function
- Variants scares have proved to be buying opportunities. We are eyes wide open, but thus far the MRNA firewall continues to hold

#2 Price doesn't mean what it used to

- Market structure has changed. With momentum, quant and trend following strategies abounding, we should be less surprised by violent moves and reversals in today's new markets
- As we go to press, the trend in bond yields remains firmly upward, though one might no know given the lurching back and forth

#3 Don't fight the … Zeitgeist?

- Pro-labor / pro-employment policies seem to be entrenching themselves in the post-Covid-19 Zeitgeist
- Should this policy-driven, reflationary environment persist, capital may need to shake hands with labor. Rather than competing, these long time adversaries can perhaps coexist and make each other better