

## The Big Squeeze: inflationary pressure persists

- Inflationary pressure is looking more persistent than transitory
- Passing the purported base effect “peak” does not help
- Portfolio interventions for consideration

Following the post-COVID restart, there was always necessarily going to be an inflationary spike from the base effect alone. Central Banks’ core thesis was that this spike would be “transitory” rather than “persistent”.

However, the combination of pent-up demand, supply chain disruptions and an energy crisis suggests that inflation could prove more persistent than transitory.

We look at the numbers and how this informs the “big picture triangle” of three key macro factors: growth, inflation and interest rates.

Finally, we outline potential interventions in portfolio positioning from an asset allocation perspective. Nominal bonds are known to be structurally challenged in an inflationary environment so we propose real asset exposure instead. Within equities, we would propose an income/value bias.

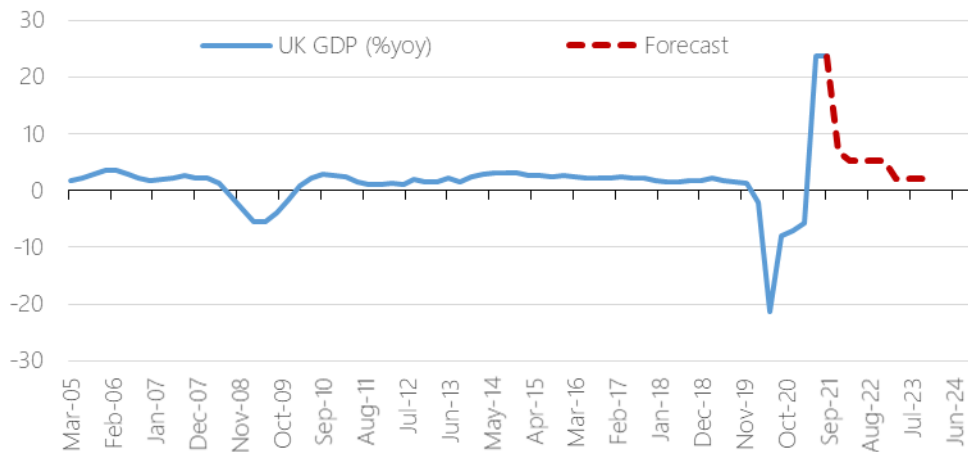
### Inflationary pressure is looking more persistent than transitory

Think back to April/May last year. We were all sitting at home. The motorways were deserted. Aeroplanes were grounded. Birdsong, Zoom and for some parents Joe Wicks, for others gin, prevailed.

The rapidity of the global standstill – and thanks to huge fiscal and monetary stimulus – the rapidity of the restart once restrictions were lifted, has meant the economy roaring back to life as we return to a “new normal”. Markets have rebounded rapidly in anticipation.

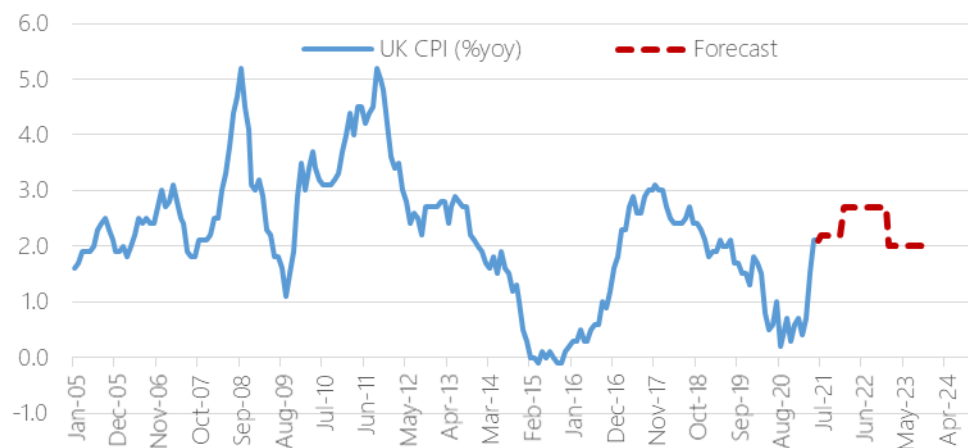
It was a given that from a very low base of economic standstill in 2Q20, all economic metrics would experience a high base effect in 2Q21 – not only for growth rates, but also for inflation.

Fig.1. UK GDP %yy and forecast



Source: Elston research, Bloomberg data

Fig.2. UK CPI %yy and forecast



Source: Elston research, Bloomberg data

The Central Banks' thesis was that the fiscal and monetary support provided during the pandemic was sufficient to keep the fabric of the economy intact without deep scarring. Hence the optically high inflation rates that we see now. Now that we are past the peak (July) of the low base effect, the argument is that these will prove transitory. And yet a combination of factors is in fact making inflation risk looking more persistent.

We focus our analysis on UK inflation as that is the real-world risk that end clients are facing with regards to their spending commitments and broader financial plan.

## The view from the UK

Since the majority of restrictions were lifted, there has been a resurgence in activity from pent-up demand.

The summer holidays saw UK hotels and getaways booked out, restaurants are busier than ever and travel both domestic and increasingly international is back on. So naturally some inflation was expected as demand outpaced supply.

There is no dearth of anecdotes or examples of supply chain disruption and/or labour and skills shortages that have followed.

There aren't enough waiters to go around, so the catering industry is having to pay more to find and retain staff. There aren't enough HGV-licensed drivers willing to drive (despite there being no shortage of licence holders) so hauliers are having to pay more.

The short-run fix could be temporary visas to import lower wages. The longer-term fix is training, skills and mobility.

Ironically, without wanting to wade into the political aspect of this too much, we are in a curious position whereby Labour, traditionally the party for workers, is supporting big business in its call to enable cheap imported labour. This would duly keep wage bills down for employers, keep the cost of goods down for customers and increase margins for business owners. Conversely the Conservatives, traditionally the party for business, are saying that better wages and more employment opportunities for UK workers are part of the Brexit promise, even if that means a bit more pain in the pocket of Waitrose shoppers and lower margins for business in general. It is – in a way – part of its “levelling up” agenda. This paradox is not a mistake but a message directed at those “red wall” constituencies that lent Boris their vote at the last election. So while Metropolitan voters may grimace and business owners complain, this policy may yet prove more popular than one would think.

That said, while this foreseeable and theoretically “transitory” inflation adjustment for labour and skills may indeed have been part of the plan, the unforeseeable energy squeeze was not.

## A tale of two energy crises

The UK energy crisis has two dimensions: one is transitory and local, the other more persistent and global.

### UK fuel crisis

The recent fuel crisis was triggered not by a lack of availability of petrol/diesel, but a lack of availability of HGV drivers to operate the tankers to deliver it. A public announcement that two BP stations had not been refuelled owing to the tanker driver shortage sparked a wave of panic buying that drained the pumps and turned the purported crisis into a self-fulfilling prophecy.

Panic buying (an ancient crisis habit reawoken when Covid kicked off) meant that customers – whether quietly or aggressively – were buying 3x the usual amount. Some petrol stations marked fuel prices up as a deterrent or to profiteer (which was inflationary), other stations soon ran dry. This crisis was resolvable via the deployment of the reserve tanker fleet with army drivers at the helm. The Government should have got ahead of it earlier, but instead suffered lurid headlines and a perhaps unwelcome spotlight on the importance of lorry drivers for logistics and supply chains more broadly.

The point is that while this mini-crisis was inconvenient, it was more a symptom of broader supply chain constraints than the cause of an inflationary spike.

### **Global energy squeeze**

A confluence of factors has led to a global energy squeeze, particularly in natural gas.

Gas has always been a major part of the UK energy mix both for electricity and for heating.

Whilst renewables are part of the mix, they are “intermittent” and the role they play remains relatively modest. For example, wind levels are particularly low for the time of year, so there is no or low wind-generated energy at present.

With western countries abandoning dirty coal and disliking naughty nuclear, gas-fired power stations have presented themselves as the ideal stop-gap while renewable capacity is ramped up (and installation costs come down). This has created a high dependency on gas particularly in the UK, where 1) we don’t have the solar resource of say Italy and Spain and 2) we don’t have as much nuclear energy as, say, France.

Natural gas is also used in industrial processes so there are knock-on effects beyond energy costs alone.

Ultimately, it comes down to geopolitics.

With limited LNG import facilities, underinvestment in nuclear power, the switch away from coal and the intermittency of renewables, Russian gas is and will remain a core feature of the European and UK energy mix. If policymakers want to change that reality owing to their dislike of a regime, and are not going back to coal, they need to build LNG ports and create more nuclear capacity for “baseload” supply.

In addition to this, other key factors include:

1. Chinese companies being instructed to secure gas and LNG at any cost
2. Norway undergoing maintenance of its fields
3. Russia restocking its inventory

### **Poor decision-making in the UK**

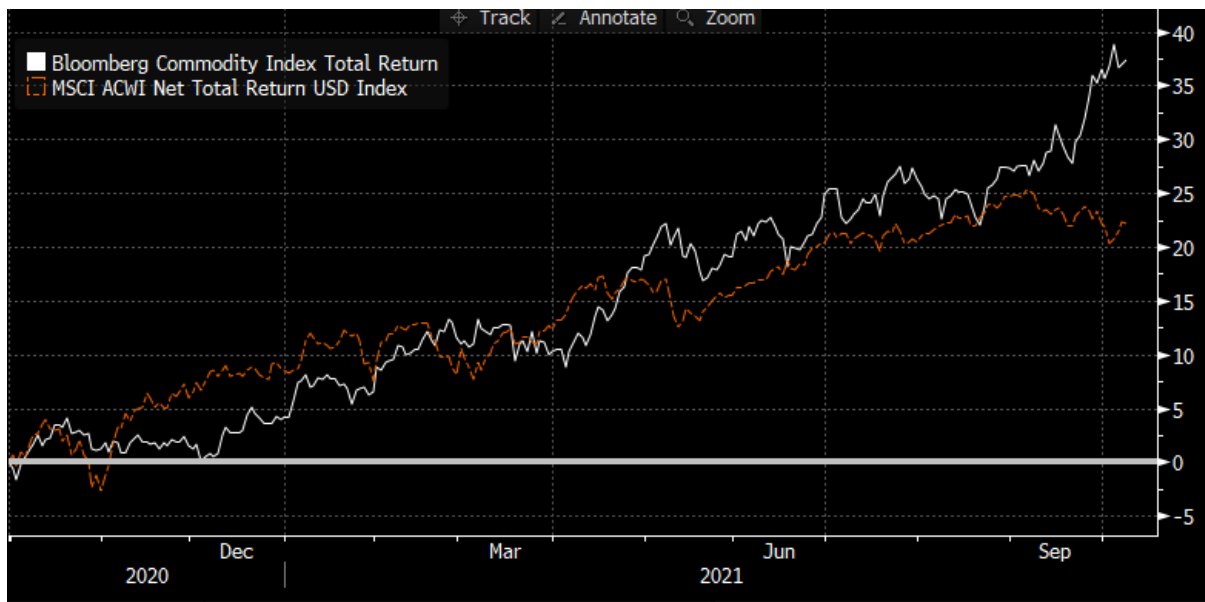
Finally, whilst European countries have typically 15 or so days’ gas inventory in underground storage, until recently, the UK’s storage capacity was only 9 days. Despite calls from some energy

analysts to increase storage capacity in order to ensure security of supply, in 2017 Centrica - with OFGEM's blessing - closed the UK's only gas storage facility. The idea was that storage was not needed with new interconnectors coming on stream from Europe and a growing share of renewables. With no storage, the UK is therefore entirely at the mercy of the supply/demand fluctuations of the gas market. And during a supply shock, like your average panic buyer, each country looks after its own.

In short whilst the energy crisis is global in nature, it is an acute problem in the UK owing to the nature of its energy mix, the lack of storage and its growing dependency on imports.

### Energy impact on the supply chain

The rising cost of energy has a direct inflationary impact with the growth in commodity prices far outstripping equities over the last 12 months. The Bloomberg Commodity index is up +37.4% in GBP terms, compared to +22.2% for Global equities.



This also has an indirect inflationary impact as the knock-on effect of rising energy costs and lack of gas put upwards pressure on the price of many goods and can also disrupt manufacturing and food production processes.

The combination of direct and indirect effects, together with labour shortages are what could make inflation more persistent.

### Big picture triangle

Cutting through the noise and focusing on each new development through the prism of three key macro factors which we call the "big picture triangle" can help inform decision-making. When growth is high, inflation low and interest rates are low, this is benign. When growth is low,

inflation is high and interest rates are high, this is malign. The movements of each corner of this triangle helps to inform the overall picture.

Over the last two weeks, the market started pricing in changes in all three corners of this triangle:

1. Growth: from recovery, to fears of slowdown
2. Inflation: from transitory to persistent
3. Interest rates: from steady to rising

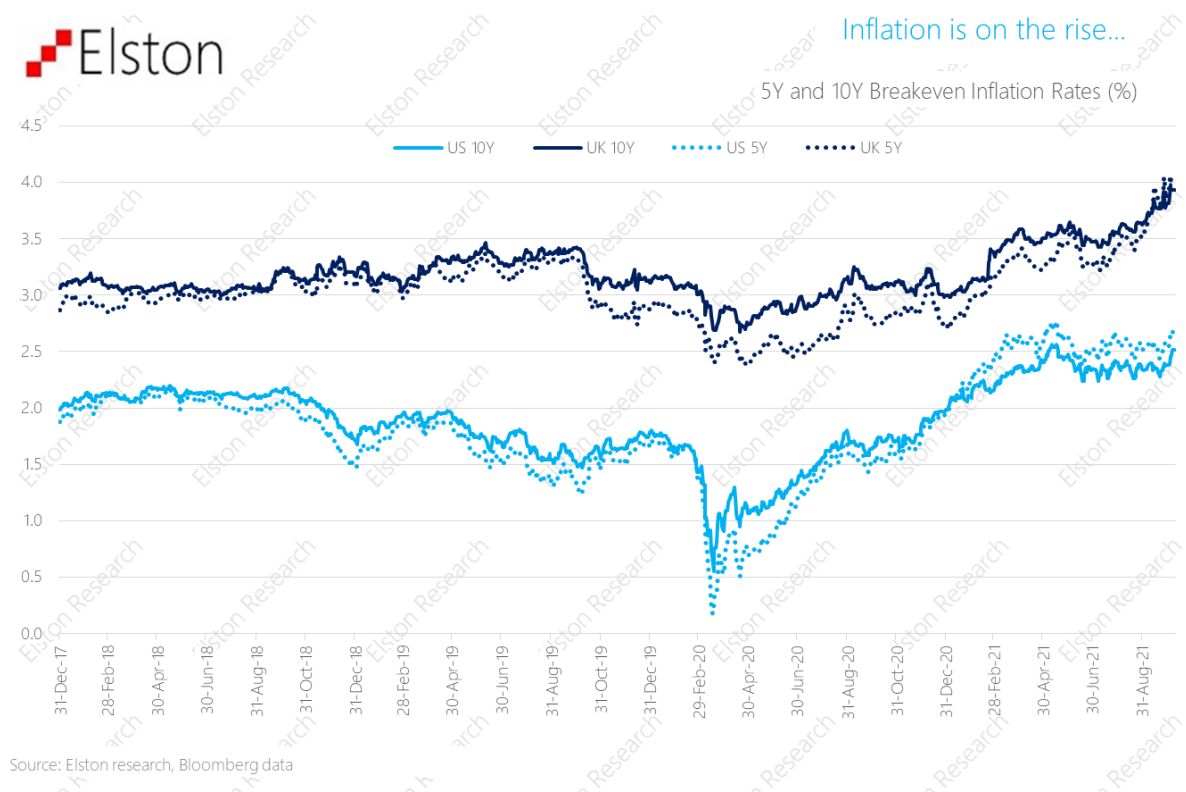
### Taking the pulse of inflation

The best way to take the pulse of inflation is to look at market-implied Break Even Inflation Rates.

In the US, 5Y BEIRs are at 2.51% from 1.97% at end 2020, and 1.70% as at Dec-19 pre-Covid.

In the UK, 5Y BEIRs are at 3.97% from 2.72% at end of 2020 and 2.90% as at Dec-19 pre-Covid.

Put differently, in the UK the market is pricing in that inflation will run at 3.97% annualised for the next 5 years. That's more persistent than transitory.



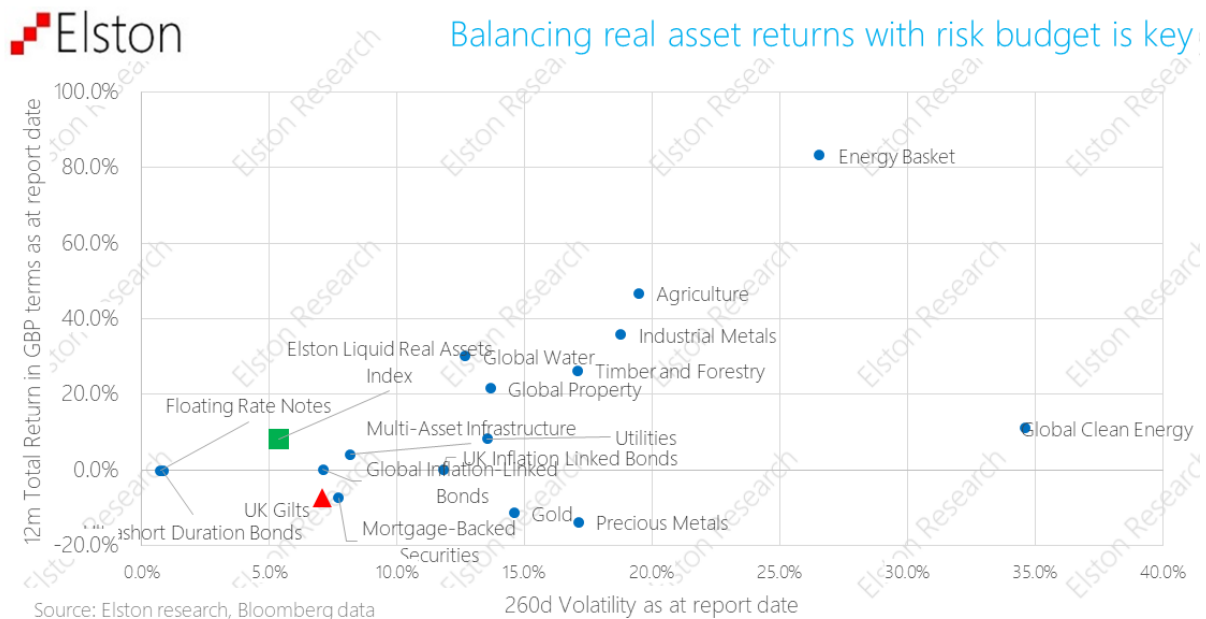
### Incorporating real assets into a portfolio

We believe incorporating real assets into a portfolio can help protect against inflation in the near- to medium-term. Real assets means physical assets or assets whose income streams are linked to

inflation, such as property, infrastructure, inflation linked bonds, timber, water, natural resources, commodities, and gold.

Assuming this is funded from nominal bonds – which suffer most in an inflationary environment, the challenge is how to incorporate real assets without materially uprisking portfolios. Our proposal is to combine them with interest rate-sensitive assets to provide a combination of both upward interest rate protection and inflation protection.

Looking at 12-month performance to end September 2021, we can see how our Liquid Real Assets Index (in green) has fared relative to its constituent parts (in blue), and relative to Gilts (in red).



## Equities provide

Equities provide a medium- to long-term inflation hedge particularly if they have pricing power. A company's value is a function of their future earnings and a discount rate to value those future earnings in today's terms. All other things being equal, as discount rates increase (owing to rising inflation rates), the value of those earnings in today's terms will decrease – unless of course those earnings are also linked to inflation. Companies in traditional industries that are cash-generative and whose earnings are near-term are said to be "lower duration" companies – near-term earnings make up a greater part of today's valuation. These companies are typically "Value"-style companies. Companies in innovative industries that are whose earnings are larger further in the future are said to be "higher duration" companies – distant future earnings make up a greater part of today's valuation. These companies are typically "Growth"-style companies. As the discount rates applied to those future earnings increase to adjust for inflation, longer-duration Growth companies tend to perform less well, than nearer-duration Value companies. For this reason, within equities we prefer including exposure to cash-generative income-focused value-bias companies.

## Summary

Our central thesis for 2021 was to be vigilant on inflation and thanks to the combination of pent-up demand, supply chain disruption and a global scramble for gas, this remains more important than ever. Despite the febrile atmosphere in financial markets, there are sensible ways in which investors can protect themselves if they focus on the right balance of assets to offset inflation risk.

Henry Cobbe

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