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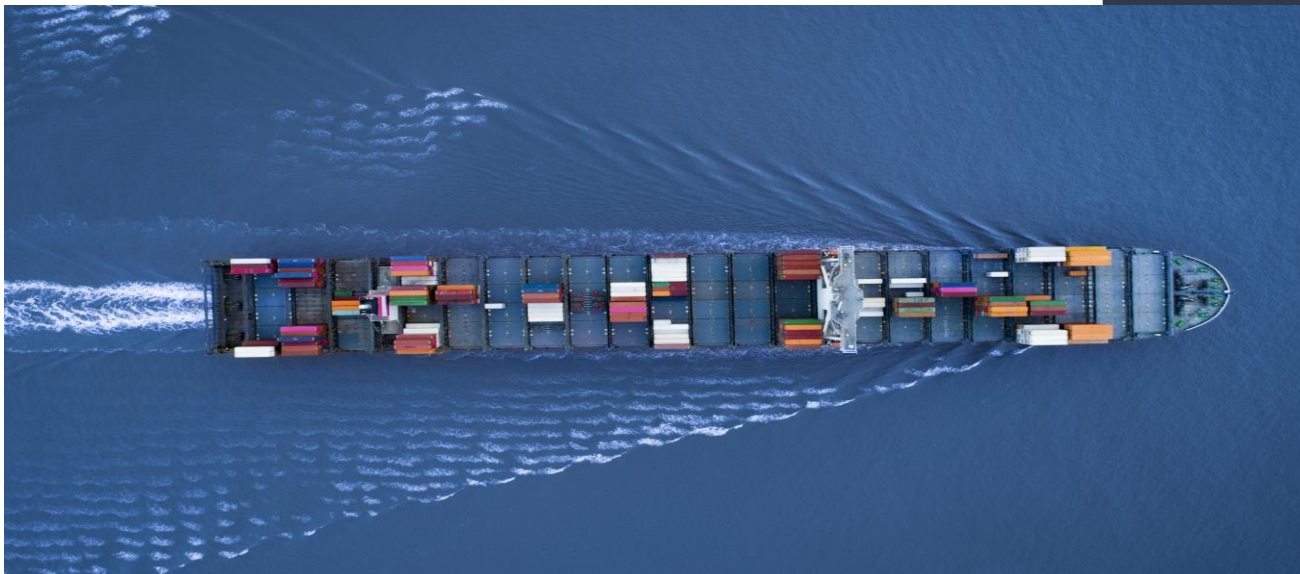
OUT OF THE ORDINARY

WEEKLY DIGEST | 18 October 2021

Be Careful What You Wish For



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Last week I took my car for its annual MOT test. A year ago, my tyres were put on an advisory status for replacement. Because I had done very little mileage over the last twelve months, that was how things remained. But I did note that the proposed cost for the tyre replacement had risen by 40 per cent. On the same day we received a nine-roll pack of Andrex toilet paper in our grocery delivery, which only had eight rolls in it! You've probably heard of the practice of

"shrinkflation", by which producers of consumer goods charge the same but make the product smaller; it famously reduced the number of triangles in a bar of Toblerone a few years ago to much outcry. I'm hoping that the Andrex situation was just the result of a packaging malfunction. But the fact that I was suspicious that it might not be says a lot about current concerns and expectations about inflation.

Central bankers have spent most of the years since the financial crisis crying out for more inflation. Now they are getting it in spades. The latest country to be surprised by a sharp rise in its consumer price index is New Zealand, where prices rose 4.9% year-on-year in the third quarter against an expected 4.2%. The headline figure in this week's CPI report for September in the UK is expected to be a relatively subdued 3.2% thanks largely to base effects, but we already know that October's print will be sharply higher owing to the raised utility price cap. It might start with a four. And there are plenty of forecasts suggesting a peak of over 5% in the new year.

The current main driver of higher inflation is energy prices, with continuing demand increases meeting a host of supply issues while we negotiate the difficulties of the transition to a low/no carbon economy. In a sobering reminder of the difficulty we face in making this transition, BP's latest global review stated that no less than 83% of the world's primary energy need was still met by fossil fuels in 2020. When one then considers that anywhere between $50 trillion (Jefferies minimum forecast) and $150 trillion (Bank of America) will need to be spent by 2050 to decarbonise the world, that has the potential to create even more inflationary pressure on the resources required.

Transport and logistics supply chains are also still a major factor in price developments. Back in May I cited comments from the CEO of the US freight forwarding company Flexport, and he was back on the same podcast (Bloomberg's Odd Lots) last week, with an update. His latest observations were equally fascinating. He reminded listeners that container demand has increased by 20% since COVID as consumers redeployed their purchasing power from unavailable services to goods. As you might imagine, container shipping is not an asset-light business where supply can be increased at the flick of a switch, and while I have noted before that there is evidence of strong new orders for container ships, the lead times mean that these will not begin to become available until 2023 at the earliest.

At the receiving end, as it were, he noted that in the US there remains the problem of a shortage of trucks and truckers, much as we are experiencing in the UK and Europe. In Los Angeles specifically, this is exacerbated by heavy traffic congestion, meaning that drivers are often able to pick up only one container a day, on average, rather than two. This leaves containers stacked up in the port, meaning that more containers can't be unloaded from ships in the port, meaning that arriving ships have to wait longer to dock – there are record numbers of ships anchored off the shore of L.A. at the moment – meaning that an increasing amount of the world's container shipping capacity is backed up in a traffic jam and sitting idle. We're back to the For Want of a Nail proverb again. He describes it as "cascading problem". It's similar over here, with ships being turned away from Felixstowe last week for lack of available berths. He sees little respite in the US in the short term, mainly because an analysis of what is going through their system

suggests a still very heavy demand for goods, at least through Christmas.

One little ray of light recently has been the slight reduction in container prices, but he was concerned that this was as much a reflection of cancellations of shipments from China owing to reductions in manufacturing output as to any real levelling out of the supply/demand imbalances. And, underlining the interconnectivity of different economic forces, these reductions are a function of energy rationing in China owing to supply shortages in that market. On a slightly more upbeat note, he suggested that the true underlying capacity utilisation of shipping containers was as low as 70% owing to the inefficient use of space. His firm is using the data required to be collected by customs about the dimensions of packages to develop software that maximises the space available – not unlike a giant puzzle, and familiar to anyone (like me) who has had to repack the boot of the car or the dishwasher to make room for the suitcases/dishes that others couldn't find space for! That could be a very easy win if it is widely adopted and assisted by evidence of manufacturers redesigning packaging to reduce wasted space.

Finally, and somewhat ominously, he pointed out that the International Longshore and Warehouse Union's wage contract is up for renewal next summer. The last negotiations in 2017 led to a three-month strike, with no goods entering ports on the US west coast and lots of disappointed children at Christmas. It doesn't take a great leap of the imagination to see a similar situation developing next year.

If those are the problems, are there any solutions? No doubt a demand shock would solve some of these imbalances, but the negative consequences for overall activity, employment and solvency would be a very heavy price to pay. There is certainly the possibility of increased investment in productive capital projects, and there is plenty of cash in corporate coffers to fund that, although it looks like too long-term a process to provide immediate relief. Thus, it looks as though we are in for a period of more uncertainty.

It definitely seems as though central bankers are increasingly of the view that this burst of inflation is going to be rather less "transitory" than they had hoped for. The latest to comment is our very own Andrew Bailey, Governor of the Bank of England. In comments over the weekend, he left little doubt as to his voting intentions at the next Monetary Policy Committee meeting, stating that the MPC "will have to act" to curb inflationary pressure. It's not so much current inflation that worries him, as the path of expectations for future inflation, as it those that tend to feed into demands for higher wages which can perpetuate the inflationary cycle. It might just be that the threat of higher rates is enough to subdue expectations, but, as we have commented before, central banks are going to have be very skilful in negotiating the next part of cycle.

From an investment perspective, I note that the latest Deutsche Bank client survey had "higher than expected inflation/bond yields" and "central bank policy error" voted as the top two risks to current market stability, and of course those two risks are very closely intertwined. Markets will continue to be more sensitive to developments on either front for the moment.

But, as we have also commented previously, this does not necessarily mean the need to take an extremely defensive stance. Overall growth should continue to progress above pre-COVID trends and corporate earnings will remain strong – certainly the first week of the third quarter reporting season has been encouraging. Even if monetary policy is tightening, it remains very loose by historic standards. Yes, I have written before about the second derivative or rate of change of growth, and there is no doubt that we are well past the heady days of peak recovery. But, as we have maintained for a while now, this is more likely to lead to a period of bumpy markets and increased internal rotation within stocks and sectors than to big moves (either way) in headline indices.

Economic Commentary

FTSE 100 weekly winners

Antofagasta plc	10.6%
Glencore plc	9.9%
Barratt Developments PLC	8.5%
Anglo American plc	8.2%
Evraz PLC	6.7%
Croda International Plc	6.6%
SEGRO plc	6.0%

FTSE 100 weekly losers

Pearson PLC	-16.2%
BT Group plc	-3.9%
Informa Plc	-3.4%
Prudential plc	-3.1%
Tesco PLC	-2.8%
Smiths Group Plc	-2.2%
Admiral Group plc	-1.8%

FTSE 100 index, past 12 months

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