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Michal Danielewicz, founder and portfolio manager – St. Petri Capital

In My Book, Everything Points to Inflation

By Eugeniu Guzun – HedgeNordic

Michal Danielewicz and Jens Larsson, the founders and managers of thematic-focused long/short equity fund St. Petri L/S, had warned about the re-emergence of inflation well before inflationary pressures started creeping up all around the world. And indeed, an inflationary surge is evident and the word "inflation" is on everyone's lips, fueled by Russia's invasion of its neighbor, Ukraine. The duo, thematic investors and students of structural change for over 20 years, believe the deflationary effects from two powerful, decades-long structural shifts may be easing and thereby will let loose the already strong inflationary pressures.

In the decade after the financial crisis, the world embarked on a big cycle of money, credit and debt creation driven by both monetary and fiscal stimulus. With interest rates hovering around zero for many years, seemingly all effort has been undertaken to get individuals, businesses and governments loaded up with the maximum amount of debt. Yet, contrary to what any formal theory of economics suggested, inflation remained subdued. The deflationary effects from structural shifts kept inflation in control, argues Danielewicz. These effects may not be so powerful any longer.

THE DEFLATIONARY STRUCTURAL CHANGES

"Three of the main structural changes that Jens and I have observed over the last years include globalization, technology revolution and demographics," starts Danielewicz. At least two of them have had deflationary effects over the past few decades. "Aside from the many benefits of globalization on economic growth and well-being, globalization was actually extremely good for low inflation with production being offshored to cheaper locations," argues the co-founder of St. Petri Capital. "The second structural change, technological revolution, has led to massive productivity growth for all of us, which again, was tremendously deflationary."

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headwinds," emphasizes Danielewicz. Globalization – a phenomenon that has defined the world's economy in recent decades – appears to be taking a step backward due to the Covid-19 crisis and more recently, Russia's invasion of Ukraine and the associated economic sanctions inflicted on Russia.

"This subtle deglobalization process is not having a positive effect on global value chains and pricing," warns Danielewicz. Global trade as a percentage of global economic output had been increasing since China joined the World Trade Organization (WTO) in 2001, but this share reached a peak a couple of years ago before embarking on a downward slope. "The current geopolitical tensions will further limit any benefits of globalization on global price deflation."

The technological revolution, another deflationary structural shift, has also been slowing down in recent years, according to Danielewicz."The slope of change in the technological evolution may no longer be as steep as it used to be," he acknowledges. "Don't get me wrong, I am still a great believer in technology and technology accounts for a big part of our portfolio," he emphasizes. Yet, one has to remember that "the technological revolution has been ongoing for 60, 70 years, and the slope of change cannot be as steep as it used to be," according to Danielewicz. "The technological revolution has been a significant contributor to productivity gains and has been deflationary." These deflationary effects are starting to wane in magnitude.

More "nascent" structural changes such as the fight against global warming and climate change, as well as increasing defense spending in response to Russia's invasion of Ukraine are adding to inflationary pressures. "The new structural changes related to global warming and climate change, reflected in our portfolios as part of the green energy wave and sustainability themes, require potentially a very large volume of physical assets such as steel and copper, among others," explains Danielewicz. "If you combine the continuation of green energy and the recent focus on defense spending, which all compete for the same resources, with slowing demographics, maybe slowing technological revolution and global disintegration, everything points to higher inflation."

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ST. PETRI'S THEMES

Danielewicz and Larsson usually build the portfolio of St. Petri L/S around eight to 12 themes, with the allocation to each theme depending on the maturity of the theme. "Every theme follows an S-curve with its own maturity life cycle," says Danielewicz. Unsurprisingly, the "inflation wave" represents the team's largest long exposure. "We very much like companies with pricing power that would be anchored within basic materials and industrials," explains the portfolio manager. "These two sectors are associated with increased pricing power and can withstand higher inflation. The common theme here is the inflation wave."

Despite sharing a cautiously positive outlook on the technological evolution, "tech is still our second-largest exposure in the portfolio," according to Danielewicz. The exposure mainly focuses on infrastructure technology, hardware and software. "Some of our long exposure lies in companies that will enable themes such as the green energy transition and accelerate the sustainability wave," continues Danielewicz. A new theme in the portfolio is dubbed the "security revolution."

"On the short side, most of the exposure is still allocated to the "low volatility exuberance" theme," says Danielewicz. This theme mainly features "highly-valued companies that tend to underperform when interest rates are increasing due to inflation," explains the portfolio manager. "The low volatility theme continues to be the largest pool of short ideas." The St. Petri team is also cautious on consumer-related companies within consumer staples and consumer discretionary sectors that are facing rising input costs.

LOOK BACK TO LOOK AHEAD

After almost doubling investors' money during 2020 with an advance of 98.3 percent, St. Petri L/S edged down 3.8 percent in 2021 followed by a gain of 1.0 percent in the first two months of 2022. Wary of the re-emergence of inflation, Michal Danielewicz and Jens Larsson had positioned the portfolio for rising inflation and higher interest rates. "Jens and I have been proponents of rising inflation for a while now, our narrative started back in the second half of 2020 due to enormous monetary and fiscal stimulus during the initial days of the pandemic," explains Danielewicz. "In retrospective, our call on rising inflation may have been too early."

The St. Petri Capital team expected higher inflation and an associated increase in nominal interest rates, which generally impact "long-duration areas of the stock market," according to Danielewicz. These areas include highly-valued companies sensitive to rising rates. While this helped St. Petri L/S during the first four months of 2021, as both inflation and interest rates moved up in tandem, a subsequent market consensus that inflationary pressures were temporary "diverged from our main scenario." According to Danielewicz, "our performance started to decline in May and gradually continued to decline throughout the remainder of the year as inflation continued to go to levels not seen in four decades but interest rates started to fall."

"You can be right and still lose money," acknowledges Danielewicz. The team's unchanged "outlook and playbook" for 2022 has already started bearing fruits. "The largest contribution to performance this year comes from last year's underperforming themes that we held on to, mainly the low volatility exuberance theme," says the portfolio manager. "The inflation wave is doing quite well, so the market is perhaps starting to recognize and price in some of our thinking in terms of what is going on with the world."

"A lot of things are happening right now, so we are trying our best to understand and capture what is structural," emphasizes Danielewicz. "We have dedicated our professional careers towards understanding disruption and structural shifts and what implications those shifts might have on equity returns," he continues. While few things seem to happen on the surface during periods of range-bound equity markets, there is a breadth of changes underneath the surface that can create significant alpha for investors. "We define structural changes as a force that is quite long in duration, a force that will persist throughout many and different economic cycles and will create value for investors irrespective of how broader markets perform."