OUT OF THE ORDINARY

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Solving the Inflation Equation

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A few weeks ago, I referred to Albert Einstein's lack of golfing prowess. Yesterday was the anniversary of the publication of perhaps the world's most famous equation, $E=mc^2$, which was first unveiled on this day in 1905 and proposed, of course, by Einstein. It is familiar to many but understood properly by very few. However, being a matter of physics, it is probably better understood than inflation, which divides the economics community and might have a

very important bearing on the fate of the current economic and financial market cycles. This week, I'm going to have another go at unravelling some of the strands of the current inflation narrative.

At its most basic level, price inflation is the result of demand surpassing supply. This can come about either because demand is higher than that which would create equilibrium or on account of insufficient supply. The former is generally deemed the more dangerous influence because it speaks to untethered consumption and fears of "overheating". But the latter can be even more pernicious in that it can create steep price increases very quickly as consumers fight for what is available. It seems that for various commodities and goods, we are currently experiencing a combination of the two. The challenge for investors and central bankers is to work out what is temporary and what is stickier.

I have written in the past year about certain commodities such as lumber which were experiencing a simultaneous combination of very high demand and short supply. And lumber is perhaps the best template for some of the price spikes that we are currently seeing. On the supply side, there was already some pressure on supplies of raw timber owing to insect infestation. But, as we saw in many industries, the dawn of the Covid-19 crisis - which threatened the deepest recession imaginable - triggered a wholesale clear-out of inventory as suppliers, wholesalers and retailers attempted to turn stock into cash to weather the coming storm.

So far, so textbook. But the Covid-19 recession turned out to be a completely different beast compared with anything previously experienced. Governments handed out cash to workers who were unable to work because their industries were shut down – and in the US, they just handed out cash to everyone on top of unemployment benefits. With no ability to spend on services owing to lockdowns, this cash was not going to be allowed to burn too big a hole in people's pockets, and so was spent on goods. Furthermore, the prospect of a long period of working from home created the desire (or need in many cases) to build a more suitable domestic working environment. Cue surging demand for building materials. To make matters worse, in Canada at least, there was plenty of evidence of sawmill workers deciding they were happier at home collecting furlough payments.

Now imagine a similar scenario playing out across all sorts of industries - a massive reallocation of demand from one area of spending (services) to another (goods). This shot to pieces all the old models for aggregate demand across the economy.

But that's just one element of the equation. I remember listening to a logistics professor talking about the potential for transport supply chain disruption very early in the pandemic. His metaphor, which I liked, was that it would be like turning up to the supermarket to find the shopping trolleys scattered around the car park rather than neatly lined up at the entrance. Ships and containers would be in the wrong places and it would take some time to restore order. But I'm not sure even he envisaged what the surge of demand for goods would do to container prices, with a fivefold increase experienced on the crucial Shanghai-Rotterdam trade route. Oh yes, and nobody (could have) forecast a massive container ship getting stuck in the Suez Canal.

But these things all make sense and pressure should be alleviated over time. Demand for lumber will stabilise (even if new housing construction remains strong) and inventory will rebuild; ships and containers are being ordered and will be built (hopefully not just in time for the next cyclical recession!). Without being too glib, the phrase that the best cure for high prices is high prices comes readily to mind. And demand for services relative to goods will rebalance as economies continue to reopen. But it's fair to say that the period of elevated current inflation looks as though it will be rather more persistent than most had envisaged.

If that was it, we could probably be more relaxed. But it isn't. There are (at least) two other major factors to consider and they might well be even more persistent. One is a rebalancing of the labour market; the other is the energy transition to a lower-carbon world.

Much attention was already drawn to income inequality before Covid-19 and the situation was ripe for social change. Political developments were a signal of that, with a shift towards more populist policies rewarded at the ballot box. Covid-19 has turbo-charged the situation. Not only has it been made clear how many jobs deemed to be "essential" to the functioning of modern economies are not very well remunerated, but also a spell at home on some form of government assistance has highlighted how unfavourable working conditions had been for many. Now many are demanding higher wages and better conditions to return to work. Even so, it's still not entirely clear just how much the incentive structure will change once income support schemes (and various interest and loan-repayment holidays) are brought to an end.

And wages are a particular bugbear for companies because they impinge on margins in the absence of greater productivity. Unless, of course, you raise prices, which in turn leads to one of central bankers' worst nightmares – the dreaded "wage/price spiral", in which each drives the other ever higher, leading to ever-higher inflation. The good news, perhaps, is that there are signs of increased spending on productivity-enhancing measures, from clever software and artificial intelligence to automation and robotics. But I suspect it will be some time before we know what is happening on a sustainable basis. From a demand perspective, it is also observed that those with lower incomes have a greater propensity to spend incremental earnings, which is positive for aggregate demand... so long as there are no supply shortages!

The energy transition is another factor, as are other considerations related to implementing environmental, social and governance (ESG) initiatives. We are currently witnessing strong crude oil prices as the resurgence in post-lockdown demand is not being met by increased supply. Yes, some of that lack of supply is the result of production discipline within the members of OPEC. Still, a decent chunk of it is down to the fact that the world's oil companies have chosen to focus on returning the cash they generate to shareholders rather than drilling for more oil. This mindset was driven to some extent by the existential shock delivered by plunging oil prices in 2015, but more so in recent years by the focus on reducing carbon emissions and investors' persistent desire to see capital withdrawn and withheld from the oil exploration industry. And, at the same time, the world has yet to replace fossil fuel-based supply with sufficient clean alternatives. But it's fair to say that the higher the oil price goes, the greater the incentive to create alternatives becomes.

Then there is the natural gas price squeeze, which looks, if anything, to be more worrying because gas is a far greater component of our energy consumption today - both for domestic and commercial heating and cooking and for electricity generation. If we need gas to keep the lights on, we will have to pay up for it. That's sort of where we are now, with countries around the world bidding up liquefied natural gas (LNG) supplies. But this comes when inventories in the UK and Europe are at historical lows and when the UK's main gas storage facility in the North Sea is being decommissioned. To add to the problem, gas supplies from Russia are also lower than usual. There has been a surge in gas demand because wind speeds have been too low to generate sufficient supplies from our wind farms and, of course, we don't yet have suitable storage capacity (i.e. batteries) to make the most of the windy days. Also, perhaps more predictably, there hasn't been enough sun to maximise solar production either.

That's an awful lot of "one-offs", but they have an exponential effect on prices when they come simultaneously. The biggest fear today is that supply constraints persist as demand is further boosted by a cold winter, leading to supply rationing. And gas is not something that the average retail consumer can panic buy and stockpile. Maybe firewood and candles are next!

And if you think that bears echoes of the 1970s, then how about queues for petrol and sold-out petrol stations? While it is very easy to lump this in with other supply chain problems, this one appears to be more homegrown. There is no underlying shortage of petrol or diesel, but there is a problem getting it from refineries to petrol stations. The fuel industry, like the food industry, is struggling to find enough HGV drivers. Some have returned to continental Europe after Brexit. Others are sitting comfortably at home rather than enduring tough working conditions. And new drivers are in short supply owing to a lack of training and testing facilities thanks to Covid-19 – not to mention the risk of entering a profession soon (potentially) to be made redundant by self-driving truck technology. While I struggle to see this petrol station problem as the same as other more prevalent inflationary pressures, I can see how loose connections can be made. But it makes for great headlines and fashions yet another big stick with which the media and opposition politicians can beat the government.

Not so long ago, the rising market narrative (to which I did not subscribe) was that of the "Roaring Twenties", a post-pandemic hedonistic boom of epic proportions. Now it seems to be shifting towards the "Stagflation Seventies". I believe that to be equally misleading and, obviously, far less alluring. Markets love labelled narratives, but they usually fail to capture the nuances of reality.

So, where on earth does that leave us? It's fair to conclude that inflation will probably settle somewhat higher than the pre-Covid-19 level. Social politics are moving in favour of that, and the energy transition, combined with the requirement to mitigate some of the worst effects of climate change, suggests an extended period of high spending in those areas. And, as we have discussed before, higher inflation relative to suppressed interest rates and borrowing costs provides the easiest way for governments to relieve themselves of their debt burdens (in real terms, at least). We also need to bear in mind that the great disinflationary tailwinds of global trade have diminished.

But the technology-related and demographic forces that have also been part of the disinflation story are almost certainly not exhausted. If anything, there is some belief that they are accelerating. Thus, while we currently see a big spike in prices, it is by no means clear that it will persist. The experience of the past decade has shown that making big pronouncements on a rapid acceleration of inflation is fraught with danger. I can't see that economists are equipped with any better tools now to make such judgements. Indeed, I tend to see that most of them are stuck in the same camps as they always were. Who would have thought that such a group would be so ideological?!

We continue to monitor the situation carefully but still find insufficient evidence to make persistently high inflation the key factor driving our asset allocation. And, as I will have to return to in a future piece, so much will depend upon the policy response of both governments and central banks, which is itself an ever-evolving source of debate.

Economic Commentary

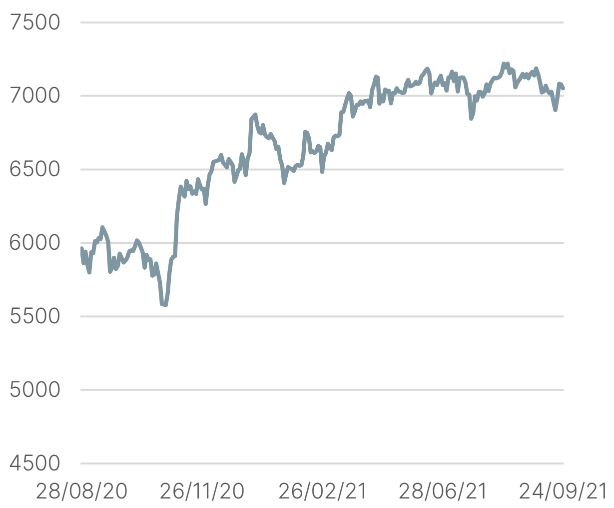
FTSE 100 weekly winners

International Consolidated Airlines Group SA	17.5%
Entain PLC	13.0%
AstraZeneca PLC	9.7%
Royal Dutch Shell Plc Class B	5.7%
BP p.l.c.	5.1%
Royal Dutch Shell Plc Class A	5.0%
J Sainsbury plc	4.6%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-8.7%
Kingfisher Plc	-7.3%
National Grid plc	-4.7%
Schroders PLC	-4.6%
DS Smith Plc	-4.6%
Intertek Group plc	-4.1%
Prudential plc	-3.7%

FTSE 100 index, past 12 months



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