CIO Roundtable

EPISODE 2 TRANSCRIPT

Inflation, “Greenflation” and Tech Regulation

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Sid Ahl (00:00:00):

Welcome to the CIO Round Table. I'm Sid Ahl, the CIO of private client, endowments, and foundations at Brown Advisory.

As we enter the fourth quarter we wanted to drill down into one of the key themes of the year: inflation. We're also going to touch on some of the other major issues that may be top of mind for investors.

This includes China, where regulatory crackdowns and concerns about its real estate sector are weighing on not just the country, but emerging markets more broadly.

We're also going to look at the technology sector, where some high-profile tech giants may be facing increased regulatory scrutiny ahead. As the COVID crisis recedes somewhat, lawmakers around the world may be using newfound bandwidth to revisit tech regulation.

To help answer these questions I'm joined by Thom Graff, the head of fixed income at Brown Advisory and our resident macro expert, Erika Pagel, the CIO of our sustainable investing business, who brings a unique ESG lens to investing here at Brown Advisory, and I'm also excited to have Lauren Cahalan, an investigative analyst at Brown Advisory, who will tell us a little bit more about her role as an investigative analyst and shed some lights on the developments in the tech sector.

But let's start with a recap of what is one of the most defining themes of the year: inflation. Earlier in the year inflation expectations reached levels not seen in decades as several trends combined. We had highly effective vaccines arriving sooner than many thought, which set the stage for an economic reopening. We had historic fiscal stimulus and even more aggressive monetary stimulus from the Federal Reserve with their new average inflation targeting policy. We had pandemic related supply chain disruptions and labor shortages that have curtailed the supply of goods and services just as demand was taking off. And we had record demand for goods, as people have cut their travel and leisure spending as a result of COVID.

We acknowledged then that inflation was likely to remain elevated for some period of time and we made changes to portfolios. We reduced our exposure to rising interest rates by shortening the duration in our bond portfolios. We shifted some exposure from high growth stocks to less interest rate sensitive value stocks. And we increased our exposure to cash flow generating real estate and infrastructure assets, which could help protect us from rising inflation.

We noted that many of these pressures might be transitory, self-correcting spikes in per prices that would be met with increased supplies of goods as supply changes were mended, and potentially a shift in demand from goods to services, but we still took a cautious approach.

We stopped short of recommending investments in commodities and precious metals that typically perform well in periods of heightened inflation, because we didn't expect to inflation to rise into the danger zone of 5% plus, which typically leads to poor performance for stock markets and great performance for commodities. In the case of gold, that's worked out. It's down on the year. But broader baskets of commodities have risen 30 to 40%. While some markets like lumber and soy have cooled as supplies increased and demand has fallen and supply chain issues have been worked out, other markets have actually been heating up and there are rising concerns that supply chain issues could last well into next year, and maybe even 2023.

Some examples of this are in the UK where natural gas prices are up 400% this year, thanks to weak wind power generation and other factors that have pushed up demand for gas, combined with shallow supplies from the UK's 'just in time approach' to gas delivery.

Meanwhile, transit times for goods from Shanghai to Chicago has doubled from 35 to over 70 days due to port congestion driven by demand for goods and shortages of labor. Those factors have led to a 300% increase in shipping costs and are expected to linger well into 2022. And meanwhile, agricultural commodity prices from coffee to cotton have risen 40 to 50%.

Thus far stock markets have been relatively unphased by these moves. Global stocks are up 16%. The S&P 500 is up over 20% this year as we're recording this in late October. And perhaps this is because these are all viewed as transitory inflationary pressures, but are they? Which businesses can navigate this volatile price environment and which can't? Which asset classes should we be leaning into and out of?

As we kick off the fourth quarter, we wanted to examine how the inflationary landscape has evolved in recent months and how it's affecting the positioning of our client portfolios. So, let's dive right in. Tom, I'll start with you. How transitory does inflation seem to you now? What's changed in the last few months and how has your view evolved?

Thomas Graff (00:04:39):

Yeah, Sid, I think six months ago it was a little easier to call the inflation we were seeing transitory when it was primarily driven by things like used cars spiking by 10% in a month and airline tickets being sold out from people desperate to travel.

But in the last six months inflation's really broadened out. So, you could look at measures like the median CPI, which takes the sort of single item that's at the center of the CPI report, and that's a 3.7% pace in the last six months. Or you could take a similar measure, which is the trim mean PCE, which sort of takes out the fastest rising items and measures where everything else is, and that's at 2.6%. So, one of the most recent CPI reports overall was 5.4, certainly a number that high is transitory, but that inflation is probably running higher than it was before COVID, probably not transitory.

Sid Ahl (00:05:42):

So, you made a statement there which I'd love to dig into. You think a 5.4% number will definitely be transitory. Would you kind of stand behind that as a comment?

Thomas Graff (00:05:54):

Yeah. Because I think if you dive deep into the numbers, there's just a lot of things that, as you mentioned earlier, as either supply responds to higher prices, or just as kind of demand spikes peter out in this kind of post COVID period, there ought to be some normalization of those prices. And then it's what's left over, and that has to do with what kinds of trends demand can withstand. What are consumer incomes? What is the flexibility of supply chains and the like?

Sid Ahl (00:06:31):

And so, you mentioned supply chains a few times. Has it surprised you how long it's taking to resolve some of these supply chain issues? And is that the factor that's leading to this broadening out of inflation? Or is it more on the labor side?

Thomas Graff (00:06:48):

Well, what's tricky, Sid, is supply chain isn't a black and white thing. Calling something a supply chain issue is not a black and white thing. So, for there to be a circumstance where there's not enough supply to go around, that implies there's too much demand for the amount of supply we have. And so I think if we were to survey all the various goods that are rising at an above average pace, we would probably find most them have a supply issue, but most of them also have demand that's running hotter than was true pre-COVID.

And so, I think it's probably more helpful for investors to focus on the demand side, because in most cases supply will adjust to the extent it can, and then it's a matter of whether demand is still so hot that it's pushing prices up.

So, I know that's a long way of saying ... I don't know that I'm surprised that the supply chains haven't righted themselves. What I'm sort of surprised by is that demand, even as sort of stimulus has waned and whatnot, that demand has remained this hot.

Sid Ahl (00:07:59):

I think it's interesting you bring up the demand side of the equation. I recently wrote in a blog post about the port of Los Angeles, we've got these 65 plus ships that are waiting to be unloaded. And part of that is an issue of labor, but part of that is an issue of just demand. Container volumes are up 30% year over year.

I wanted to quickly ask you because it's become a topic du jour, are we headed for stagflation? A toxic combination of slowing economic growth, higher unemployment, alongside inflation. What do you make of people who say we're headed for stagflation?

Thomas Graff (00:08:43):

I think that's kind of taking two points on a trend line and just drawing it too far. Because I think what's going on is that economic activity is slowing from a torrid pace this summer. The summer was the combination of items you mentioned, sort of this large stimulus and the vaccines coming online, and everybody's like, finally, I can get out of the house.

And as that torrid pace has diminished, or is in the process of diminishing, we're going to have certain numbers slow down. You're going to have retail slow down a little, you're going to have GDP in general slow down a little, and the like.

But that's different than what we normally think of as slowing. Normally when we've seen those kinds of things happen, we're transitioning from an expansionary phase to a contractionary phase. Here we're probably just transitioning from a spike to a normal. And so I think what we should really focus on is, what does normal look like? Let's not get over excited by just the fact that the last two points seem to be pointing down.

Sid Ahl (00:09:49):

Well, let me transition for a moment then to the labor situation, because I know you and I have talked about how surprising some of the statistics have been in terms of labor force participation. People aren't coming back to work to meet the unmet job need, in America at least, the way that we might have thought. Is something structurally changing in the labor market in the US? And is this something that could put continued pressure on both inflation and perhaps constrain growth in the years to come?

Thomas Graff (00:10:23):

Yeah. I think you've got to conclude that it has to be. So, as you said, you and I have had this conversation. 12 months ago, I would've guessed that labor force participation would've rebounded a good bit, particularly if I knew how high or how hot the wage market was going to be, but we just haven't seen it. And even though at this point the expanded unemployment benefits have fallen away, school has started, sort of all the excuses we might have given for why folks were waiting to come back into the workforce, they've kind of come and gone. And so I think we've just got to look at the data and listen to what the data is telling us, that something structural has changed.

Now, what's most likely here is that there's some amount of people who work ... Maybe there were two income houses and one person has decided to stay home with the kids. Maybe someone got an early retirement package during the COVID era and decided they're hanging it up. I don't know what proportion those are. If you dig into the data there's no smoking gun for those things.

But I think for investors what we ought to focus on is the labor market we see now is probably going to be the labor market for the foreseeable future. So, when we're thinking about margins, when we're thinking about wage growth, when we're thinking about all these things, we should just assume it's going to be tough to hire people, and it's going to be expensive to hire people.

Sid Ahl (00:11:50):

That's helpful, thanks. Let me turn it to Erika right now and talk about one of the other drivers, or potential drivers, of inflation. And maybe you could start by you first defining what is greenflation?

Erika Pagel (00:12:02):

Yes. The greenification of economic investment terminologies. There's greenomics, there's greenium, which is actually the greening of commodities, and then we also have greenflation, which is, will moving to a more sustainable future result in rising costs? Will green technologies and materials lead to sustained price increases throughout the supply chain? And regulation and low carbon emission and targets, some believe are creating increased demand for products and limited supply. Several commodities that are used in renewable energy technologies like solar, wind, or electric vehicles. If you look at aluminum, it's up more than 50%. Copper, up more than 30%. Lithium, used in batteries and other technologies is up more than 300%.

But it's not just renewable energy demand that is driving several of these input costs higher. So, if you look at oil and natural gas, prices are spiking recently. For that, its production levels. Remember, oil went negative at the beginning of the pandemic. So, did electricity prices in some regions of the world. Production was stalled in some places. Production was cut. And it hasn't yet picked up. There are governments and organizations that could also help intervene and help stabilize the market. And then there's other areas that are impacting price. There's the surge demand from the reopening from the pandemic, a broad shift away from coal and falling inventories. So broadly, the supply chain is stretched. Rising energy prices, which we know they can have short term ripple effects globally for governments, for companies, for consumers.

Sid Ahl (00:14:03):

So, lots of other drivers, other than just the transition. And I know we've talked about this in the past, you do expect the transition, perhaps could bring more volatility. It'll be a bumpy ride. Could you talk a little bit though, about the long-term deflationary impacts of shifting to renewable energy?

Erika Pagel (00:14:20):

So, on the flip side, higher traditional energy prices might be exactly what is needed to increase innovation and to continue to accelerate that energy transition. These higher prices may also make forms of renewable energy more attractive. But as you mentioned, there is going to be volatility. Wind and solar are at the mercy of mother nature. They are weather dependent.

The International Renewable Energy Agency reported last year that more than 60% of all of the added renewable energy generation had a lower cost than the cheapest fossil fuel option. So, technology innovation could help the cost curve and drive lower prices over time. It's a technology decarbonization learning curve, if you will. As innovation drives usage or capacity, there's often a tipping point that results in a declining cost curve and a deflationary environment.

And we've seen that in solar. The price of solar modules declined steadily since 2010 as new scalable technologies were introduced. From 2009 to 2019, that cost of electricity from new solar plants actually declined 90%. If you look at that cost of electricity from wind, it was down 70%. And during this time coal was pretty stable. So, the question is, energy prices could possibly be even a higher today if it were not for those renewable options that we have.

Sid Ahl (00:15:55):

That's a really good point. And when you kind of think about that, project that out five years, ten years, the cost of extracting natural resources staying stable or mirrors the cost of extracting natural resources, staying stable or increasing, certainly in the case of oil, we're going, farther and farther out into the ocean, drilling deeper and deeper at more expensive levels. And as the cost curve's coming down for renewables, you'd imagine that could eventually have a deflationary impact.

Maybe I could shift gear years and ask a little bit about what's going on in the semiconductor market right now. We hear a lot about chip shortages and the impact on inflation. And some of that is the electrification of vehicles, but what else is impacting this shortage in your mind, Erica and Tom as well? And how persistent could that impact be?

Erika Pagel (00:16:46):

Right. So where are the chips? It's been very well publicized, the shortages of semiconductor chips or microchips, and the impact on the auto industry, which you highlighted. However, these chips are actually used in a large range of products, right? So, computers, kitchen appliances. And then as a major input in the digital part of our economy. Areas like mobile devices. And so, last year we saw a spike in at home technology, that drove the initial disruptions in the industry. Production then ramped up, but it still has not been able to meet demand. There's overseas producers, several of which have had their own drawbacks recently. There's been power outages and fires, and that's only exacerbated a very fragile supply chain. Intel estimates that semiconductors will account for over 20% of the input costs for new premium cars. That's up from 4% in 2019. Companies like Taiwan Semiconductor, they're spending on CapEx to increase their production capacity and build new facilities.

So, in autos specifically, the production gap of new cars has led to a surge in used car prices this year. Tom mentioned earlier that more than or nearly two thirds of headline inflation over the past year has been driven by a few areas; fuel, used vehicles, travel related components.

However, in recent months, prices of rent and food are larger components of household expenditures. We've seen that on the rise. And now we have energy costs that are rising. So, we're seeing inflation pressures across the supply chain and bottlenecks, but the impact of semiconductors, it's not only on auto manufacturers. There's many other industries that are being impacted.

Sid Ahl (00:18:50):

Makes me think of what we've been talking a lot about in terms of business quality and the pricing power that you have. As we talk about semiconductors, thinking about a company like Taiwan Semiconductor that we own, and lots of our external managers own and the kind of position that they've been in right now in this market, to provide mission critical services, raise price, maintain, and even expand their margins.

Maybe Tom, I could go back to you and just ask, what role consumer behavior and mindset plays in inflation? We talk about this, it's a monetary issue, but it's also just are consumers going to believe that goods won't be available or they're going to cost a lot more in the future, so they're going to rush out and buy things today? I think of conversations I've had recently with grandparents in our families looking in September for Christmas present ideas, because they're worried there won't be anything left on Amazon. How close are we to this bleeding into mindset? And how important is that?

Thomas Graff (00:19:51):

Well, I mean, grandparents don't want to show up to Christmas empty handed, that's for sure. Consumer behavior absolute matters. And so, there's sort of a psychological element to it. Economists have long said that inflation expectations are somewhat self-fulfilling. That may be a reason why inflation stayed so low in the post financial crisis expansion. So, if that reverses, that certainly matters.

I think just as important though, is sort of how consumers feel about their own income and their own ability to spend. Because really, we can talk about the supply chains and the cost push pressures and all those things, but if consumers don't have the income to spend, then companies can't raise prices. And so, we're looking carefully at both wage growth, as well as kind of overall consumer income. We ran recently total household disposal income minus government transfers, has risen at about a 7% pace the last six months. That's versus only 4% in the 2014 to 2019 period. So, consumers, if they feel flush, plus they feel like, "I better get my stuff while I can," that's definitely an inflationary mindset.

Sid Ahl (00:21:18):

So maybe we could talk a little bit about what could relieve some of the inflationary pressure here. I mean, one of the things that we noticed is inflationary pressures and interest rates were falling in the second quarter and into the summer. And one of the things that happened was we had a spike in COVID cases. We had the Delta variant and that probably delayed some of the shift from spending on goods, which are clogging the ports all over the country to services. And so, we saw things kind of worsen. Obviously, cases are now down in the U.S. by 50% from peak levels. Theoretically, there may be more of that shift we've been waiting for from spending on goods to services. What are other things that could provide a little bit of relief?

Thomas Graff (00:22:07):

Well, in the short term, we already mentioned that there's probably going to be some burn off of some sort of special cases. So, from a kind of measurement perspective, there'll be some natural decline. More importantly to think about that pressure that you mentioned. And look, I've said a few times, this is the weirdest recovery of all time. So, it's got a combination of items we've never seen before. Obviously, there's the pandemic issues, but there's also sort of the treatment of policy. The Federal Reserve is going into this with a different attitude towards inflation than we've ever had before. And so, it could be that the most important force that has been holding down inflation for the prior 30 years was things that are endemic, like globalization and technology and whatnot. And maybe that stuff just naturally takes over and pulls inflation back down into the mid ones or so. But if it really was an expectations thing and if a different kind of policy and a different consumer mentality and more income changes the mentality, well, then that'll be pretty different.

Sid Ahl (00:23:15):

I was just going to say, I'm not getting a lot of confidence here. This doesn't sound like we have a lot of countervailing trends.

Thomas Graff (00:23:24):

But I think in the long run, there is some great news. And that is companies aren't going to just sit back and do nothing in the face of all these supply chain challenges. And then frankly, just the difficulties of getting enough labor. They're going to invest in strengthening their supply chains, making them more resilient to change. And then also probably productivity enhancing investments, that can help reduce the need for labor. And that's great news. We had a sharp underinvestment in CapEx in the prior decade. And so, the combination of some of the things Erica mentioned. So, sort of greenification of a lot of our economy, plus this improvement in resilience and improvement in productivity caused a CapEx boom, that's an incredibly bullish thing, probably both for markets, but also certainly for the real economy.

Sid Ahl (00:24:23):

So, we've heard this from some of our internal analysts here, especially those on our industrials team, in quarterly conference calls this quarter, management teams talking about increasing meaningfully their investments. So this CapEx boom idea. I'm curious, Erica, what you would have to share on a kind of company level or broadly, an industry level, in terms of that.

Erika Pagel (00:24:49):

Yeah. CapEx is an indicator of a company's future focus. And spending took a big hit in the first two quarters of last year. And we are seeing a pickup in investment. Many industry experts estimate that the rise will be the largest since the great financial crisis. Interest rates have allowed companies to borrow more and companies have cash. Consumer spending started the recovery and capital investment should help drive and sustain economic growth going forward. Amazon is a great example. They announced last year that they ramped up investments in their logistics.

And then, we'll probably see more ESG CapEx. Many companies in carbon intensive industries are sinking meaningful CapEx into climate mitigation. So, what is that? That's structural improvements to operations. It's finding ways to transform products and services.

And going back to auto companies, several manufacturers have announced transformative forays into EV or electric vehicle production. Bloomberg actually recently reported that several have pledged approximately half of their long-term R&D and CapEx budgets on EVs or other digital initiatives. So, the likes there are Volkswagen, GM, and Ford.

So right now, it's a little bit like leapfrog. As soon as one player jumps in, in an industry, others will likely follow.

Sid Ahl (00:26:22):

When I think about inflation being persistent, I wonder how it's going to impact markets. Clearly, rising inflation, rising rates, not good for duration and fixed income portfolios. It could pose a risk to valuations, especially in the higher growth end of the market, who are also just worried about lower quality businesses that don't have pricing power, seeing a margin impact. I'll admit, I've been a little pleasantly surprised as we're not quite a quarter of the way through earning season, but we've seen a pretty strong earning season for the S&P. Margins are holding in there. We've seen more than 80% of companies beating expectations. We've seen stocks seemingly respond relatively well. But what are the things that you're worried about right now, Erica, if inflation is more persistent, if this lasts not 12 months or 24 months, but perhaps even longer, and what might you do about it?

Erika Pagel (00:27:25):

Yeah. The question is, first, what's been winning? What's been losing with the inflation that we've started to see, and how persistent will it be? This is an extraordinary time. The bull market just keeps expanding. And over the past year, you've seen growth companies that have had significant appreciation on improving fundamentals, but then they've also benefited from a low rate environment. And then as news of a vaccine surfaced early last fall, you started to see the cyclical recovery. And there's so much conversation right now about inflation, but the markets overall do not seem that phased. But the reality is inflation has been a winning trade this year. So, we've talked a lot about commodities. We've talked about value in more cyclical companies. Energy financials in real estate are the top performing sectors this year.

If you look at small cap, an area that was particularly hard-hit last year at the onset of the pandemic, the small cap value, Russell 2000 value, it's outpaced growth now by about 20%.

And other areas that might be more traditional, buying gold, that has not held up from a return standpoint. Bitcoin or what some actually called digital gold. That's also been volatile. These are two places that are really focused on supply and demand. So absolutely, right now, the focus is on earning season. What will the rest of the year look like, how will companies be able to pass through price increases, as well as offset higher wage costs, and mitigate some of these bottlenecks.

And the biggest thing that we're seeing right now is a focus on margins. And the good news, is the underlying fundamentals that a lot of these companies that have reported so far, they seem strong. That momentum has continued from the first and second quarter of this year. And so far margins, yes, they're being impacted. I think most, if not many companies, are citing all of these issues we're talking at about, but they've been able to offset them and acquire either through pricing or leverage within their financials.

Sid Ahl (00:29:44):

So, you've seen some really high-quality companies. I think about Microsoft, just announced they're raising price for the first time meaningfully in nearly a decade, kind of 15% across the board. We saw Fastenal, industrial company that we own, raising price and actually increasing their margins. This quarter, I talked about Taiwan Semiconductor, some really high-quality technology, industrial businesses being able to deal with this environment. Well, what companies or industries do you think will continue to struggle?

Erika Pagel (00:30:22):

Pricing power is not the easiest to measure, right? How much above marginal costs can a company sell a product without negatively impacting volume or market share? So, what we're looking for are companies that have those strong underlying fundamentals, strong cash flow, strong balance sheet, and that they can manage through this margin pressure. So, as you mentioned, Microsoft, they recently announced that it would increase prices next year. They've cut subscription pricing, pretty stable for several years, but then we've also seen it in payment processing. So, Visa, MasterCard, they also announced that they intend to raise prices next year. We're also seeing, with supply chain shortages in freight and trucking, there's some near-term price bumps that are happening in certain industries. So, a few transportation companies are now marking up rates. We've also seen some packaged goods and retailers preannounce on margin pressure and revised guidance, specifically pointing to higher cost.

And this is a time where we think that quality should win. High quality, large caps continue to outperform. Investors right now, are seemingly willing to give a pass for slightly lower margins in order to own quality. And there's not a lot of places to go right now. And what we've seen so far in third quarter earnings is that they're coming in better than feared.

And then, if you take a look at the consumer, don't forget, the past year has been buying double of everything, right? So, you go to the grocery store, instead of buying one double of everything. Right? So, you go to the grocery store instead of buying one toothpaste, you buy a package of two, or maybe you buy two or three packages just in case. Right?

And so, when is some of that double purchasing or I guess, we're all now in a hoarding behavior mentality, when does that ease? And is that going to last your year end? And, will we see some of that ease next year?

Sid Ahl (00:32:24):

I think the pictures that we all see circulating online of empty shelf space in grocery stores, the US and the UK, and elsewhere, would suggest it's not over yet, but hopefully will be soon.

Another place that we've been hiding out in portfolios, or investing in, to try to protect act against inflation is real estate and infrastructure. Maybe you could talk a little bit about what you find as the appeal of those asset classes in a time like this?

Erika Pagel (00:32:51):

The S&P is striking distance to all-time highs, valuations in many areas are extended, and there's a lot riding on low rates and accommodative central. And, in a scenario where there's increasing growth and a moderate rise in interest rates, equities can actually be an effective way to hedge inflation. But there are headwinds which we've talked about today.

And as a result, we've been emphasizing diversification within portfolios. And for many clients, we have an alternative bucket or allocation. And what we've focused that area on particularly over the past year, year and a half, is a search for income. How can we supplement a part of a client stability or fixed income allocation? But also, as a way to offset any equity market volatility and potential inflation.

So, over the past year, we've recommended a global listed infrastructure portfolio, but we've also recommended some more liquid real estate options for client portfolios. And specifically, in real estate, we like the consistent cash flows. The strategies that have really garnered our attention are those that are focused more on multifamily, as well as industrial.

So, apartments and warehouses, as opposed to long office leases. But that consistent cash yield, or cash flow, has been attractive in this pretty much nominal income environment that we're seeing at a fixed income.

Sid Ahl (00:34:23):

Speaking of the nominal environment out of fixed income, maybe I'll kick it to Tom for a second. We were talking about this the other day, noting that the inflation adjusted yield on the 10-year bond is basically at record lows, minus 1%. And I'll put you on the spot a little bit.

I know you've mentioned that your recommendation for clients is to have as little fixed income in portfolios as they would need to provide the kind of diversification and liquidity, and protection, that they desire. Maybe you could expand on that or correct me if I've gotten that wrong.

Thomas Graff (00:35:02):

I know that might sound a little weird coming out of the mouth of the bond guy. But first of all, knowledge, real yields on treasury bonds are basically at all-time lows. And so, after adjusting for expected inflation, not just the inflation we see right now, but expected inflation over the long term, you're getting less out of fixed income than ever.

But actually, that doesn't figure that much into when I say that you probably ought to minimize fixed income that much, because in general, the safety assets that a client has, has opportunity cost. Maybe the opportunity cost is somewhat higher right now than normal. But, regardless the client ought to think about how much liquidity, how much absolute safety do they need? Make sure that that allocation fits that bill within reason.

But then make that as small as possible because everything else you're going to invest in probably makes more money. And if you have that, a solid liquid allocation, that kind of buys you freedom to do some of these other things that you and Erica have been talking about; some less liquid stuff or more volatile stuff that can have more upside.

It sort of buys you not just the liquidity, but the time to sort of live through that variant. So, we're going to be here for you, but we should be a pretty small percentage of your portfolio.

Sid Ahl (00:36:30):

We know you'll always be here for us, Tom. We're certainly not advising people to give up on fixed income in their portfolio, right? I mean, I would note, I've seen so much capital flowing into real estate and private credit.

We've seen a real institutional shift, structurally, reducing fixed income and adding to these asset classes, and, we're seeing an impact on pricing, right? Cap rates are coming down in real estate, and rates are coming down in private credit so that we need to apply more leverage in order to get the same return.

Risks are building and valuations are increasing. And so, the operating bucket that we talk about, of liquidity that you need to meet multiple years' worth of spending and be calm in times of market stress is still incredibly important. So, we're not leaving you, Tom.

Thomas Graff (00:37:21):

That's good. I'm not leaving you either.

Sid Ahl (00:37:23):

While I'm chatting with you, I'd like to shift away from inflation and just talk about another big story of the day, which is what's going on in China. We're not going to talk about the regulatory crackdown here and the disappearance of Jack Ma and so on and so forth. But I'd like to talk about this distress at the country's largest property developer Evergrande. And just, could you talk a little bit about it?

It's the biggest property developer in China? The bonds are trading at 20 cents on the dollar. There's worry that this could become a little disorderly. What impact could this have on the markets?

Thomas Graff (00:37:59):

Well, it's funny, sort of. It seemed just a few days before the quarter end that it was going to be one of the biggest stories of the quarter and it faded really quickly. But I think, it faded more as an acute immediate issue. Some people were talking about a Lehman moment, that probably never made sense. But that there could be some fundamental shift in how property development operates in China. But also how they kind of treat creditors. That could be pretty meaningful, just will take a little more time. It's healthy and probably a good step in China's kind of financial development to allow a bankruptcy to play out. So, that's good. But it's really not going to be without consternation. So, we've seen a lot of property developer bonds sell off as we try to figure out what this all means.

We'll say the wider kind of contagion has been very minimal. There's been some sell off in Chinese high yield more broadly, but even that has been fairly contained. And then there's been really no ripple elsewhere in credit markets. So, I think markets are properly viewing this as more of a, it's a local issue. There could be impacts on other companies if you sell into the Chinese property market, for sure. So, you're going to look at that.

But it doesn't seem to be this kind of global panic that, for a few days look like could be an issue. I mean, another interesting angle, this kind of China and then broader emerging markets issue is that with interest rate volatility picking up here as central banks start talking about hiking and the like, that's often coincided with foreign exchange volatility.

And often been most acute in emerging markets. We've seen some pressure in Turkey and Brazil. And so, Sid, what are we doing? How do you think that impacts client portfolios?

Sid Ahl (00:39:58):

It's a good question. I mean, certainly a stronger dollar has historically not been great for emerging markets. If we assume we're eventually going to start raising rates here. That's been part of the discussion for a while that the dollar could see some strength and put pressure on emerging markets currencies. We're seeing that pressure already.

I was looking at the Brazilian real the other day. We were at three to the dollar just a couple of years ago. We're nearing six now. And inflation rates there are approaching double digits and it's just put a lot of pressure on the stock market.

So, it's definitely impacting emerging markets in a negative way. You add on to that, we talked about Evergrande in China and the regulatory issues in China. I would just underscore that many global investors are taking a bit of a second look at their allocations to China because of this pretty meaningful shift in policy.

Some of this regulation may be catch up regulation. But some of it was fairly unexpected. And the fact that it can be made kind of outside of a normal political process with very little lead to time and preparation, brings about a level of uncertainty you just don't see in other markets. That probably requires a lower valuation on earnings and cash flows coming out of China.

So, I know that's something we've been thinking about. Some of those valuation discounts are already very much baked in and sentiment is extraordinarily negative. I know specifically with regard to China, we have not abandoned our investments there. We have not added to them. It's still an enormous economy. One that is likely to be larger than the US within the next decade or two.

It's still a very large liquid market. It's got a very active venture capital ecosystem. That's creating some really interesting companies. And it's also a really inefficient market; lots of retail investors dominating the trading there, 70% retail versus say 20 to 30% in the US.

So, there's a lot of opportunity for alpha and out performance there. But, I think outside of Asia, in emerging markets right now where we don't have that structural growth and we have these inflationary issues, we've been certainly reticent to add exposure. I don't know, Erica, if you'd add anything there.

Erika Pagel (00:42:32):

As far as thinking about emerging markets, I mean, this is a question that we're being asked a lot by clients right now, and whether or not we're going to add to positions or reduce positions. And we are maintaining holdings and there's a couple of areas that we would like to see before either considering any of those other options.

And, first is just some consistency or reduction in the pace of regulatory focus or action. So, we're really looking for stability there. We also look at a lot of our external managers and what they're doing. So, signs that managers are really starting to lean into the area, or lean into the region, or different segments of the market, that would be a good signal to us. But right now, we feel very good about the current investment managers that we have in the region and how they're mitigating the current environment.

Sid Ahl (00:43:38):

So, I guess summing this up. I mean, Erica, I might kick it to you, but I'll start by saying we haven't changed our positioning that much over the last few months, despite, I think, a slightly worsening inflationary picture. Still short duration in fixed income, still trying to be balanced between growth and value within equities.

We're allocating to real estate and infrastructure assets a little bit at the expense of fixed income. And, generally speaking, credit spreads are tight. And so, we don't have a lot of credit risk in portfolios. We don't have high yield, fixed income allocations and the like. Anything else you'd add to that?

Erika Pagel (00:44:23):

I think that's right Sid, and reflecting on this time and it's been a volatile, and more challenging, market over the past 14 to 18 months. We've also seen some options in private credit options that offer attractive yields and can be inflation hedges in portfolios.

From an asset allocation standpoint, we're pretty neutral and we're much more focused on finding concentrated high conviction strategies in each asset class or geography. And in short, we are positioned for a wide range of outcomes right now.

Sid Ahl (00:45:07):

The other two things that we've talked about more, but we still haven't acted on are commodities and tips. I think in the commodity area, we typically don't have a lot of exposure to commodities. These are assets that don't have cash flows, that are dependent on pretty volatile supply demand balances that are affected by all of the supply chain issues.

And kind of buying a basket of oil at 80, and natural gas at five, and agricultural commodities up 40% on the year is not something that is necessarily preferable to investing in cash flow, generating real estate and infrastructure assets where you get paid to wait.

And I think on the tips side of things, generally speaking, if rates are going up, tips will do better than trip treasuries, but they tend to lose money and do actually worse than cash. And if we expect inflation to continue to stay at a reasonable level, and rates to continue to rise, tips won't be a great place for us to hide out.

Thomas Graff (00:46:07):

We talked earlier a lot about inflation pressure, tips only get paid on realized inflation. So, if it's just inflation pressure that the Fed responds to real rates are going to rise, and tips aren't going to be a protection.

Sid Ahl (00:46:18):

Yeah. And right now, tips are pricing in 2.7%, annualized inflation. So, let's turn now to another area that's been of growing importance to investors, the potential for additional regulation out of the major tech companies. We're happy to welcome Lauren Cahalan, an investigative analyst for Brand Advisory.

So, thanks for joining us.

Lauren Cahalan (00:46:40):

Thanks so much for having me, Sid.

Sid Ahl (00:46:41):

Maybe we could start just with a definition. What is an investigative analyst at Brand Advisory?

Lauren Cahalan (00:46:47):

Yeah, absolutely. So, to kind of level set on what the investigative analyst role is on the equity research team here at Brown Advisory. So, I am essentially a generalist at heart. I work across our entire team of about 50 investors, all of our sectors, all market caps, and all of our strategies. And so, what this role is, is it's essentially special projects where we do deep dive analysis and then primary field work interviews.

So that sounds a little vague. So, let me give you some examples of what that ends up looking like. So there tends to be three projects that can kind of fit into the investigative world. The first one is what we can kind of consider survey research. And so, this is an art mate, not a science. But a good example of this is something where we have a product, we're really interested in it.

And so, we want to go and talk to users of the product and kind of just get a feel for what people are thinking. A good example of this is in healthcare. So, we might be interested in a medical device. One product we recently did was on insulin pumps. And so, we learn all diabetes. And then we go out and we talk to both endocrinologists and insulin pump users to try to get an understanding of where these companies are placed in the market, and what people are thinking. So that's kind of your typical investigative kind of investigative, kind of pure investigative project. A second bucket of project types is something we might call a quick fix. So, what's something where we need kind of all eyes on something for a few days? And this could be something along the lines of drive to rural Virginia and go to a bunch of Walmarts and talk to people in their vision centers, or it could be we really need to understand wildfire liability law in Oregon for one of our public utilities that we might hold. So, it's a wide range of things, but it's really specific. It might involve going to the site and talking to people, things like that.

So, then this third bucket and final bucket of investigative type projects is what I tend to call the nebulous issue. So, these are huge, complex, tangled up problems where our team needs a few extra eyes on the issue. So, our fundamental analysts cover a lot of different companies, and there might be some thematic issues that we can see and connect dots on that we need an additional person to look at. So, a great example of this is tech regulation. This has been a project we've been working on since about April, 2019, and it's just been helpful for us to think about frameworks, to think about these really complex issues. So that's a little bit of color on what the role looks like. It's a lot of deep dive analysis and then going to find the right people to talk to on a variety of different issues.

Sid Ahl (00:49:23):

I love that. So, it's kind of a combination of seeking that informational advantage that we look for in valuing businesses and risk management and just staying up to speed with a 24-hour news cycle. So maybe you could tell us a little bit about what you've learned over the last couple of years in that nebulous tech regulation research. What are the pressures that these companies are facing and how real are they? Do they have teeth?

Lauren Cahalan (00:49:57):

Yeah, absolutely. It's an excellent question. So, to give you some context, this project started out back in 2019. We were coming up on the one-year anniversary of GDPR being implemented in the EU. So that's the EU data privacy law. And we wanted to understand what data privacy law meant for big tech companies. About two months later, you saw announcements in the US around the Department of Justice and the FTC were going to look at big tech companies, so specifically Facebook, Google, Amazon, and Apple. So all of a sudden all these topics became intertwined, and tech regulation is just kind of this catchall term. So through a variety of primary research kind of tasks, going down to DC, listening to congressional hearings, going to meetings at the Department of Justice and the FTC, we were able to talk to a lot of different experts and try to understand these issues. So what we've done as a team is think about tech regulation in three specific buckets and issue areas. So the first is data privacy, second is antitrust, and third is content moderation.

So obviously there's more than just these three, and all these three are intertwined, but this helps us conceptualize these complex issues. And then we can tie back these concepts back to the business models and back to the fundamentals. So, if we kind of split up these three areas, I think key thing to recognize when we talk about these three issue areas is the difference between enforcement of existing laws and the potential creation of new laws. So what we've seen in kind of from that 2019 start data when we started this project, is you saw the thinking through of enforcing existing laws, and what you've started to see in 2021 is the potential creation of new laws and new rules, mainly around antitrust is kind of the general focus, both in the US and the EU, but you're also starting to see content moderation come up more, as well as data privacy. So these are kind of the themes that carry through, but using this framework helps us simplify these really complex topics to help us understand how it impacts the fundamentals, potentially.

Sid Ahl (00:52:03):

And which of those three areas do you think could theoretically have the greatest financial impact?

Lauren Cahalan (00:52:09):

It's a really great question, and it's different for each company. And I think that's what's key to come back to, is that we'll see headlines about big tech and these companies get lumped together, and they all have different business models. So, I think one area that's been interesting to us specifically around antitrust is less so about breaking up. That's not really a concern to us. Let's say something gets broken up. Okay, that's a potential additional investment for us. If we like the fundamentals, that could be an additional way for us to be invested. We are looking at what are potential impacts to changing underlying business drivers? So, one of the things that's out there being discussed is around prohibiting self-preferencing. So, the EU has a log that's kind of moving through their process called the Digital Markets Act, and then in the US, we've started to see a bill come through Congress, both in the House, and recently proposed in the Senate that are looking at should we be banning companies from self-preferencing their own products on their own platforms?

So, this is something that's really interesting to us, as far as you could see it in Apple's app store, you could see it in Google with their vertical search products. When you type in cheap flights, Google Flights is the first thing that pops up. So those are the things that are really interesting to us, is that could change a behavior model within a growth driver, so those are some of the things that we're thinking about as far as how it would impact the fundamentals. The big question that's out there that we are still trying to wrap our head around is on content moderation. It's a really complex topic. The world is trying to figure out what it means, as the companies are, as we are as investors. So that's one that there's a lot of uncertainty around, and it's a challenge to understand as we try to piece that together.

Sid Ahl (00:53:59):

I mean, these companies, in many ways, have never been more central to our lives. Everyone certainly post pandemic is probably even more glued to their phones, interacting with the internet for commerce, for socialization. Do you think it's fair to say that this increased importance that has emerged through the pandemic has pushed some of these issues to the front burner?

Lauren Cahalan (00:54:22):

It's a really great question, Sid. So, what we've seen through the pandemic, if we kind of go back to March, 2020, there was a question on our team at one point of COVID is happening, the world is shut down, there's bigger are issues out there. Do you think that all this tech regulation discussion is going to fall to the side as some policy topics tend to do? And that was a question we had. And as you've watched it play out, I wouldn't say you've seen the opposite. I'd say there's a spotlight on the role that technology plays in our lives.

So, while we were all so thankful that a lot of these tech products were there during the pandemic and lockdown, that we were still able to stay connected and you're connecting with your friends through Facebook products, you're still using Google ... schools are using Google to access school for free virtually, things like that, but what it also showed is that these products and these companies are really important to us. So, do we really understand how these companies operate and kind of have transparency into the roles they play in our lives? So, where you thought people would be, "Oh, we're so thankful. We'll stop kind of investigating," that was not the case. It's, "Do we understand the role that technology is playing for us?" So, you have seen it come forward as far as kept momentum going in thinking about how fast technology is changing, and then the fact that regulation and enforcement is not moving at the same pace.

Sid Ahl (00:55:47):

So, another thing that has brought the issues to the forefront, again, has been the recent developments at Facebook with the whistleblower that came forward. And Facebook, perhaps, is as large as any of these platforms, two and a half billion people, a third of the world's population using this platform. What new have we learned? And what's important out of what's come from the new complaints?

Lauren Cahalan (00:56:16):

Yeah, absolutely. So, I think it's really important when we talk of about something as complex as the news that's been revealed about Facebook is we really have to level set on what has happened and what has been revealed. So, if we kind of go to the beginning, in September the Wall Street Journal started releasing articles related to Facebook that they called the Facebook files. These articles were about the documents that were released by the whistleblower Francis Haugen. She revealed herself on 60 Minutes, then sat in front of Congress for a three-hour hearing discussing her findings. So, with this, it's important to know that a lot of what is being discussed is not new, but there are kind of these incremental findings that give us kind of a lens into decision making internally at Facebook that raise more questions for us as investors.

So, I think when it's key, when we talk about these issues, we have to kind of make a delineation between what is illegal that's happened, and what's not illegal, but raises questions? So first in that bucket of what's potentially illegal, Haugen and her lawyers have filed eight SEC cases against Facebook, potentially making the case that investors have not been given the information that maybe we would need. So that's kind of a key case of what's actually happening? And then what's not necessarily illegal, but that raises questions can kind of fit into the content moderation discussion, but is slightly different. So, content moderation, think of it as, okay, Sid's on Facebook, he sees terrorist content. He reports it to Facebook. They take it down. That gets into the discussion of is Facebook an arbiter of truth? Facebook doesn't want that. Governments don't want them to do that. It's a really complicated area.

So, think of content moderation as one bucket, and then in a separate lens, think of algorithmic decision making. So what choices has Facebook had internally on what their algorithm can amplify? So that's a little bit more information than we received through Francis Haugen's and the whistleblowers' documents is around that decision making. So, she kind of gives some information around January 6th and how they were able to kind of turn different levers throughout that process on management's end. So, there's some additional questions that we have there on do we have transparency into how the company operates? So those are questions that our team is really looking at and trying to understand, and it's been helpful to use our framework of how does this fit into tech regulation, but is nuanced specifically for the company?

Sid Ahl (00:58:56):

Right. In some ways it's kind of a peak into the human soul. Facebook's algorithms try to promote these meaningful social interactions, and it appears what the data says is more inflammatory content that pushes you perhaps further in one direction leads to greater engagement. And how do you police that? Should you police that? Is that a fair statement?

Lauren Cahalan (00:59:24):

Yeah, it's a challenge. And the best quote that I think I've heard as going through this research on tech regulation, I believe was at Department of Justice's section 230 conference that they had. And someone said, "Everything you hate on the internet is just the worst of humanity illuminated." And these are really difficult issues that as a society we're grappling with, and no one company or no one government is going to be able to fix. So how do we kind of understand those issues when they really are so complex? And it's, as you said, looking into kind of humanity as a whole. It's really complicated and our team is really trying to put those pieces together. And we're not going to have all the answers. So how do you take such a complex issue and try to make sense of it? It's a really difficult question.

Sid Ahl (01:00:15):

But I like how you broke it down though into there are legal considerations that we need to very much factor in. Then there are ESG considerations we also have to factor in, but in a different way. They pose different risks. And all of that needs to get fed in to the fundamental analysis of the company. How can this impact their business, their cashflows, investor perception, the valuation you might get on the company? Erica, I'm curious what you think of all this. Maybe the industry regulation is one issue. And then if you feel like you'd like to weigh in on Facebook, feel free.

Erika Pagel (01:00:52):

Yeah. This is complicated. Data, privacy, content moderation, and transparency are all top of mind. And this isn't just Facebook. To regulate or not regulate is the big question. Well, let's think about your day. You wake up. One of the first things you do is grab your phone. You go to morning websites, or you search for something on Google. That data is being recorded. Then you go to Facebook and what you just searched for in Google is now in your Facebook news feed. Then you set your GPS to drive to work. That information is stored somewhere. You pay for coffee at a local restaurant or Starbucks with a credit card or a digital cash app. Somewhere, what you did is being logged as part of consumer preferences for future sales.

And going to your point earlier, Sid, digital technology has created this behavioral interconnectedness. And at what point does this behavioral interconnectedness start influencing your decisions each day? And where are the boundaries for privacy now and going forward? And this really isn't just about social media. Some of the world's largest companies hold data about you. And it's a lot of data. And these companies are playing a big end growing role in our days and in our lives. And the question remains, at what point do these regulators step in? At the very least, consumers should have an option to opt out, but I mean truly opt out, rather than it be a subject that you have to click a disclosure that many of us don't even understand.

Sid Ahl (01:02:41):

That's great, Erica. Thank you. I'm sure more to come on this topic. Thank you, Lauren, Erica, and Tom for joining me today. And hopefully we'll see you again soon.

Tom Graff (01:02:50):

Thanks, Sid. Great to be here.

Lauren Cahalan (01:02:52):

Thanks for having me, Sid.

Erika Pagel (01:02:54):

Thanks, Sid. It was great being here.