

High energy prices haunting inflation

Monthly Commentary

For wholesale or professional investors only

Europe's energy crisis intensified in October with natural gas prices hitting record highs. The Netherlands 1-day ahead gas price index has increased more than 6-fold since the start of the year. This has fed into electricity prices for households which have more than tripled since March. The crisis has brought attention to the cost of Europe and the UK's net zero ambitions. The transition to clean energy has been a support for gas, seen as a 'bridging fuel' to a world dominated by wind and solar energy. It has also exposed Europe's over reliance on imported gas particularly from Russia which has received blame for withholding supply and exacerbating the crisis. Continental Europe receives more than a third of its total gas supply from Gazprom. Whilst Russia has defended its decisions citing the need to prioritise domestic storage, others claim that pressure is being forced upon Berlin to approve the Nord Stream 2 pipeline. The pipeline is ready to start operations and received the go ahead from the German Economic Ministry this month. The final step is regulatory approval from the German Federal Network Agency.

The surge in gas prices has not yet had a significant effect on Eurozone growth. The economy posted higher than expected growth of 2.2% for the third quarter, surpassing the 0.5% growth registered by the US and 0.2% in China. Eurozone growth was driven by France (3%) and Italy (2.6%), whereas Germany grew by only 1.8% as supply chain shortages continue to disrupt industrial production. Despite encouraging growth from the Eurozone, inflation remains the greatest risk. CPI growth hit a record high of 4.1% this month slightly higher than the 4% recorded in mid-2008. As the inflation debate has continued it is interesting to note the divergence in central bank policy among major central banks. The European Central Bank has remained resolute in arguing the transitory nature of inflation and has downplayed the need for any drastic change in its current asset purchase plan. President Lagarde

stated that after 'a lot of soul searching' on the drivers of inflation they expect a 'decline over the course of 2022.' This contrasted with the Bank of Canada (BoC) who earlier this month shocked the market by ending its bond purchase program and bringing forward its expected timetable for rate rises. A day after CPI growth in Canada was measured at 4.4%, the BoC stated that 'higher energy prices and pandemic related supply bottlenecks now appear to be stronger and more persistent than expected.'

The spectre of Evergrande looms over the Chinese real estate sector

China's economy has continued to decelerate, growing 4.9% over the last year and essentially stalling in the 3rd quarter of this year (0.2% growth). A severe coal shortage has led to power cuts and factory shutdowns in energy intensive sectors. The hit to production has dampened GDP growth and the manufacturing Purchasing Managers' Index is now at a contractionary level of 49.2 after declining for the second straight month. The continued decline in the construction and real estate sector, which makes up roughly 29% of GDP is worrying. This level is far more than any other major economy and evokes memories of Spain and Ireland's economy before 2008, where the size of their respective real estate sectors totalled more than 20% of GDP. In the 3rd quarter the Chinese real estate sector contracted by -1.6% and the construction sector -1.8%. Housing starts were 4.5% less than levels last year. Since the Evergrande crisis last month, Chinese developers have been shut out of international bond markets risking a wider string of defaults within the highly indebted sector. Nevertheless, Chinese officials remain calm and dismissive of the potential for the crisis to snowball into a 'Lehman' moment. A People's Bank of China spokesman earlier stated, 'the risk exposure of individual financial institutions to Evergrande is not big and the spill-over effect for the financial sector is controllable.'



UK labour productivity needs to contribute more

UK Chancellor Rishi Sunak announced his Autumn budget this month which delivered a very slight easing relative to the fiscal tightening announced in the March budget. The budget results in a 1.2% tightening per year to 2026. Notably, the living wage was increased 6.6% to £9.50 and £10.9bn was directed towards health care facilities and research and development. Higher spending has been met with higher personal and corporate taxes. In 2026-27 the tax burden is expected to be 36.2% of GDP, the highest levels since the early 1950's and up 3% from before the pandemic. Sunak also announced an allocation of £3bn to boost skills in the workforce. Despite this, a report released by the Institute of Fiscal Studies argues that more needs to be done to address human capital development, especially after the severe hit from the pandemic. Upskilling the workforce is paramount if the UK is to achieve a sustainable level of growth. From 2013 to 2019 the UK economy grew at an average of 2% a year, with more than 1.5% of the growth coming from an increase in working hours. After the exodus of workers from both Brexit and the pandemic, it is unlikely that labour force growth can contribute anywhere near the same level going forward. In fact, it may even be a negative drag on growth. An increase in labour productivity will therefore have to do most of the heavy lifting in the decade or so to come.

Short end of the yield curve spooked

Following weakness in September, equity markets rebounded in October despite slowing economic growth and central banks pivot from supporting growth to being increasingly concerned about inflation. Inflation continues to be elevated, with the ability of central banks to manage inflation without starving economic growth the focus of markets. Given high inflation, real yields on benchmark sovereign debt remains firmly in negative territory.

Global stocks remain close to all-time highs, supported by a robust corporate earnings season thus far, with broadly stable profit margins despite cost pressures. Inflationary pressures were confirmed by consumer facing businesses. Nestlé, Procter & Gamble and Unilever all reported higher input costs, though they managed to protect profits by passing on higher input costs to end customers.

Markets have begun to price in tighter central bank policy with the front-end curves moving higher. The picture at the long end is different with the yield at the long end tighter, causing the curve to flatten, suggesting the efforts to tackle inflation may well instigate a slowdown in economic growth. The flattening of the curve has caught

some investors off guard as a steepening of the yield curve driven by the tapering asset purchases was generally anticipated.

Looking ahead, risks are accumulating on the horizon with the market having to digest various China risks, Washington DC policy risks, energy risks, a weakening of earnings as well as a shift in central bank tightening. Given elevated valuation, expectations for further upside mainly resides in continued earnings growth. High household savings, robust fiscal stimulus, and optimism on economies fully reopening support the view that earnings will remain healthy, although much of this earnings growth seems priced into US valuations, less so outside the US given the delay in rolling out vaccine programs.

Pyrford International

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