SINGALLIANCE

Letter n°54

Price increase or inflation?

"By not wanting to know, we end up not wanting to know anymore." Simone Weil.

- As any basic economic textbook teaches, we must distinguish between price increases and inflation, and that is why, for many months, central banks have been stalling. Today, price increases are diverse and sometimes pronounced, for energy, for cereals... but there are no price-wage spirals yet, the essence of an inflationary process from which it is difficult to escape. There are wage increases but they are more categorical and isolated than generalised. But we must be vigilant, otherwise we will fall into the pitfall evoked by the philosopher Simone Weil.

- ***Price increases***: the rate of price increase exceeded 5% in nearly 60% of developed economies and 7% in more than half of emerging countries according to the Bank for International Settlements. In 2019, the respective figures were 0 and 10%.

  In the United States, the CPI price index was 7.8% in February, far from the 12% observed in 1974 during the 1st oil shock, but at a level incomparable with the many years of low inflation favoured by the opening of the world to globalisation. In Europe, the price of energy is up 44% over one year and the price index, moderate in 2021, has just accelerated to 7.5% in March for the Eurozone, with more than 10% in the Baltic countries, 11.9% in the Netherlands, 9.8% for Spain, 7.3% for Germany and 5.1% for France. In Asia, the rates of price increase are much lower and in the emerging countries much higher, with Turkey as an extreme case at over 60%.

- ***The causes of the resurgence of the rise in price indices***: Following the first wave of Covid and after months of forced savings, there has been a surge in consumption, a disruption of supply chains, bottlenecks in semiconductors aggravated by the war in Ukraine as the country provides half of the world's neon gas essential for this production, a rise in energy prices following years of underinvestment, rising wages fostered by labour shortages, soaring shipping costs, the costs of additional investments in the energy transition and defence.

- ***The episode of rising prices, initiated by disruptions in supply chains, is reminiscent of the aftermath of the Second World War***: In the United States, for example, demand for capital goods had exploded and the price index had peaked in 1947. In France, the price index had reached 45% in 1946 and the same was true in many states.

- ***Can price increases, which are currently cyclical, become structural***? The effects of Covid on prices were to fade in the first half of 2022, but the invasion of Ukraine raised fears of more structural inflation as the price-wage spiral in many countries is now underway. The duration of the war will nevertheless play a key role in the eventual anchoring of inflation.

  Over the last 15 months, the appreciation of commodity prices has represented between 3 and 5 points of GDP and with the resumption of military spending, the financing of the energy transition, the increase in wage costs in emerging countries, relocations or the shift from globalisation to regionalisation, demographic ageing, we must ask ourselves the question of a structural component to inflation that has not been compensated for by productivity gains.

- ***The risk of stagflation***? The war in Ukraine has a twofold effect on the economic situation: on the one hand, it causes a sharp rise in the prices of agricultural commodities and energy, thus aggravating inflation and encouraging the acceleration of relocations in sources of supply, with the risk of further inflation.

  On the other hand, it affects consumer and business confidence, and therefore consumption, investment and GDP growth.

  Thus, faced with more inflation and less growth, financial markets fear stagflation. All regions are concerned, the EU probably more than the United States because the latter benefits from full employment and exports gas, oil and agricultural products while Europe will have to finance an increased defence effort and the substitution of Russian gas.

- ***Central banks cannot do everything to counter price increases***: Monetary policies have been very accommodative and it is essential to raise rates, but the rise in rates is not the palliative for a rise in price indices initiated by a rise in energy prices, fuelled by labour shortages and aggravated by an investment cost in the energy transition or bottlenecks.

  In order to better understand these different issues, we will successively analyse the variables of the rise in the prices of food, metals, energy and wages.

Rising food prices:

- ***The actors***:

The main wheat producers are China and the European Union, for amounts close to 135 million tons, India 110MT, Russia 76MT, the United States 45MT, Ukraine 32MT, Canada 22MT.

The main exporters are Russia 35MT, Europe 33MT, Australia 26MT, Ukraine 24MT, USA 23MT, Canada 15MT (according to the FAO).

The Ukrainian crisis is indicative of the fragility of the balances because 30% of the world's wheat exports and a quarter of fertiliser exports come from Russia and Ukraine.

- ***The fragility of the supply-demand balance:***

Wheat prices have risen by 35% since the beginning of the year to €337/tonne and the issues are both on the supply and demand side.

Supply is weakened by the conflict because several countries, such as Hungary, are blocking their exports. Despite good harvests expected in Australia and India, global wheat production is expected to decline. To make up for the shortfall, there is great temptation, especially in the EU, to sow the 4 million hectares of fallow land, but their yield is often poorer. It is not known what the Ukrainian production will be this year but, a priori, the third produced in Donbass, the stage of war today, will be lost. For the time being, freight costs in the Black Sea are prohibitive and many stocks are blocked in Ukrainian ports. Faced with the impossibility of exporting by ship, Ukrainian farmers are trying to use rail links to Western Europe and, failing that, will favour the production of oats, barley, millet for domestic use and sacrifice part of the wheat production this season. It will still be necessary to be able to find replacements and buy fuel and fertilisers.

We are talking about wheat here, but the problem is exacerbated for sunflower oil because Ukraine accounts for 60% of world exports and, to a lesser extent, for rapeseed, because Ukraine is responsible for 20% of world exports and for maize, only slightly less.

Demand is accentuated by drought in many countries. For example, China, with one-fifth of the world's population but only 7% of arable land, expects one of the worst harvests in its history and could increase its imports by 50%. Fears are also high for the countries in the Middle East, especially Egypt, the Maghreb countries such as Morocco, African countries such as Senegal, all of which are victims of a drought and therefore of poor harvests this year (-12% in 2021 for the Sahel countries).

This conjuncture no doubt explains why a majority of these countries want to spare Russia and why they chose to abstain at the UN during the vote on the motions accusing Russia. According to FAO, 45 of the poorest countries source more than a third of their wheat from Russia and Ukraine.

- ***Fertiliser price inflation***:

Fertilisers, obtained either with nitrogen, phosphates and potash are a problem: nitrogen fertilisers are influenced by the price of gas (80% of production costs) and the availability of ammonia because Russia provides 25% of the supply and prices had increased by more than 250% in 2021.

For potash, Russia accounts for 20% of world production, Belarus barely less. The two countries account for nearly a third of world trade.

China and Russia have halted fertiliser exports, which could reduce cereal yields by a quarter but the impact will not be felt in 2022 as there are wheat stocks and fertiliser stocks.

In Brazil, which buys 45% of its potash from Russia and Belarus, production is thus affected by cuts in Russian fertilisers sales.

Rising fertiliser prices may prompt many farmers to rethink their recently highly intensive agriculture.

- ***Social risks in emerging countries***:

The main victims of rising food prices are emerging countries because food represents a high proportion of the household budget, 40% in Egypt or neighbouring countries, more than a third in Africa, 30% in South Asia, 20% in Latin America while in Europe or North America, it is 7 to 15%. From Peru to Tunisia, we see an increase in protest against the high cost of living.

Let's take the topical example of Egypt because the country is the world's largest importer of wheat and is dependent on Russia for 45% of its wheat and Ukraine for 25%. As a result of the sharp rise in cereal prices, the inflation rate in February reached 8.8% and even 17.5% for food products, which represent nearly 45% of the household budget in a country that has nearly a third of its population below the poverty line. The central bank had to raise its interest rate by 1% and devalue the currency by 18%.

Rising energy prices:

- ***2022 is not 1974 or 1979-80***:

By 1974, the price of a barrel had quadrupled. Since the beginning of the year, it is up 35% to $102 but at one point it touched $134.

Reassuringly, the energy intensity of the world economy has halved since 1973, so the sensitivity to price changes is lower, especially for developed countries. In the United States, energy-related expenses have fallen from nearly 10% of income in 1980, at the time of the 2nd oil shock, to just over 4% today.

- ***The impact of sanctions on Russia***:

Russia, before the invasion, supplied a quarter of the world's gas exports and 10% of oil exports. The sanctions could reduce the country's exports by 5 to 3Mb/d and decrease sales of refined products which, before the invasion, reached between 2 and 3Mb/d.

With the slowdown of the world economy and in particular the Chinese economy which consumes 14% of the world supply, demand could fall by 1Mb/d but there is still 2Mb/d to be found, which is difficult because Saudi Arabia and the Emirates, two of the countries rich in available capacity, remain deaf to American solicitations. Worse, OPEC's production is lower than its posted quotas.

Beyond the barrel of crude, which has recently eased relatively, tensions have been observed and should persist on refined products. A segment of interest in the stock market.

- ***Palliatives***:

The IEA: To ease prices, member countries are drawing on their strategic stocks, the United States by a third for 160Mb/d over the next six months, the others for 60Mb/d.

The United States: Production remains below 11.6Mb/d, below the pre-crisis peak of 13Mb/d, because the number of drilling wells does not exceed 75% of the pre-crisis level, even if extraction is profitable at $30 a barrel. Companies remain cautious, focusing on free cash flow generation and are worried about a tightening of regulations.

At the same time, the consumption of crude oil and refined products, +8% over 1 year, has returned to its pre-crisis level, 21 Mb/d, and the bad habit of buying energy-intensive vehicles has resumed.

Iran: If the nuclear deal is finalised, then crude production can increase rapidly by 1.3 million b/d and eventually by 4 MMb/d to 6.5Mb/d and the country, the world's largest holder of gas reserves, could offer an alternative to Russia. This may be the reason for Russia's reluctance to endorse the Iran nuclear deal.

Venezuela: If US sanctions are lifted, crude oil supply could increase by 0.3Mb/d in the short term to 0.8Mb/d, but far from the 4 Mb/d of 2015 because the facilities are dilapidated.

- ***Gas price volatility***:

The price of gas fluctuates widely. For two decades, the price of gas has fluctuated between €20 and €30/MW, recently it reached €335/MW and now €110/MW and is equivalent to a barrel of crude at more than $190/barrel.

- ***The cost of the energy transition***:

The financing of the energy transition is a structural component of inflation with, on the one hand, the depreciations of assets related to fossil fuels, and on the other, the cost of investments in clean energy.

Rising metal prices:

Russia's weight in the supply of metals is undeniable with 45% of the world's palladium production, 15% of platinum, 11% of aluminium and 10% of gold. Similarly, Rosatom holds a third of the world's enriched uranium market, but Russia accounts for only 5% of the world's uranium production.

Fears of supply disruptions pushed the prices of nickel, aluminium, palladium to record levels before they fell back somewhat. Since the beginning of the year, the price of nickel has risen by 61%, that of uranium by 40%, that of aluminium by 22% and palladium by 16%. The appreciation of copper, 6%, is more modest but it had increased a lot just after Covid with then the strong Chinese demand.

Often these increases are temporary while trade is redirected, supplies are diversified and alternatives are found.

Boeing has announced that it will stop buying titanium from Russia, which accounts for 1/3 of its purchases, and is considering how to increase its purchases in Japan, the United States, China and Kazakhstan. At the same time, Airbus buys 50% of its titanium from Russia and has more than 6 months of stocks to prepare a diversification of its purchases towards Toho titanium and Osaka titanium, two Japanese groups, UKTMP a group from Kazakhstan, the Saudis and the Americans.

Rising wages, a real inflationary risk:

More so in the United States than in Europe, it is the result of a rapid return to pre-crisis unemployment rates, the consequence of job shortages in many service sectors and record resignations in the United States. For example, work remuneration in the United States has increased by 13.5% since the beginning of Covid compared to 5% in Europe.

It is now fuelled by the desire to compensate for the declines in purchasing power caused by the surge in commodity prices and by the demand for an increase in the wages of low-skilled workers.

From a more structural perspective, according to ***Goodhart***, formerly at the Bank of England, price indices should be between 3 and 4% depending on the country at the end of this year because with the ageing of the population, an era of labour shortages of workers is opening up, the opposite of the last 30 years when China and India had opened up to globalisation. China's labour force is now expected to shrink by 20% within 30 years, and many other countries are facing ageing.

Conclusion: Stock market opportunities and risks.

- ***Producer price indices are rising sharply***: 10% in the United States, 8.8% in China and this could affect companies' margins if they fail to pass on these or the no less significant increases in transport costs. This is an incentive to invest in companies capable of passing on price increases.

- ***Energy, despite the recent rise in prices, is less expensive than in the early 70s and is less of a threat to growth than it was then***: The price of a litre of gasoline in relation to the minimum wage is 40% lower than at the time and the energy intensity (energy consumption / GDP growth) is half as much.

  In 1974, US GDP fell by 0.5% after an increase of 5.5% in 1973. This year, it could grow by 4% after 5.7% in 2021.

  1974 marked the end of the "Thirty Glorious Years", and the emergence of structural unemployment, chronic inflation and a long period of stagflation. In 1980, as a result of the 2nd oil shock, the price index in the United States reached nearly 15%, interest rates were raised to 20%, the unemployment rate reached 11%. 2022 will accelerate the energy transition.

- ***Price rises are affecting emerging countries and disadvantaged populations more***: Rising interest rates, capital flight, shortages, social and political unrest, many factors contribute to the weakening and destabilisation of many emerging countries. In Turkey, the official figure is 61% but the reality is worse as the Turkish £ had lost 45% of its value in the fourth quarter of 2021 and the repercussions are beginning to be felt. In Russia, following the sanctions, the one-year price index exceeded 16%. All of these factors call for caution before investing in these markets.

- ***The investments necessary for the energy transition and for defence are inflationary***: The cost of closing down and depreciating assets and the cost of investments in renewable energies, in the exploration of metals and rare earths and in equipment (solar panels, wind turbines, etc.) are all combined. But, from a stock market point of view, the suppliers of such equipment are to be favoured.

  It is also important to note, and the analysis of recent decades confirms this, that the energy transition does not mean the decline of any particular energy but the addition of new sources. Thus, the consumption of coal, supposedly replaced by hydrocarbons for many years, has never been so high.

- ***The policies of relocation, reindustrialisation can have an inflationary character***: In the 80s, the globalisation of production, the stimulus of international competition and the unprecedented innovation movement were effective responses to the inflationary pressures of the 70s. Tomorrow, we risk the opposite.

- ***Central banks have begun to raise rates and so we will continue to limit bond investments***: The Bank of England has raised its rate to 0.75%, its third increase, because it anticipates a price index at 8%, the Fed, which has raised its rate to 0.25%, should begin to reduce its balance sheet, currently at $9 trillion, by $1.1 trillion / year from May, and should carry out 7 rate hikes this year, far from the 3.5% target desired by Bullard, a "hawkish" member of the Fed, but nevertheless enough to stop the increase in real estate prices since the 30-year credit rate is approaching 5% against 2.75% at the beginning of 2021. The ECB could erase its negative rate, -0.5%, by the end of the year, the SNB will wait and maintain a negative rate of -0.75% this year.

- ***Central banks will nevertheless be cautious in raising rates: as Oscar Wilde said, "Never put off till tomorrow, what you can do the day after tomorrow".*** Raising rates too much would risk causing a recession, raising them insufficiently would be a lax against inflation.

  Concerned about solvency problems for governments, aware of global debt levels and eager to ward off the risk of a bursting of financial, stock market and real estate bubbles, central banks will allow negative real rates to remain.

  The rise in interest rates will take time to penalise states because they have extended the average duration of the debt to 9 or 10 years.

- ***The acceleration of price increases is not an obstacle to the appreciation of stock markets:*** In addition to the previous point, companies in 2021 were able to pass on cost increases, recorded an improvement in their margins and were able to capitalise on productivity gains born of digital technology. For example, in the United States, productivity per hour of work increased by 2.2% in 2020 and 2021, a level higher than the 0.9% annual average observed between 2011 and 2019. Stock markets have thus been able to appreciate and the work of the London Business School on the evolution of the markets since 1900 shows a rise in the markets in periods of inflation.

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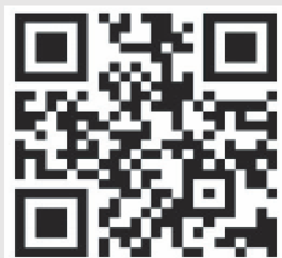

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