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Brummer Virtual Talks April 2021:

Will Li on a holistic view of inflation and the cost of capital

In the latest installation of Brummer Virtual Talks, Brummer Multi-Strategy's Head of Research Kerim Celebi speaks with Will Li, Co-Founder and Managing Director at Arete Capital Partners.

Born and raised in China and educated in the United States, Li has been based in Hong Kong for more than 15 years. He founded Arete Capital Partners in 2012 where he manages the Arete Macro Fund, a global macro strategy fund focusing on China and the rest of Asia.

Li is the first to admit his views of the market aren't always in line with the mainstream, not least when it comes to inflation.

"I tend to think from a contrarian and unorthodox angle when I can," he says.

Li believes that consumer price inflation, while important, sometimes takes up too much bandwidth in discussions about inflation.

"Policymakers tend to be singularly focused on consumer price inflation, which may not in fact be the only key driver of economic harmony and success in the world," he says.

Asset price inflation

He points out that the consumer price basket contains many goods which "aren't that scarce anymore". Rather, Li preaches what he refers to as a more "holistic" approach to inflation that also incorporates asset price inflation.

"It's equally important to pay close attention to asset price inflation and its wealth effects," he explains.

"The costs of housing, your equity portfolio, and other assets also affect spending."

Consumers, Li explains, may be more willing to spend money when they feel their home value is rising. But if they have a more pessimistic outlook about the value of their assets, consumers tend to be much for frugal.

Furthermore, uncontrolled asset price growth ultimately can lead to a lot of "dislocation" in the economy, he adds.

As evidence, he cites the 2008 financial crisis, which was precipitated by inflated US home prices fueled by various schemes to make financing easier. Easy borrowing brought more participants into the market, resulting in artificially high prices which eventually came crashing down, causing a deep recession.

"We ended up seeing dramatic dislocation and a very deep impact on the global economy and on the lives of economic participants," he says.

Consumer price inflation

Li sees the significance of equity valuations for entrepreneurial start-ups as further evidence of the importance of considering asset price inflation. New companies' hiring plans and capital expenditures – as well as options-based employee compensation schemes – are all tied to start-ups' equity valuations.

"Today, asset inflation has just as important an impact on the fundamentals and smooth functioning of the real economy as consumer inflation," he concludes.

And when it comes to consumer inflation, Li believes it remains largely in check as so many of the components in the consumer price basket are actually declining in cost due to technological innovations. In the agriculture sector for example, advances in genetics continue to increase productivity, while AI is helping streamline customer service in the retail and other consumer sectors.

Costs that are rising, such as bespoke education and healthcare, are not included in the consumer price basket.

"But even more importantly, asset prices are not included in the basket," Li warns.

"And if you are a young person trying to buy a home, you are acutely aware of how asset price inflation impacts your livelihood. And this can in turn impact the social harmony that governments strive to foster in societies."

Interest rate disconnect

When it comes to interest rates, Li agrees there is a bit of disconnect between the market and the US Federal Reserve. On the one hand, the market is pricing in up to four interest rate hikes by the end of 2023. On the other hand, the Fed's Average Inflation Target indicates a more reactive approach to rate hikes.

Li believes the market is likely being a "a little too vigilante", while the Fed has been clear it wants to run the economy "hotter", indicating its intention to be "behind the curve" when responding to inflation.

He explains that the front-end of his portfolio's bet is based on the assumption that the Fed's dot plots are probably closer to what may actually transpire. The back-end of the curve is driven by inflation expectations and term premium, which is in turn driven by volatility.

"With the front-end really anchored by the Fed there is a chance that the back-end volatility will increase and therefor increase the term premium," Li explains.

"Increasing risk, including term premium, and increasing inflation expectations may lead to a further steepening of the yield curve. So our current view is that we're still seeing more curve steepening on the US dollar rates."

The Fed's next moves

While the Bank of Japan has resorted to yield curve control as a tool to stimulate the economy, Li points out that Japan faces a unique demographic situation with a rapidly ageing population. The Fed, on the other hand, has ruled out yield curve control, a decision Li believes is the right one.

He explains the ideal situation is one with a healthy rise of longer-term yields.

"This indicates improved economic fundamentals and potential for organic growth as well as a more harmonious society and a less distorted economic structure," he says.

"But because of the tremendous amount of debt, the system is fragile. The Fed is watching all the economic indicators and will respond – and the overall direction is that they want to exit from the current regime at some point." Li says.

"Rising longer-term yields also promote a sound rise in inflation expectations and a rising risk premium, with a vigilante effect on too much leverage and too many excesses in the financial markets."

Li admits he has concerns about the potential for negative effects on the economy and financial markets as the Fed considers steps such as tapering its quantitative easing (QE) or potential rate hikes to normalize the situation.

"This is one of the key worries," he says,

"Governments have taken on a tremendous amount of debt to deal with the after-effects of the global financial crisis and to fight the Covid pandemic. There is so much debt that a small increase in yields could make debts very costly to service, which would entail raising new debt that also needs to be paid back."

It's important that inflation not be too low, Li adds. But if government income can grow faster thanks to higher inflation, that can be a path for resolving the debt burden.

"Obviously, it's a very delicate process to manage a smooth transitioning out of the current regime," he says.

"But at least theoretically, higher inflation leads to less debt burden for people, for companies, and for governments as well."

Ultimately, Li believes the Fed will likely stick to its average inflation targeting regime. This will result in realized inflation rising slightly, leading government income to increase faster than government obligations on debt services.

"That's one theoretical path out of the current dilemma," he explains.

"But because of the tremendous amount of debt, the system is fragile. The Fed is watching all the economic indicators and will respond – and the overall direction is that they want to exit from the current regime at some point."

Portfolio and positioning

When asked about current thinking for the Arete Macro Fund portfolio, Li highlights that after four decades of declining costs of capital, an "inflection point" may have arrived that will shift things in the opposite direction, resulting in an upward trend.

He adds it's important when considering the costs of capital to go beyond interest rates and to include volatility and inflation expectations we well. More than a decade of loose monetary policies since the global financial crisis has also resulted in too much borrowing of cheap capital from future generations.

"Thus, we believe that if this rising cost of capital can continue at a smooth pace, it can be very beneficial for social harmony, peace and demand across the globe," says Li.

"You don't want the cost of capital or cost of labor to be too cheap, however, as that leads to distortion and uneven developments."

While the potential rise in the cost of capital is a longer-term trend, Li generally takes shorter term catalysts into account when making specific trades or taking positions in different asset classes.

"The most direct way to play this is through a US dollar rate steepener, a position we've had since last October," he says.

"And we still think there is more room for the curve to steepen."

Li has also chosen to rebalance slightly away from long-duration assets like fast-growing companies with high valuations towards shorter-duration assets such as cheaper companies with good profitability.

"We take long-term positions through macro frameworks, combined with shorter-term catalysts which take the supply and demand situation into consideration," he explains.

"Idiosyncratic factors for each position are also key."

Generating strong risk adjusted returns entails marrying top-down, long-term themes with short-term catalysts, idiosyncratic factors, and solid risk control. And the rising cost of capital in the medium to long term may continue to weigh on long-duration assets like growth stocks. However, value and cyclicals might benefit from the current inflationary environment.

And when it comes to fixed income, US steepener positions likely have more room to run. However, it's also always important to be open minded and flexible and ready to shift gears in light of new evidence.

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