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INFLATION – The Six, Powerful, Slow Acting Forces

There has been much talk of a return to inflation which has only picked up pace if you are fan of financial market news and podcasts. Whilst a lot of the conversation focuses on the Federal Reserve, global money printing by central banks and more recently the record fiscal spending, there seems to be less attention being paid to some of the slower acting forces.

To overcome the past 40 years of deflation would require a force greater than the big deflationary tailwinds of technology and demographics. The idea of the Six Slow Acting Forces comes from an interview by Joseph Walker with Ian Macfarlane, the former Governor of the Reserve Bank of Australia from 1996 to 2006. Listen to it here.

He talks less of monetary policy (whilst of course acknowledging its impact), but instead of six underlying characteristics of the period from the mid 1960's to the end of the 1970's that seemed to spur inflation. You do not necessarily need all these forces at the same time to create persistent inflation, and each in isolation does not create inflation. As economies move through the business cycle the forces ebb and flow but the direction of travel is still the same. Macfarlane acknowledged there were six forces generally in place over that period.

The six forces, in Macfarlane's view, relate to the period from the of the mid 1960's to the end of the 1970's:

1) Strong Economic Growth
2) Rising wages in line with inflation
3) High Levels of Trade Protection
4) Little to no competition from Developing Markets.
5) Ability for business to operate at cost plus, that is they had pricing power.
6) Inflation Expectations were elevated.

There are of course other factors over that period such as demographics and the oil price shock. However, you could argue the demographics drove the growth and the oil price shock drove the change in inflation expectations.

If you look at the setup in the 2020's we have the following as a backdrop:

i) Levels of fiscal and monetary stimulus that we have not witnessed before and a bipartisan propensity to spend your way to a recovery.

ii) Pressure on minimum wages to rise from two forces:
   a. ESG and societal concerns around how staff are treated and remunerated:
   b. Government support payments that are similar to, or higher than, the minimum wage in some countries.

iii) Global Trade and Just-In-Time (JIT) supply chains are being questioned for an over reliance on China in an environment of increasing friction on trade that started under the Trump administration.

iv) At present, some Developing Market are currently struggling with the lack of progress on COVID19 vaccinations. Could they benefit from the West's desire to diversify away from China?

v) Currently, firms that can hold inventory near the consumer are able to charge an "availability premium". Seeing this in technology and some food & essentials

vi) Inflation expectations are on the move and starting to break out of the long term down trend.

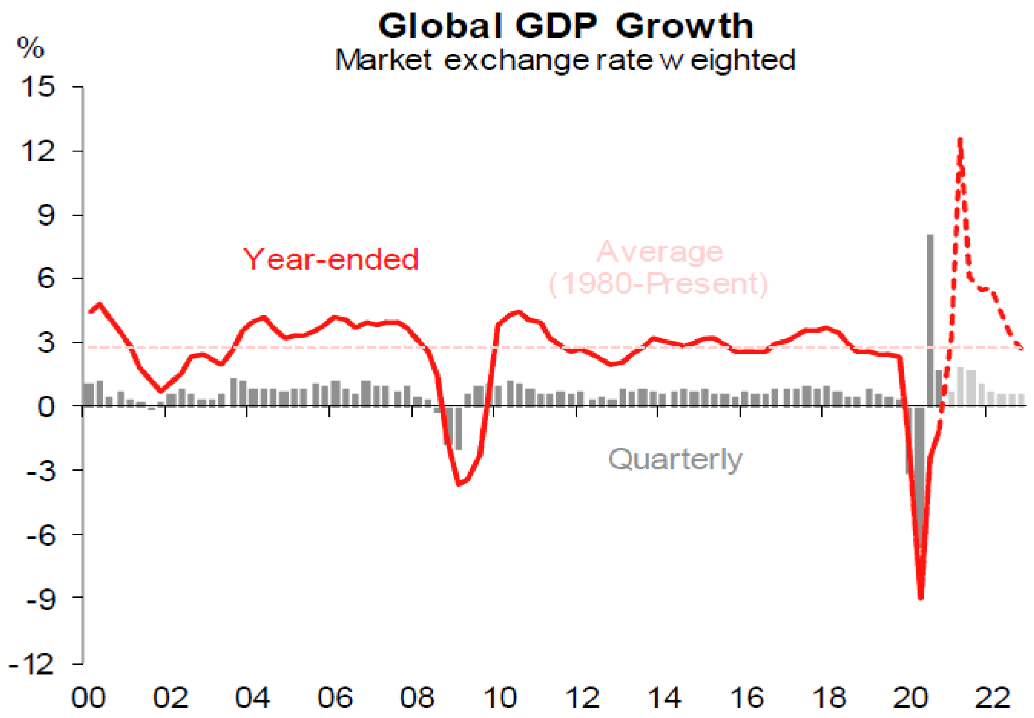
Below we will look at each of the six forces and how that could impact inflation over the next decade. We will break it into Six Sectors.

1. **Economic Growth**
2. **Wages, Unions and Labour availability**
3. **Trade Policies and Geo-politics**
4. **Developing Markets**
5. **Business Attitudes – cost plus approach**
6. **Inflation Expectations**

1) Economic Growth

Direction of travel: stronger from a low base but can it be sustained past 2021?

After a huge hit to growth in H1 2020 we are seeing global growth pick up pace. There is a strong argument that this will be temporary and global GDP growth will return to the prior trend. The chart below from Macquarie shows expectations of normalization in growth rates by late 2021/22.



Source: Macrobond, Macquarie Macro Strategy

This view assumes that governments globally will remove direct payments to individuals and remove the accommodative corporate policies. There is a good argument for this to play out, but I think the pullback will be shallow as governments (democratic or not) do not have the stomach for letting their economies contract even further.

With the embrace on both sides of politics to the benefits of aggressive fiscal policy we could see the direct payments continue in different forms. Maybe less in magnitude and titled something else, but it is politically difficult to turn these payments off once the (voting) constituents are used to it. The next 3-6 months will be pivotal because if the vaccination roll out is successful and the private economy can pick up the slack then the government support can be removed as per most consensus expectations. If there is a hiccup with that strategy, governments will be forced to step in again.

The risk to growth disappointing is that governments try to raise taxes to quickly. This would be negative for both the real and financial economy but likely to lead to higher inflation as the costs are passed to the consumer. This would be the worst of both worlds' scenario.

Others, are more optimistic around GDP. In Q1 2021, Morgan Stanley forecast global growth for 2021 at 6.6% and 4.7% for 2022. The IMF has recently revised higher their world GDP number to 6% for 2021 (from 5.5%)

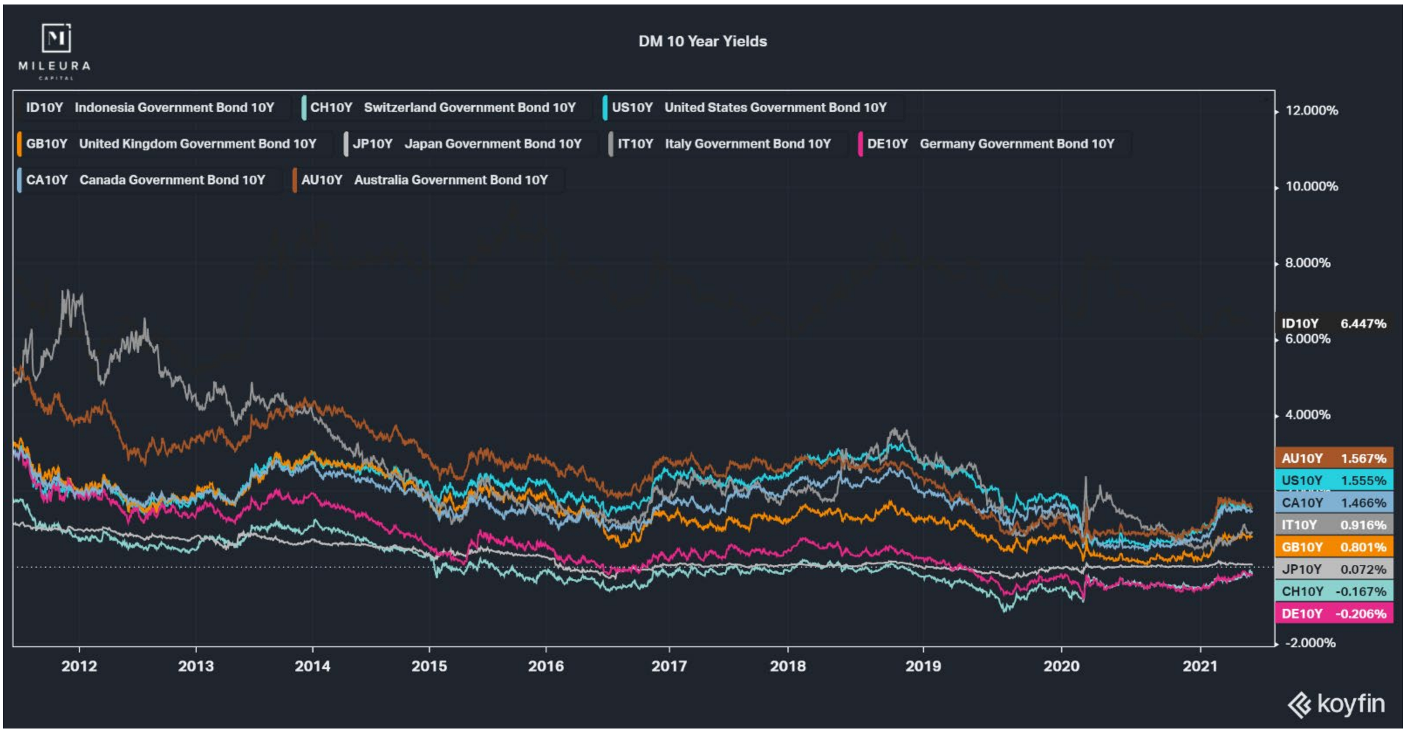
As we head into Q2 2021. The U.S. bond market has been pricing in growth with a rise in yields in the long end of the curve causing a bearish steepening of the curve.

This rise in yields has been consequence of rising inflation expectations and a rotation out of very high-priced low yielding government bonds into more risky assets such as equities, commodities, private equity, and credit markets.

St Louis Fed 5-Year, 5-Year Inflation Expectation Rate

From a longer-term perspective, we still have very accommodative global monetary policy in developed markets. Emerging markets are more of a mixed bag and is a concern for global growth. However, we are seeing stabilisation as we finish up Q2 2021.

Developed Market 10 Year Yields



Emerging Market 10 Year Yields

That leaves us with what we know.

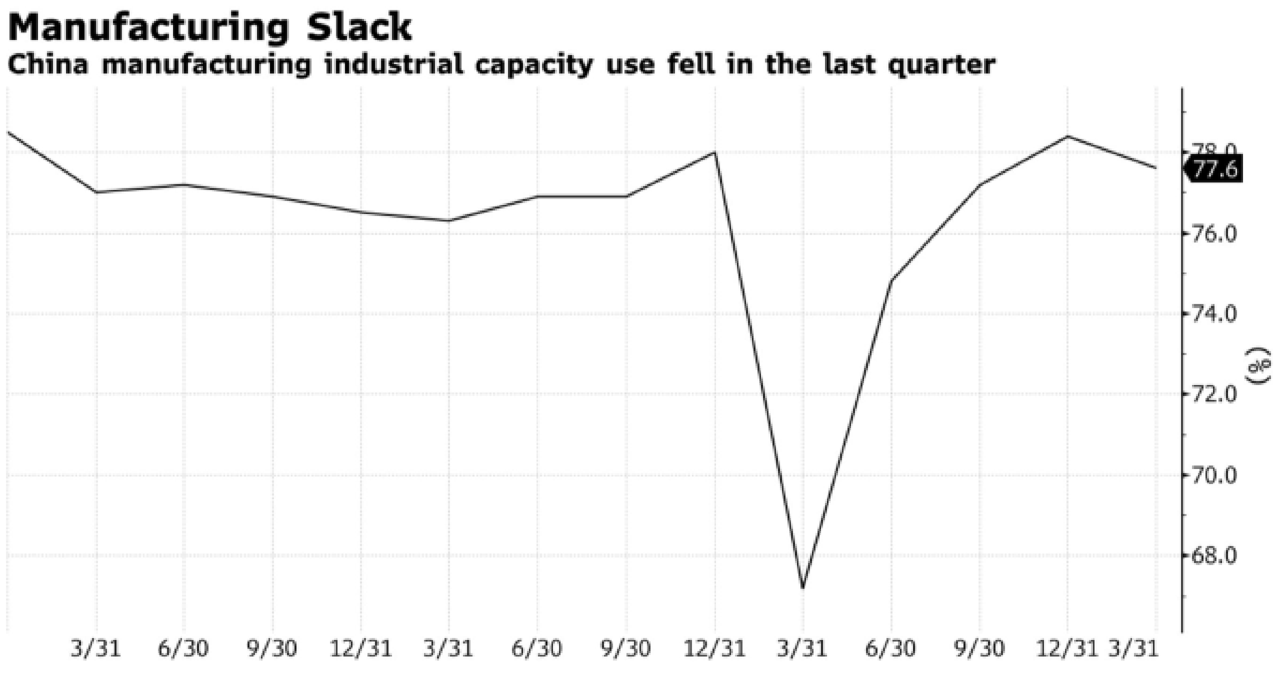
G10

- Government Fiscal Support remains strong in the G10 but starting to taper off for the balance of 2021.
- Voters on both sides of the aisle are becoming more comfortable with high deficits as a % of GDP
- Central banks are indicating they want to see inflation run higher than target to get average inflation up to their 2-3% target.
- There will be idiosyncratic issues impacting each main region. Japan for example is going into another period of lockdown.
- However, the general trend should be stronger than average growth overall with pockets of over and under performance due to COVID and bottlenecks.

China

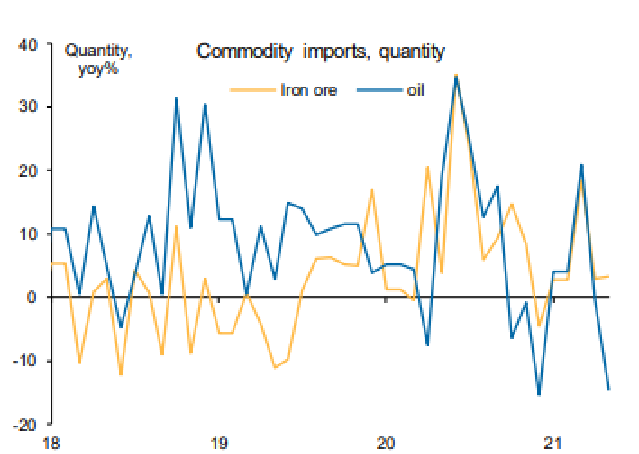
- The economy remains strong in China though the government is slowing down in magnitude its support for housing
- Commodity demand in China for iron ore, corn, soybeans and energy remains strong but the pace is slowing due to government intervention and seasonal impacts.
- As the West re-opens consumer spending starts to revert to services over goods after lockdowns.

This is reflected in some slack in industrial capacity. The chart below, courtesy of [Bloomberg](), shows some moderation in Chinese manufacturing.



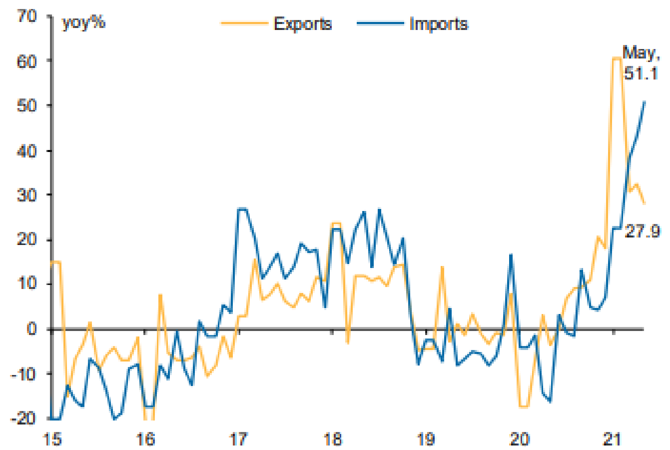
- After a blistering 2020, quantities of imports are starting to slow and volumes of exports to the US are also slowing as well.
- The charts on the next page courtesy of report by Macquarie's commodity research team highlights this well.

Quantities of commodity imports slowing



Source: China Customs, WIND, Macquarie Macro Strategy, June 2021

Exports to the US have slowed relative to others



Source: China Customs, WIND, Macquarie Macro Strategy, June 2021

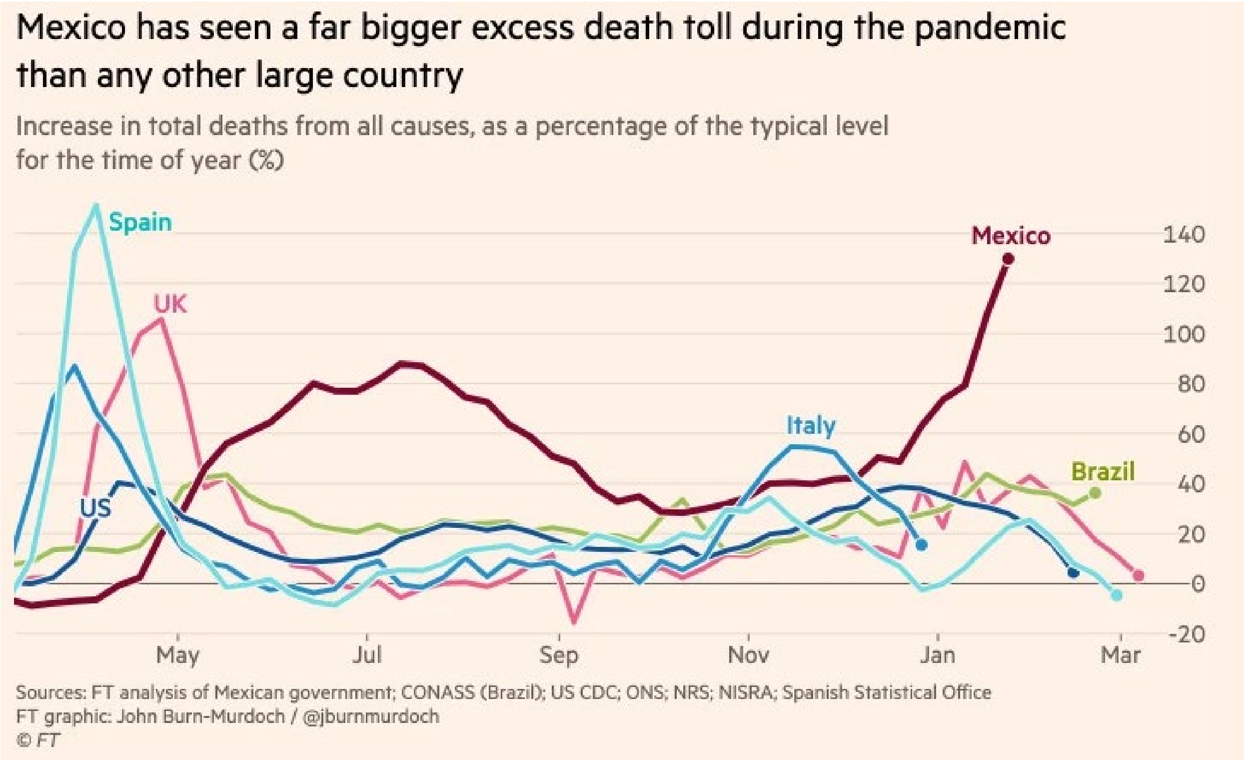
Asia-ex China

- Despite suffering acutely from COVID-19 currently, India should rebound strongly and along with the rest of the sub-continent is in a strong position to play an increased role in certain supply chains.
- Textiles and vaccines being one area where further growth could come from
- SE Asia should be a net beneficiary from a change in supply chains away from China
- Korea and Taiwan have recovered well thanks to the manufacturing sectors
- According to a [Bloomberg] article the rise in container shipping rates has supported flows in South Korean benchmark indices.
- There is some worry though with PMI's rolling over that we see some slowdown in H2 2021.

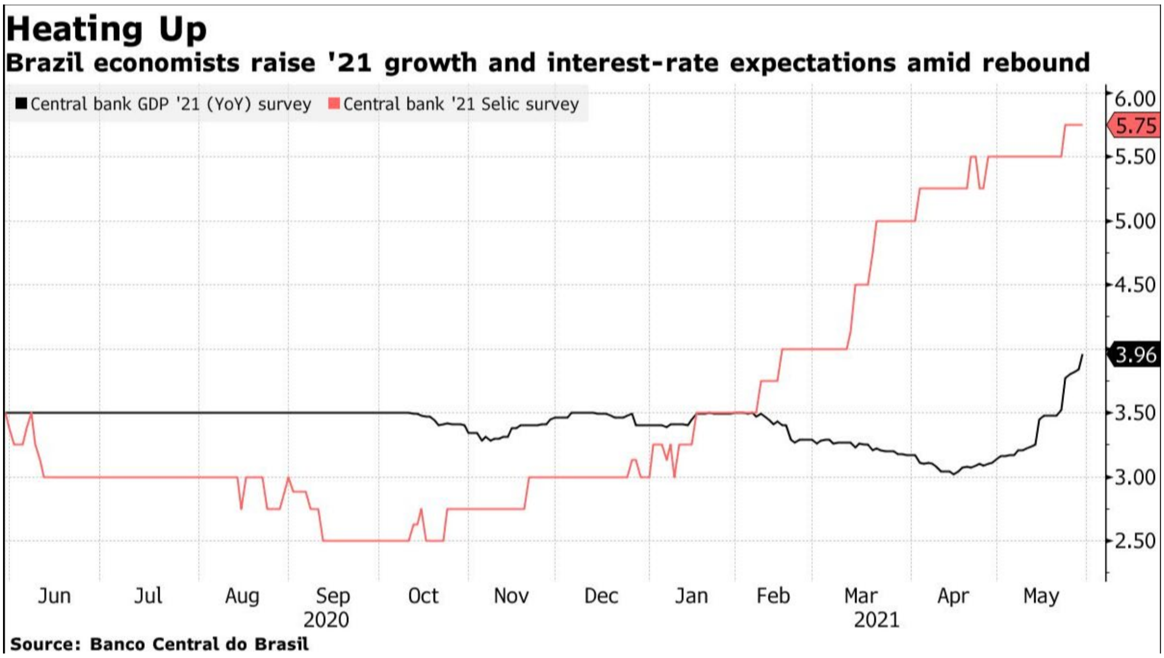
- Vietnam performed relatively well during the crisis but has recently struggled with the virus causing new lockdowns in Q2 2021.
- Longer term, Vietnam is likely to be beneficiary from the move of manufacturing out of higher cost locations like China, South Korea and Taiwan.

Latam

- Remains unpredictable politically but over time most areas will benefit from generally higher commodity prices.
- The short term is highly dependent on how COVID19 is handled.
- More idiosyncratic risk with the political situation hard to predict.
- Mexico has suffered badly from the pandemic. The below chart from the FT highlights the issue.



- However, due to efforts to move industries away from China, Mexico should be a large beneficiary of re-shoring back to the continent.
- Brazil remains attractive alternative to source agricultural commodities and iron ore than the U.S. or Australia for China.
- Currently expectations for Brazil are quite optimistic. It remains volatile politically so some of the natural tailwinds could be offset by poor economic and social policies.



Africa

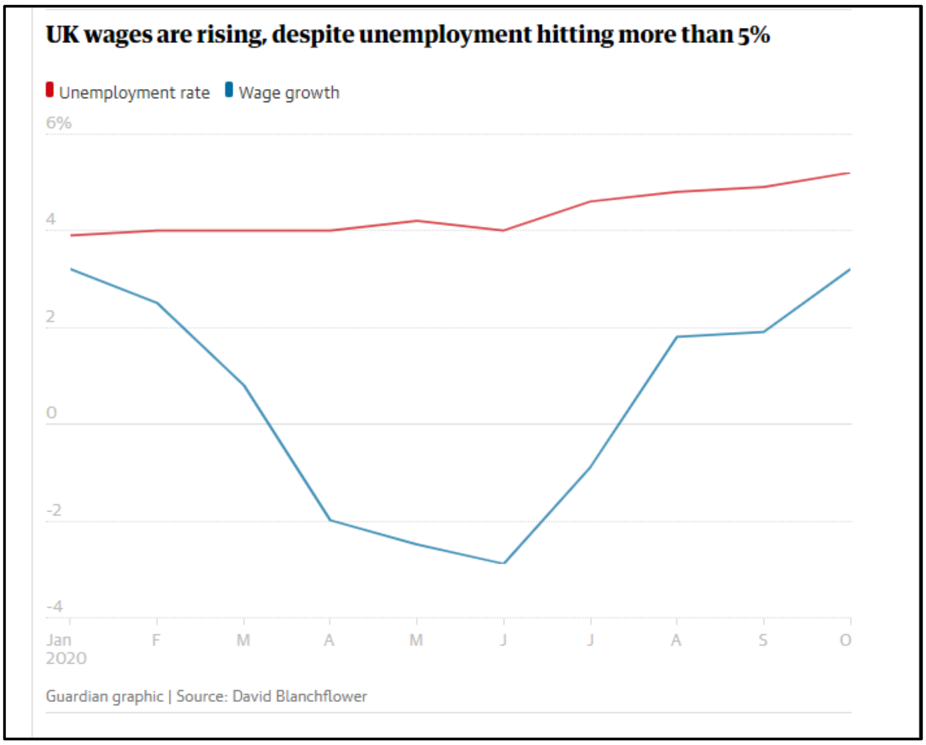
- Generally handled better than most EM.
- Most countries are in a position to benefit from higher commodity prices
- Provides an alternative for China in sourcing agricultural commodities, metals and energy.
- The politics in the region remain unpredictable across the continent making any sort of forecast beyond 3-6 months very challenging.
- In the short term the lack of clarity of how the population will be vaccinated is the biggest hurdle. Over the balance of norther summer, there is hope that the US & EU having made significant progress on their own vaccination programs can export more doses.
- Africa remains a region of huge potential and an area we need to a lot more work on to understand and comment with more authority on.
- In an interesting side note, Ghana, the 2nd largest producer of cocoa beans is looking to establish its down manufacturing capacity. Currently, of the circa $130bn in the global chocolate industry, less than $2bn goes to Ghana. See more here

In summary, the direction and composition of growth over the next decade will be different to the past several decades. With politicians being supported to spend more and whilst interest rates remain low the first few years of this decade should see stronger than average global growth rates. For 2023 and beyond it will driven by if and how central banks and governments remove support for the economy. One thing that will not change is politicians like power and getting elected. Currently, they are being supported based on spending plans not fiscal conservatism. I do not see that changing for another election cycle or two at least.

2) Wages and the Strength of Unions

A recent study by the Bureau of Labor Statistics showed, over the last 50 years middle-class earnings in the United States have fallen by more than 11 per cent when adjusted for inflation. Over the past 1-2years we have started to see minimum wages start to rise in western countries. Part of this is a response to political pressure, protests and the rise of nationalism that coincided with Brexit and the election of Trump.

Today, an interesting phenomenon being experienced in the West today as economies start to re-open. Several businesses are struggling to find workers despite unemployment being higher than pre-pandemic levels.



via the Daily Shot @soberlook

It is hard to point to any single issue driving this. Some contributing factors may be:

i) Because of the large government payments, the private sector will need to "bid" workers from unemployment benefits to the workplace.

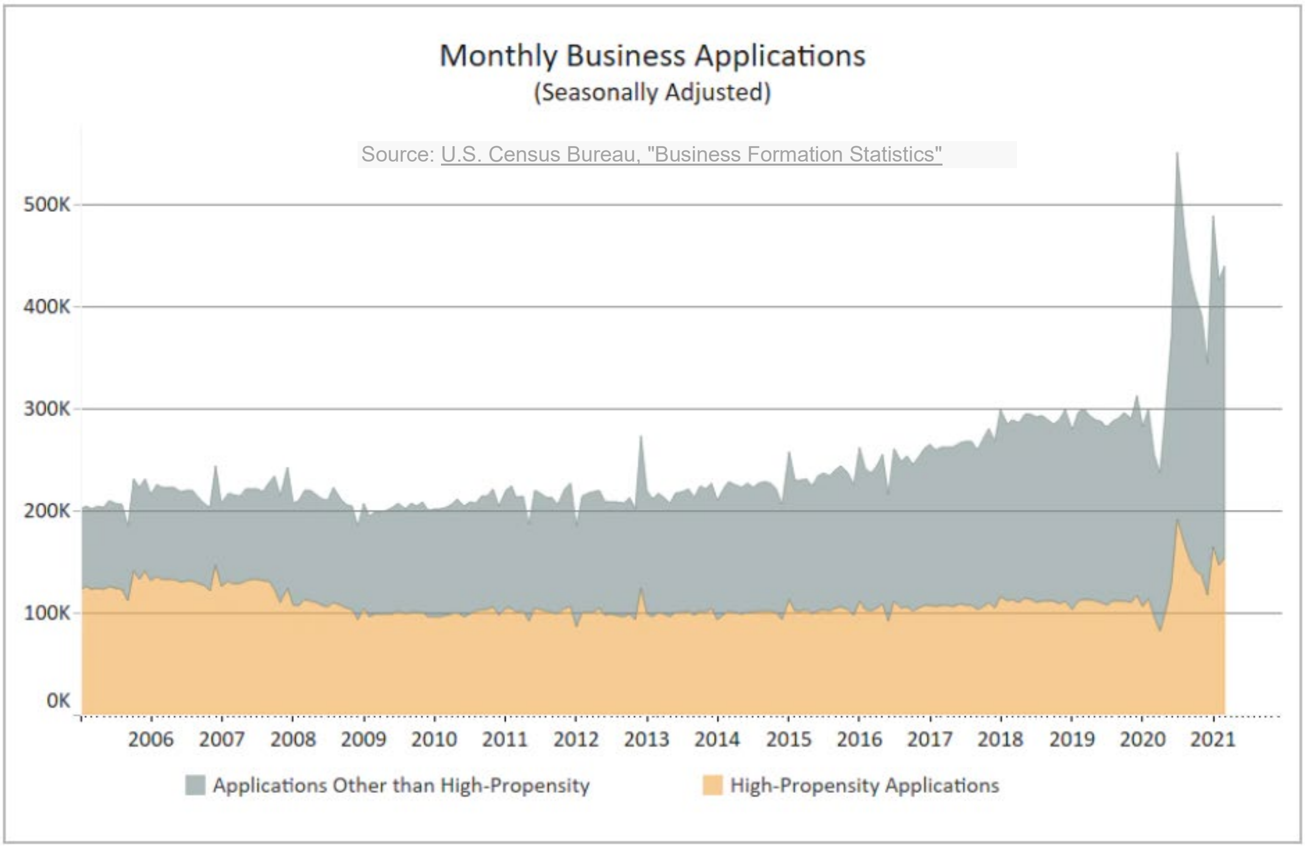
ii) Fears of going back to work and catching COVID-19. UK is rated as one of the highest on this scale with close to 60% of respondents not wanting to go back to the office.

iii) Not all countries have schools fully re-open so workers are having to stay at home to care for children

iv) Working from home has become more acceptable so workers are moving to jobs that offer that type of flexibility.

How long these will persist for will be better known in 2022. In the short term wages are likely to remain supported.

An interesting statistic is the number of companies that have been established over the pandemic. Could these new business owners be resorting to buying & selling services online rather than working in the lower paid service industries that are currently suffering to hire workers?

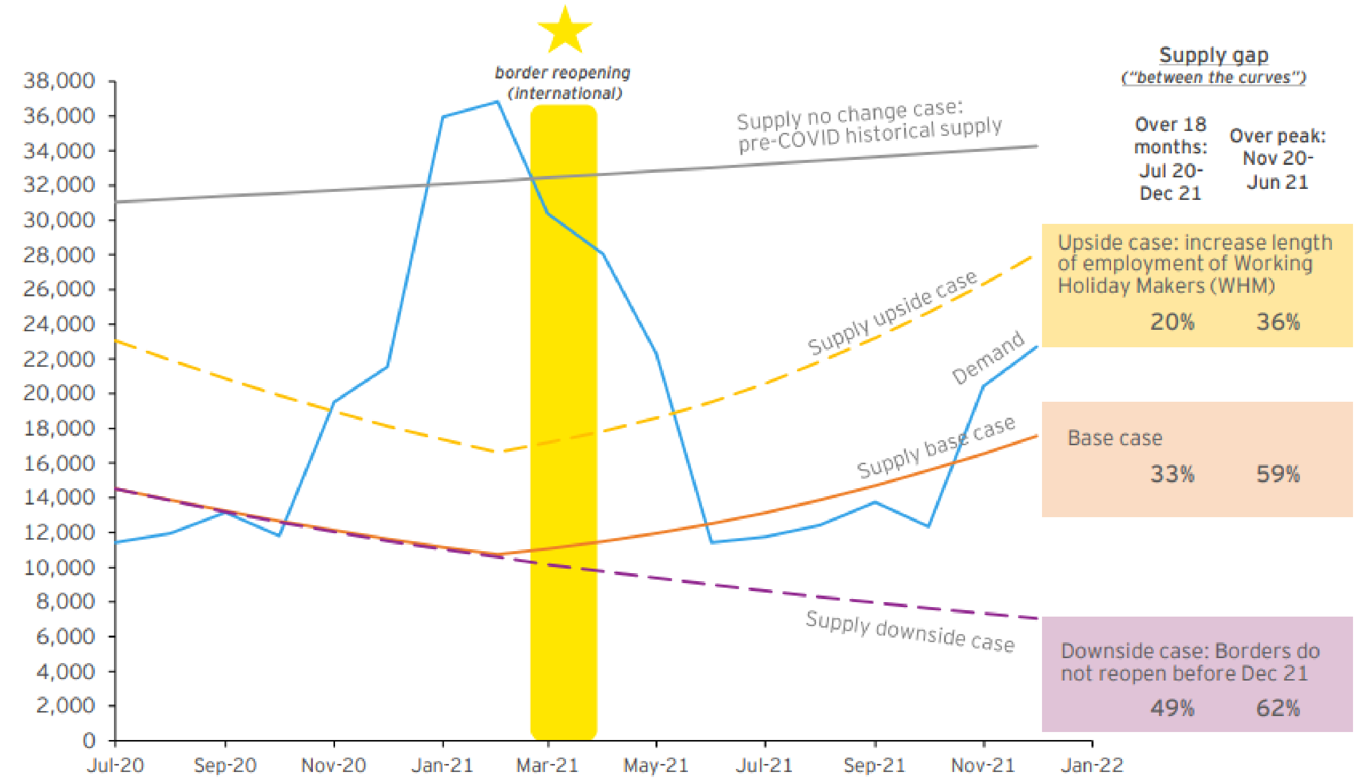


Then there are the anecdotal stories across different parts of the world where it is becoming harder to find workers for lower paying jobs.

Attracting workers to rural areas is proving a challenge across the U.S., UK and Australia. This is at a time when prices for most agricultural commodities are elevated. You hear stories of paying $120,000 a year to retain staff as the lead farm hand (like a Site Manager at a factory).

In a study done for the Australian vegetable and potato industries by Ernst & Young shows the gap in labour requirements. They estimate a monthly casual labour gap of around 35-55% for the first half of 2021. This estimate was done with the assumption international travel in Australia would re-open in March 2021. As things stand today, it seems unlikely international travel without quarantine will be available on a large scale until 2022 at the earliest. This is driven by the lack of available labour from foreign workers, but it also driven by the lack of desire of those living in urban areas to move to rural areas for temporary work. Remember, in Australia the minimum wage is about A$25 per hour.

Total forecasted casual labour demand and supply, by month (headcount, Jul 2020 - Dec 2021)



 EY | 14

Source: EY - Seasonal horticulture labour demand model, Note: *DISCLAIMER: The reopening date of international borders has been set to March 2021 as agreed with Hort Innovation as a key variable to forecast potential impacts on casual labour. However, the labour gaps could be much longer/of higher magnitude if the border reopens at a later stage. We have not done a detailed analysis of labour supply and have used publicly available information using basic assumptions within the model

These labour pressures will eventually be felt through higher prices to consumers. Given it will impact food prices on the shelves this will eventually flow through to people's discretionary income.

Service industry impacts

In the U.S., where restaurants are further ahead in the re-opening phase, you see plenty of news articles and social media posts of businesses suffering from a shortage of staff. It is too early to tell whether this will pass or will wage inflation finally return after being absent in real terms for decades. Is this due to immigration, fears about catching COVID or the unintended consequences of government support program? These type headlines are a regular occurrence in the Spring of 2021

Restaurants Serve Up Signing Bonuses, Higher Pay to Win Back Workers
With job openings above pre-pandemic levels, eateries from McDonald's to Wolfgang Puck's Spago are battling for new hires

(Link here)

4 things that might explain the labor shortage hitting the reopening American economy

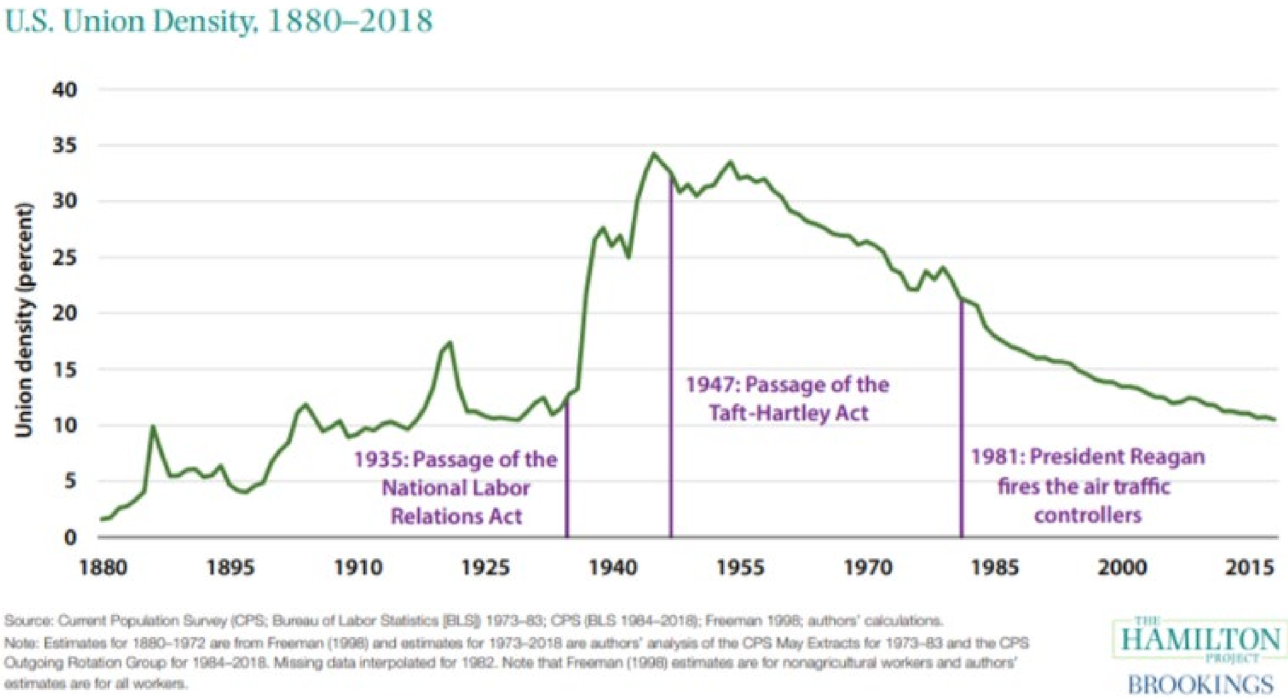
(Link here)

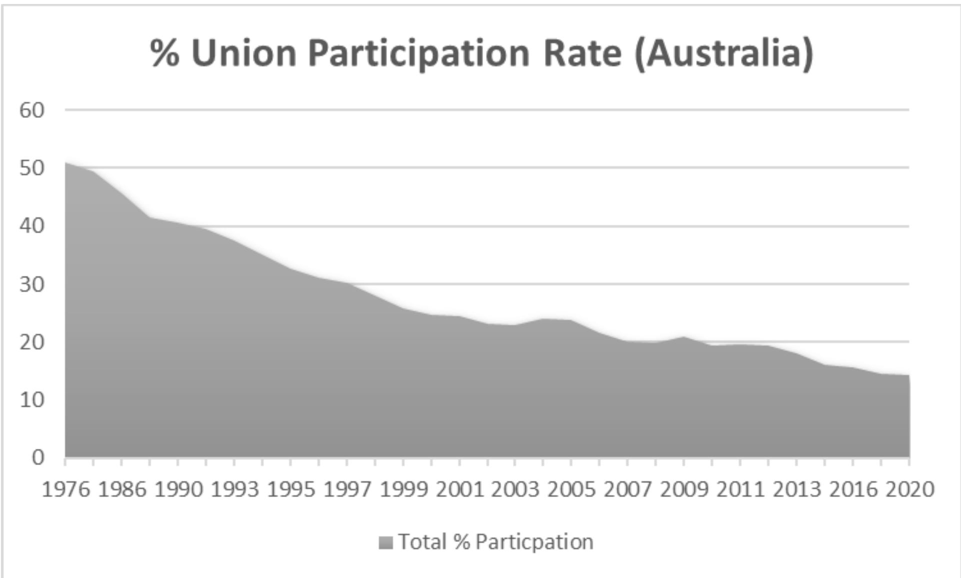
A Florida McDonald's is paying people $50 just to show up for a job interview, and it's still struggling to find applicants

(Link here)

Unionization – Is ESG and Stakeholder Capitalism today's version of Unionisation of labour forces?

The trend for unionisation has been clear over the past 30-40 years with participation rates dwindling across the western world.



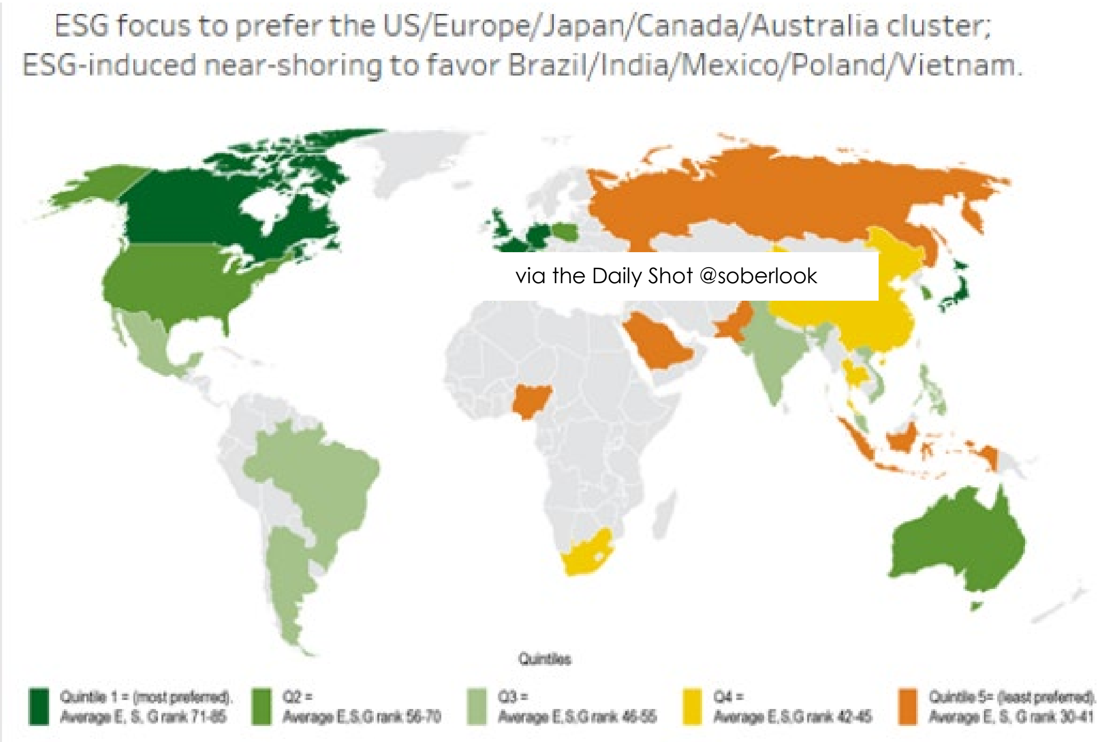


However, after decades of decline there are signs of trends starting to change. As the west slowly turns away from globalization and the power of the corporation is being questioned, union voices are becoming louder. In conjunction you are also seeing the rise of stakeholder capitalism and ESG concerns. Whilst these are different to unions, they may have a similar impact on worker's right and lead to increasing upward pressure wages.

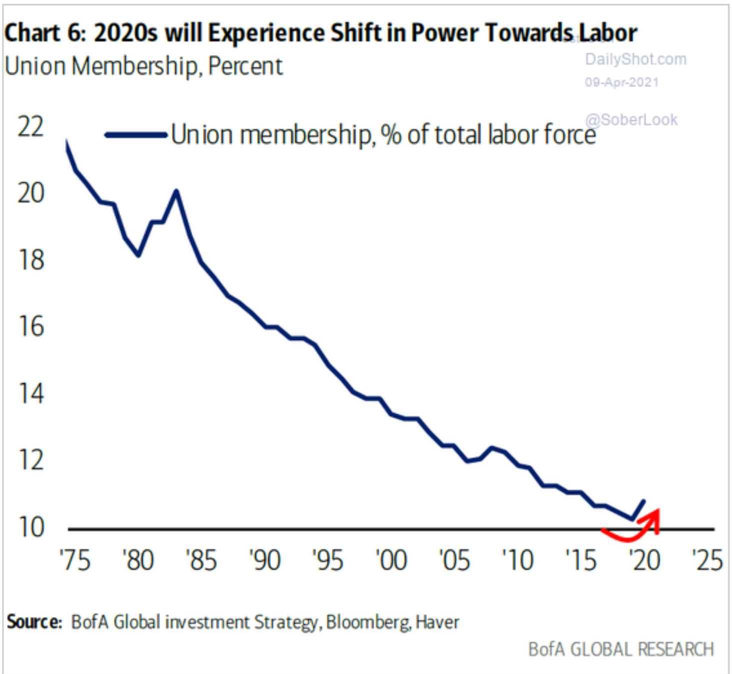
These trends of ESG and stakeholder capitalism are coming at the same time as re-shoring is going on in the U.S.A. So, whilst different in symptoms from the 1970's we are seeing pressure applied on corporations to look after their workforce and be able to prove that they are following through with these promises. Corporations are becoming increasingly willing to pay for convenience and security rather than outsourcing labour to the cheapest alternative.

Further to this trend of ESG and reshoring there are some great charts from BofA [here](#) . The ESG map and chart is below:

ESG impacts on CAPEX decisions.



Unions themselves are also attempting to stage a comeback. Below are some anecdotal stories highlighting the labour issues.



Amazon vs. Unions

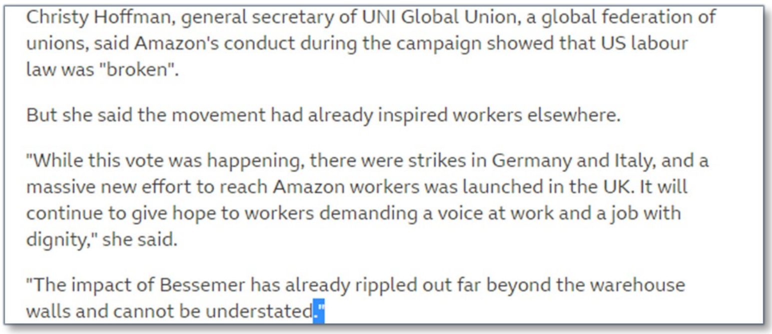
Even the GOP has been supportive of the recent bid by workers in an Amazon warehouse in Alabama to form a union. See story (here)

AXIOS

Marco Rubio sides with Alabama warehouse workers in Amazon union battle

Mike Allen
March 12, 2021 · 1 min read

Ultimately Amazon won this fight, but it does seem the tide is turning. See BBC article here



Christy Hoffman, general secretary of UNI Global Union, a global federation of unions, said Amazon's conduct during the campaign showed that US labour law was "broken".

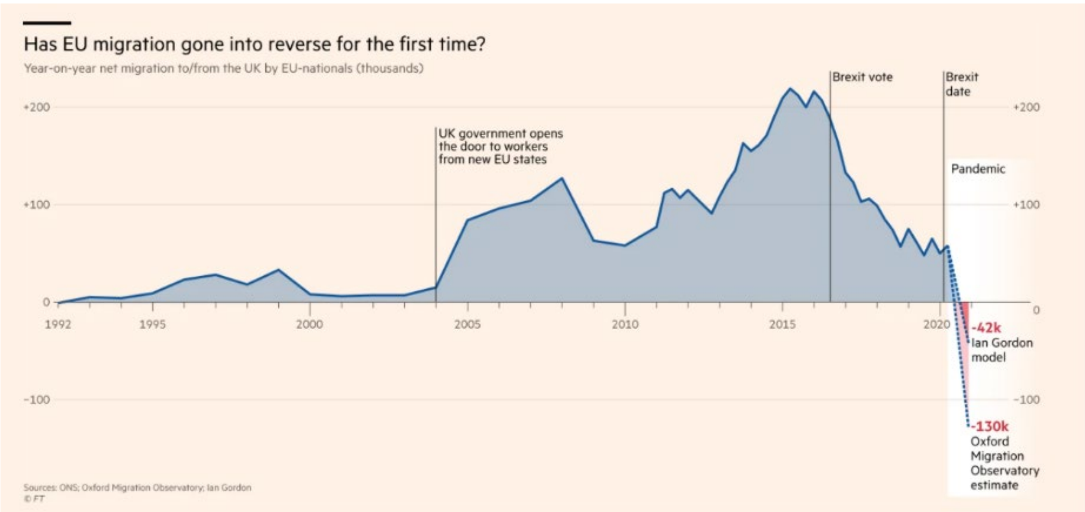
But she said the movement had already inspired workers elsewhere.

"While this vote was happening, there were strikes in Germany and Italy, and a massive new effort to reach Amazon workers was launched in the UK. It will continue to give hope to workers demanding a voice at work and a job with dignity," she said.

"The impact of Bessemer has already rippled out far beyond the warehouse walls and cannot be understated."

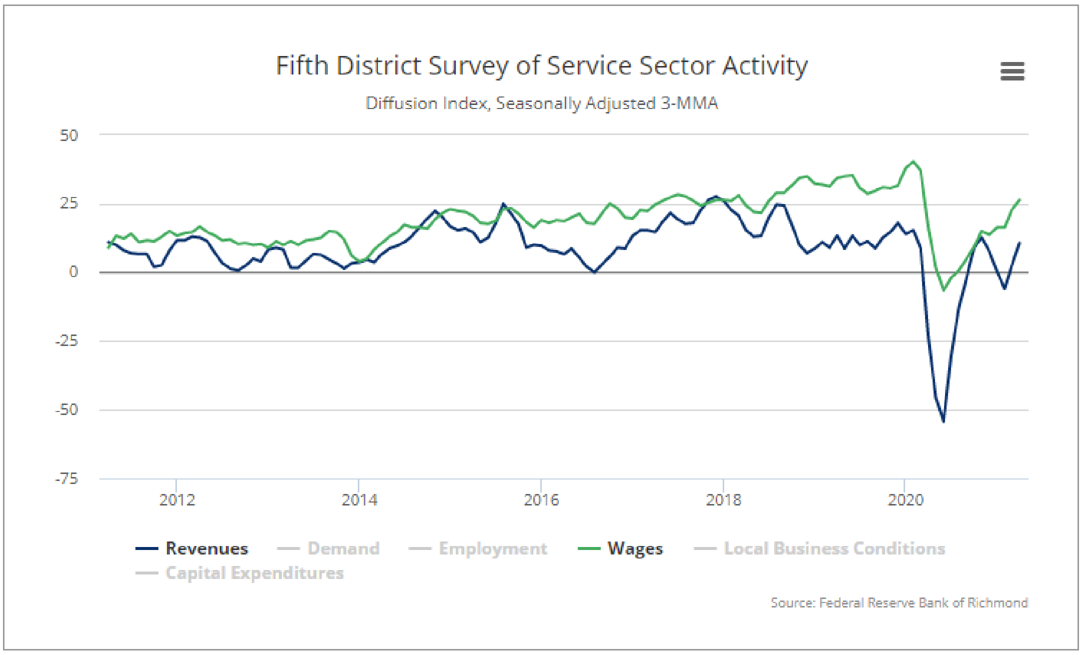
UK Post Brexit

In the UK due to the combination of Brexit and COVID19 restrictions, the availability of foreign workers has declined. (see FT article here). This leads to a shortage of the low-skilled work in construction and serviced based industries such hospitality. Whilst part of this will no doubt be transitory, the UK's move out of the EU has changed the dynamics in the longer term will be no longer be under as much pressure from Eastern European migrants who have flourished in the UK over the past 15 years.

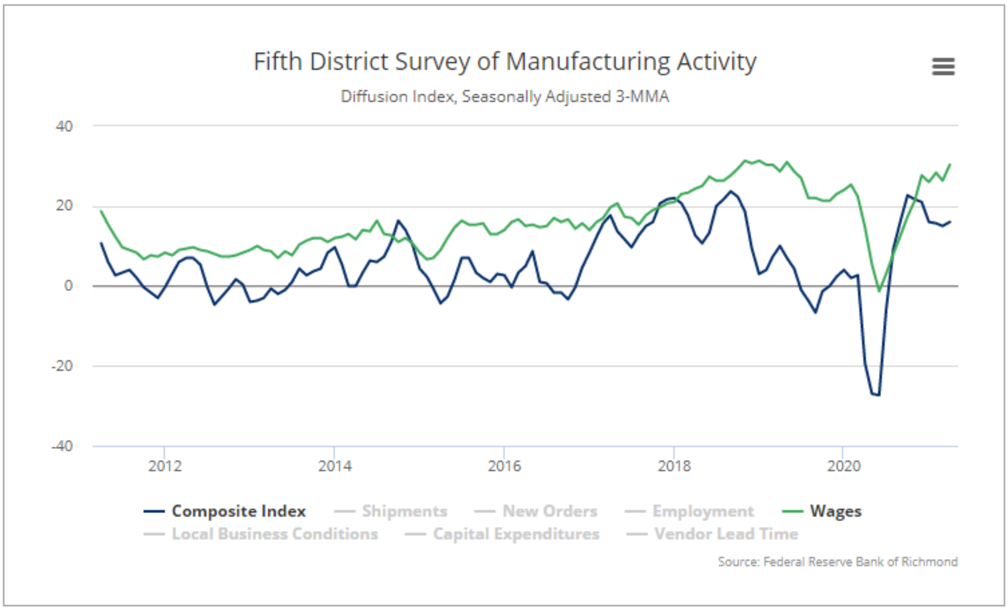


Pressures on Wages

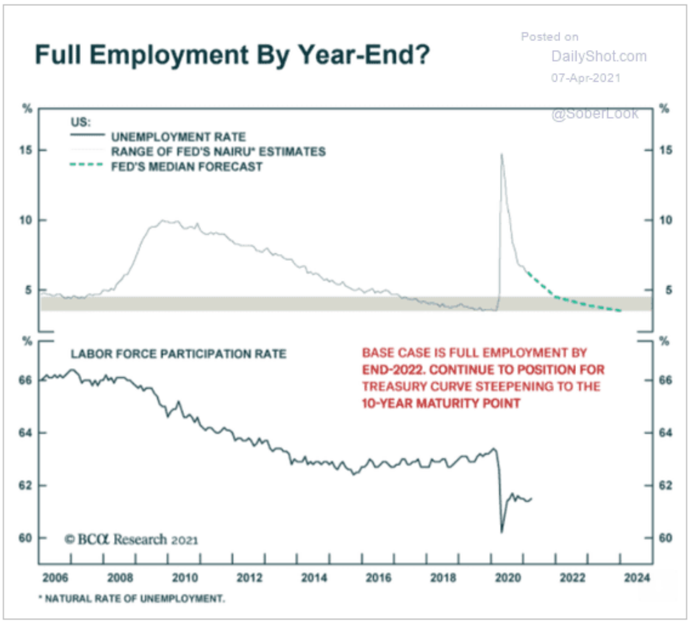
The U.S. is currently (Q2 2021) struggling to find workers as the country re-opens. Given the combination of the above we are seeing wages and labour tightness indicators move higher across the board in the U.S.A. This has especially been felt in the service sector as per the above stories about food services



But it is not only being felt in service industries. Across manufacturing, agriculture and the broader business environment, wages are surging. A large proportion of this has been (and should be) attributed to COVID-19 impacts. Over the coming months has more people become vaccinated and inter-state and international travels normalises some of this wage pressure should ease. Whilst still early to make any bold predictions how this will impact the next decade it does suggest some of the longer-term headwinds to higher wages are changing direction. Thanks to a focus on re-shoring, ESG and lack of immigration the floor in wages is likely creep up in real terms over the longer term.



Some market pundits are calling for full employment by the year end. The amount of momentum in the economy is positive so this is not out of the question. This does bode well for wages and inflationary pressures in the economy to be more persistent than in the past.



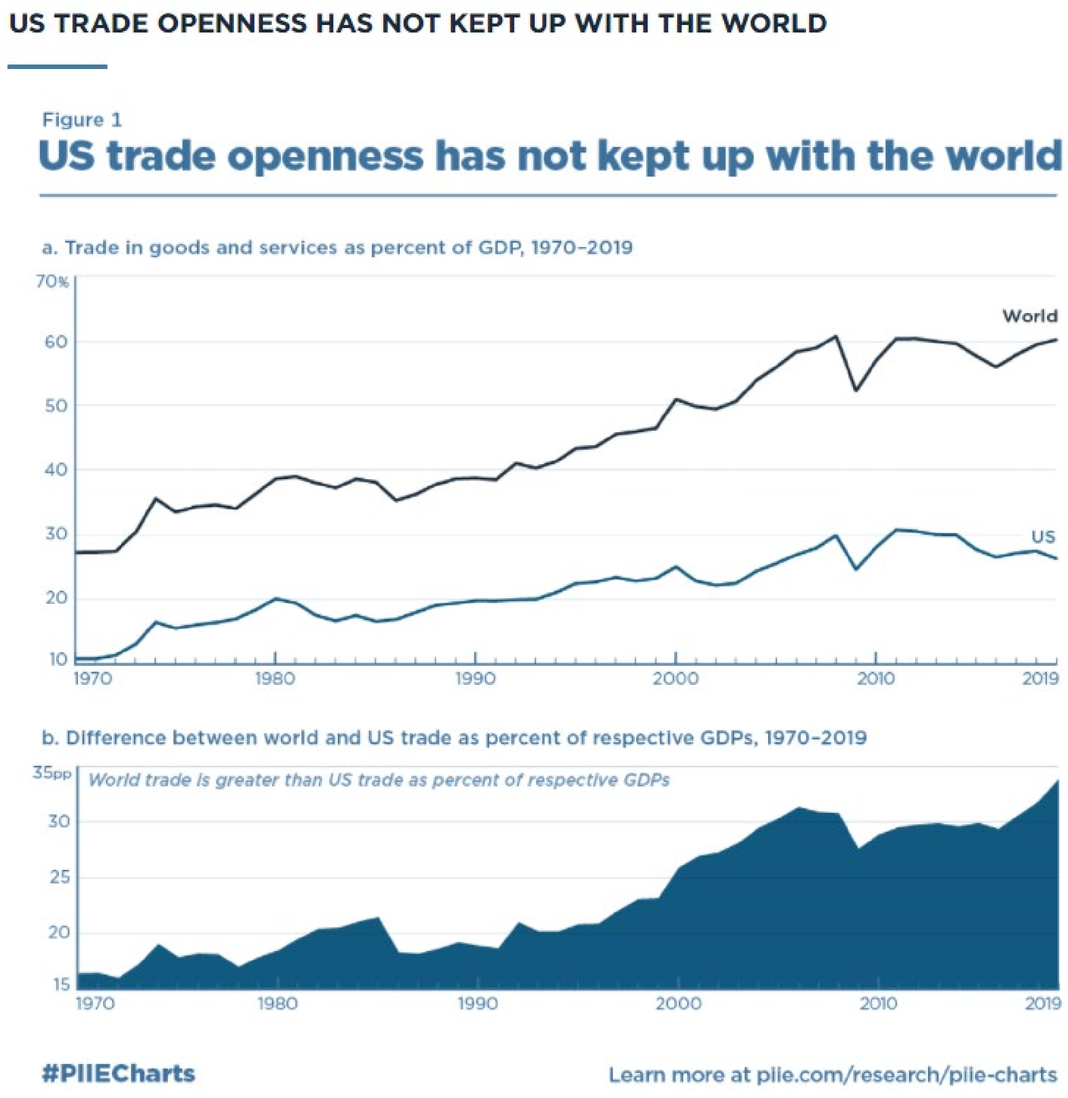
Source: BCA Research

In looking at wages today there so many issues with the data due to base effects, lack of "normal" immigration and availability of workers that a lot of what we are seeing will end up being transitory. At the same time there does appear to be a change in approach from large US corporates to wages and the impact of the "S" in ESG will only be a net positive for wages and workers rights. This longer-term force should lift the floor over time. Whether it lags or keeps pace in real terms is too early to tell but the feedback of loop of higher wages, higher prices etc does seem a lot more possible under the environment we see now.

3) Trade protection policies

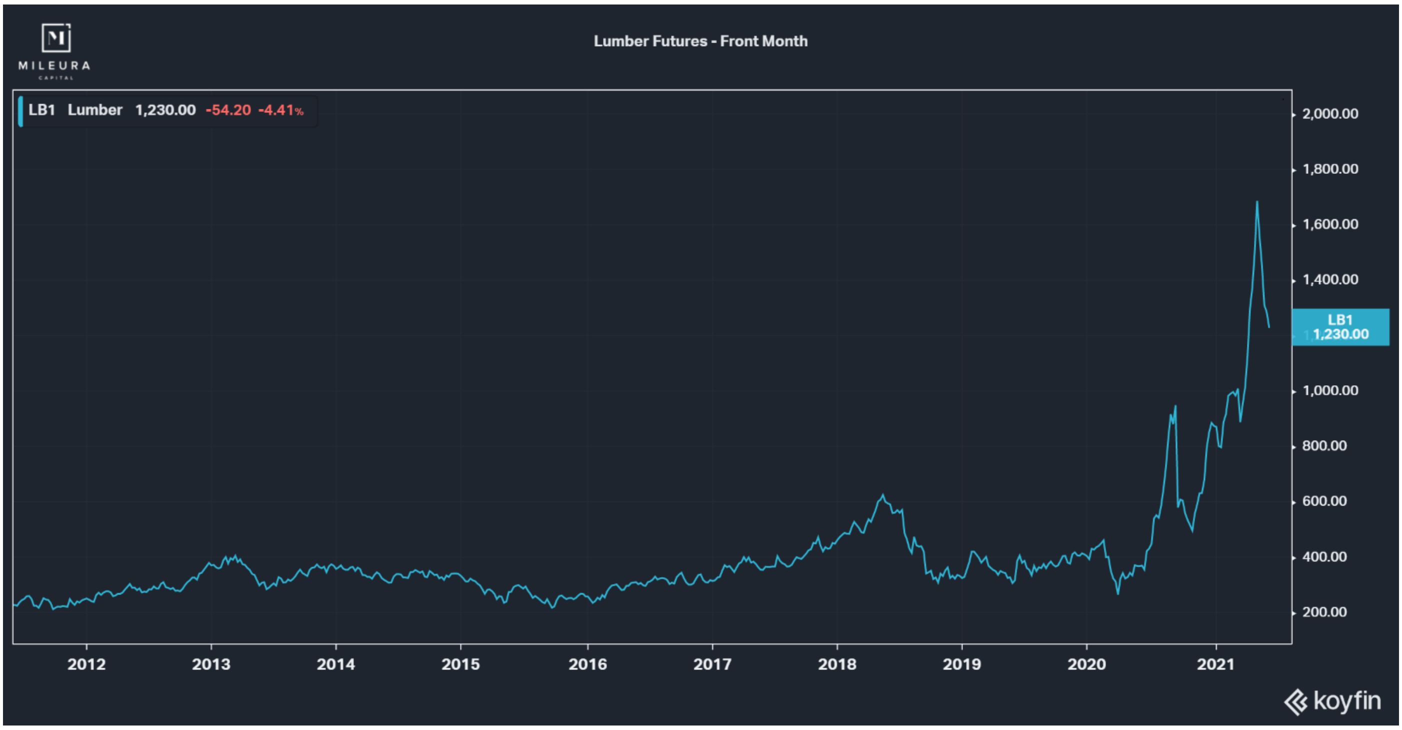
Over the past 5-years the pace of trade protection, nationalism and the consequential increase in geo-political tensions has put into the question the case for globalisation. The results of globalisation can be scene in most western democracies, and I won't spend time on the politics of the consequences. However, what is changing in direction of travel is the nations are retreating from a policy of globalisation. The impact of COVID-19 has also reminded governments that countries will look after themselves and their constituents before helping other nation states. When it comes to food, vaccines and necessary commodities this has become an issue for all countries.

The level of trade barriers today is higher than it was 5-years ago. Certainly, the U.S. has been withdrawing from open trade for a number of years. See the below from the Peterson Institute here



Across the West there has been an increase in bi-lateral agreements but otherwise trade barriers are on the increase. Even Canada and the U.S. have had a lot of trade friction that has impacted everything from aluminium to lumber. They are even being blamed for the recent rise in Lumber prices in the United States. However, as a student of commodities that is a bridge too far to blame Trudeau for the cost of building a house in the U.S.!

Lumber chart

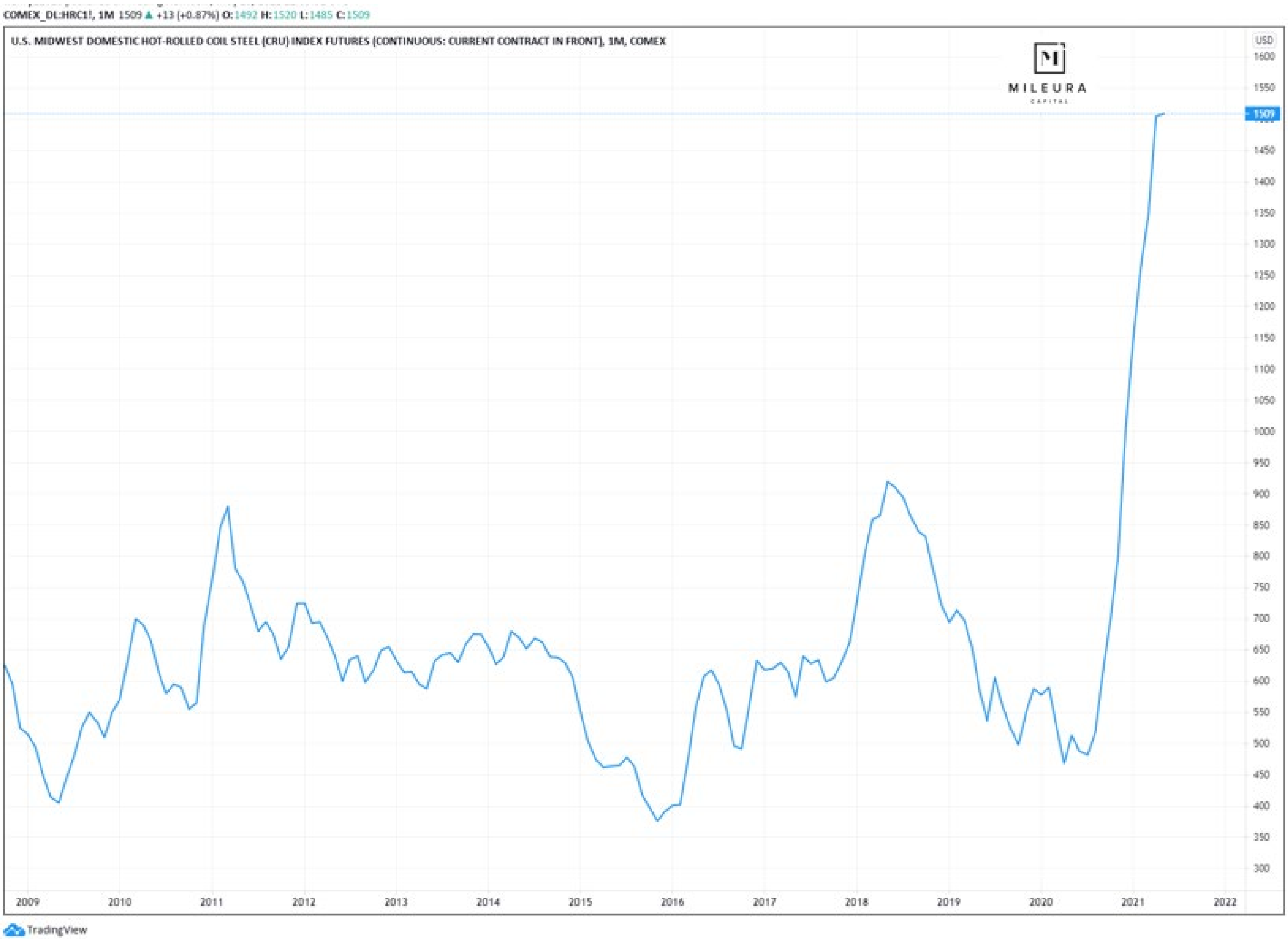


Across certain markets availability of certain products and commodities is becoming a challenge. Most of this is due to supply constraints and not trade protection policy. But trade policy has played its part. In commodity markets you are seeing the Chinese Government buy large amount of agricultural produce from the U.S. as part of the trade agreements signed under President Trump. This is at a time when the relationship between the two largest economies in the world as at its lowest in decades. The ramifications on China buying commodities to stockpile in its strategic reserves is now flowing through to inflation numbers across the rest of the world.

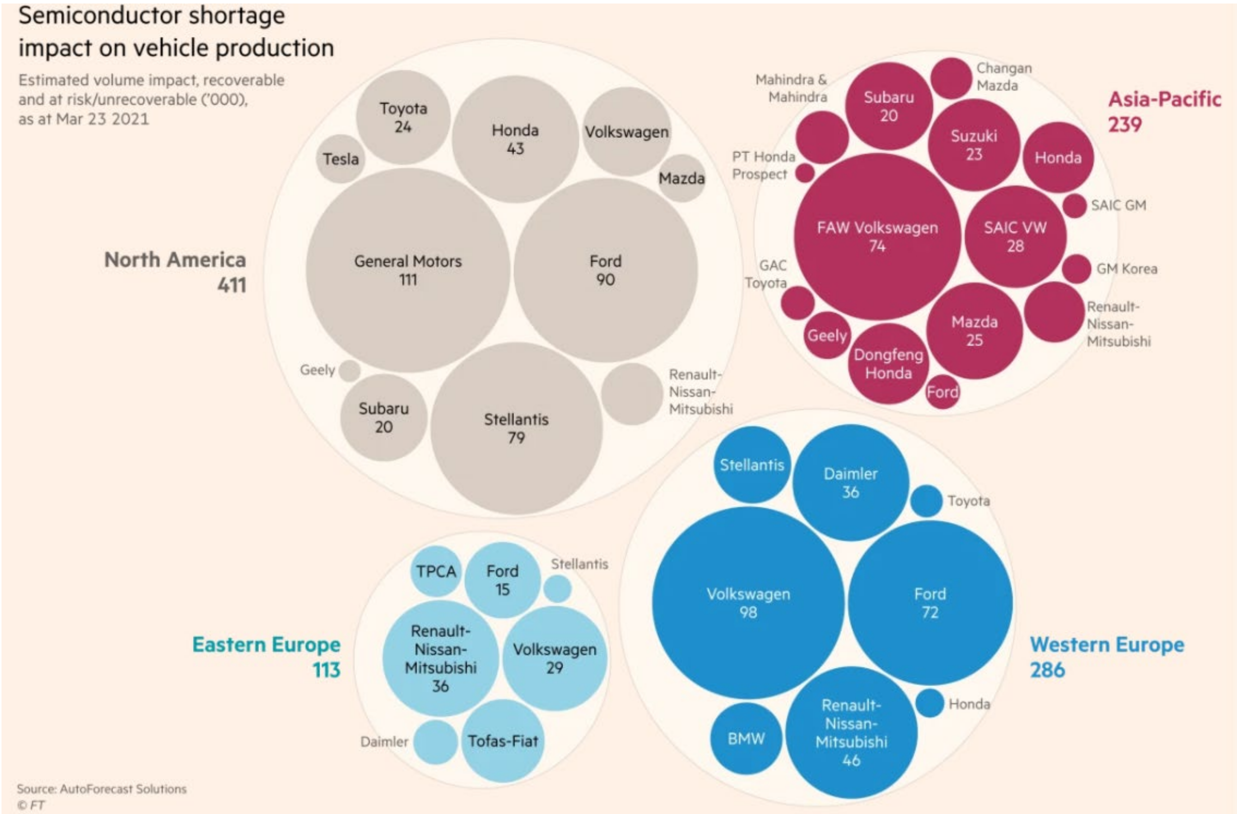
Across the Atlantic, a rise in tariffs has been experienced since the escalation of trade tensions began a few years ago. In 2020 with the WTO ruling that both the EU (via Airbus) and the U.S. (via Boeing) did not follow nest trade practices or comply with international rules around subsidies. As a consequence, the U.S. imposed duties on around $7.5bn of imported goods and the EU to place around $4bn in tariffs starting in June 2021. As of early this month (May 2021), Europe has indicated that it would not go ahead with the planned escalation of tariffs. This provides some time for both parties to review trade policy and where to go with Section 232 tariffs on EU steel and aluminium, which triggered the reaction from the EU on U.S. goods such as clothing, bourbon and motorcycles (Harley Davison was especially vocal about this). See FT article here.

It is unlikely that these tariffs will be rolled back completely. The U.S. Steel sector is especially important to both U.S. political parties. A roll back will not happen without mutual concessions or at least of the perception of a U.S. win. Progress might be made in tariffs across the Atlantic if the two sides decide to unite against China's perceived over capacity in steel. Right now, though that is going to be a challenge with steel prices soaring, steel producers globally will be doing their best to maximize their production where possible.

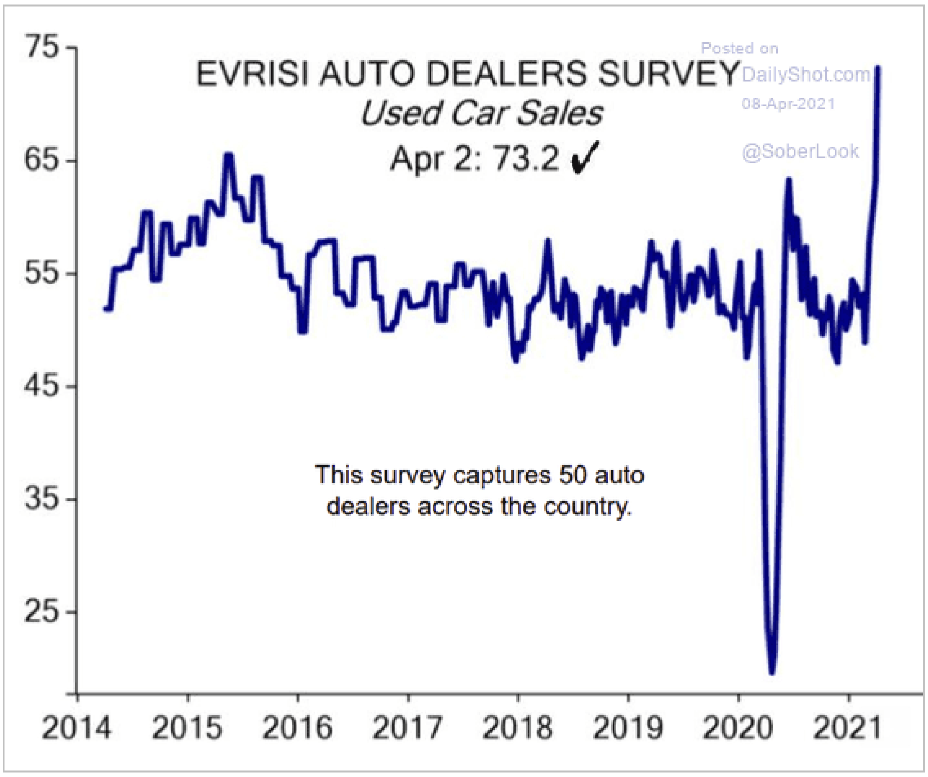
U.S. HRC Steel (Comex)



In the manufactured world the big pinch point currently is semi-conductors. Despite a ramping up in production the shortage is causing shutdowns of car plants. Below shows the impact to the vehicle production globally. Courtesy of the FT [here]

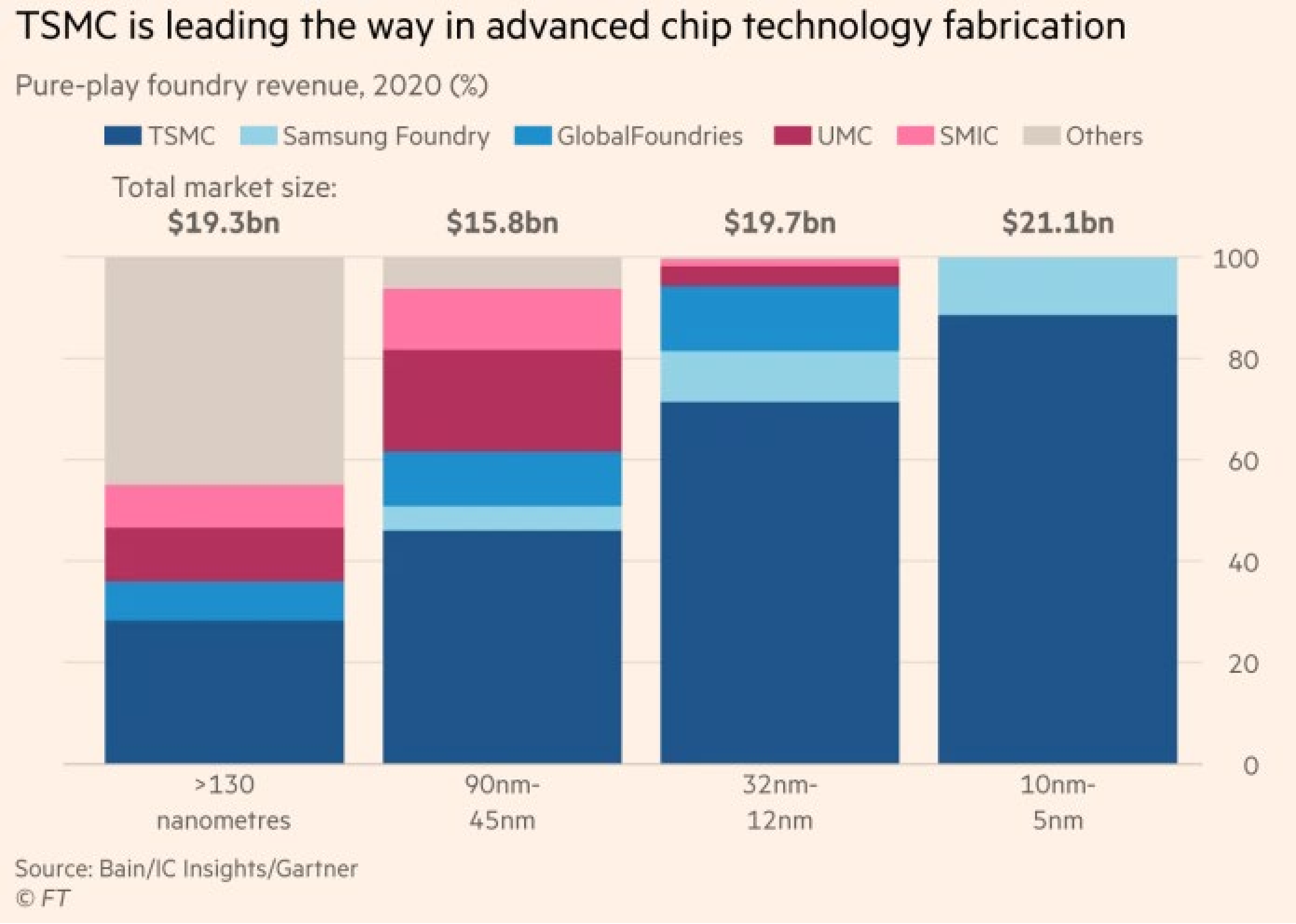


This has had second order consequences in the second-hand car market in the U.S..



via the Daily Shot @soberlook and Source: Ed Hyman (Ed.hyman@evercoreisi.com), Evercore ISI

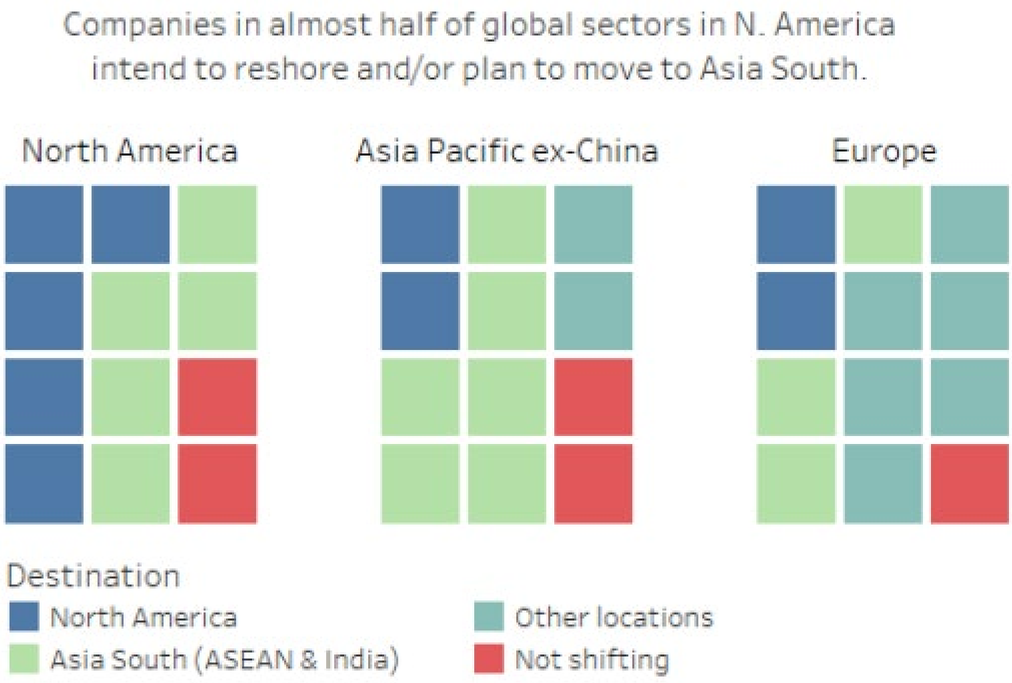
Whilst trade protection policies are not the only contributing factor to the current issue in semiconductors, it has been exacerbated by the off-shoring trend we have seen over the past 20-30 years across a lot of key component in today's most popular electronic goods. The concentration of key semiconductor production amongst a few companies such as TSMC has left the many supply chains struggling. Foxconn, who is one of the major producers of mobile phone screens, moved some of their production capacity out of China (at extra cost) and 4 years ago Foxconn made a pledge to build an LCD plant in the United States. This was not well thought out and did not (obviously) have any impact on the much more strategically important semiconductor market. This promise from Foxconn has subsequently never materialised. In TSMC's case they are being enticed by subsidies to build a semi-conductor plant in the U.S. A good article from the FT highlights the issues. Currently TSMC is facing some tough decision on whether to takes sides as it is the leader in advanced chip technology globally.



As a result of the trade war China is increasing its domestic capability to produce their own technology. Currently, it imports about $350bn worth of semiconductors and reducing its reliance on US impacted parts became a priority as the distrust between the two countries escalated.

Whilst the semiconductor issue is catching the news, it is a symptom of a broader issue. The U.S. and its Allies are looking to establish new trade flows that are not reliant on China. Whether this be semiconductors, iPhone screens or rare earths. At the same time due to imposition of punitive tariffs or bans such as for Huawei, China is looking to free its manufacturing from the risk of US regulation.

In this type of environment where trade becomes less free costs can only go higher. If the state, the corporate and the individual start to make "irrational" choices based not the on lowest cost or most efficient product but what is strategic, what is least likely to be regulated and what is perceived to be best for the country, then trade flows will change, and the trend of re-shoring will continue. From the BofA chart pack mentioned above is a good graphical display of the changes occurring.



4) Developing Markets

In the six forces mentioned at the beginning of this article, having minimal competition from developing economies was seen as a contributing factor to higher inflation in developed economies. Whilst, I do not think we are going back to the 1970's ,I think we can given what has already been written about trade policy, that the world is slowly moving away from globalisation. This means that the developing markets that do prosper are likely to be due to strategic reasons in terms of political alignment or location rather than purely the lowest cost.

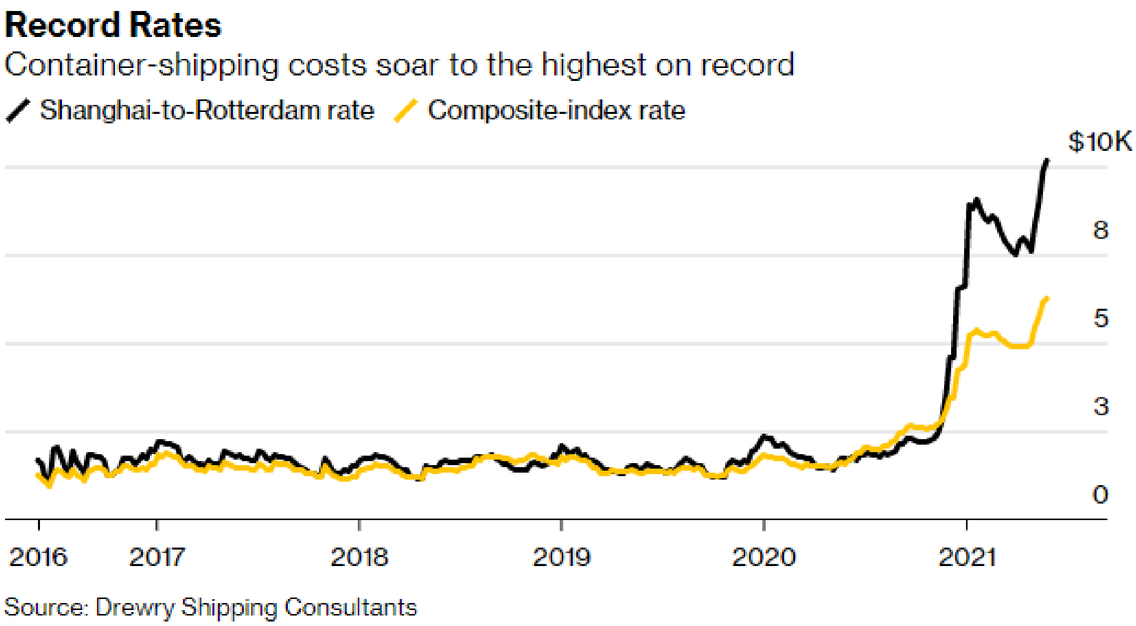
In today's context, the trend is clear. The world is moving back to trying to manufacture goods domestically or with perceived allies. A complicated supply chain is going to be simplified. This should benefit certain developing markets like Mexico and Eastern Europe as they are close to large demand centres of the U.S. and the E.U.. It will be interesting to see how it plays out in Asia with Taiwan sitting right in the middle of a complicated situation.

For the purposes of this discussion around inflation, I think it is best to say the aircraft carrier of "JIT & Globalisation" is turning, albeit slowly. I acknowledge that most of the goods we buy today are from or via China and this could continue for the next 3-5 years. Over time though, the proportion of goods manufactured purely in China will become less over time. Will this be inflationary or deflationary? A harder one to call as Chinese wages are more expensive vs most developing economies. So you could argue it will be similar to the previous cycle and you see the lower wages transfer through into lower cost production and lower priced goods.

Overall, this is the most likely longer term trend that will act against sustained inflation. There are many emerging markets that are increasing their skill sets very quickly. As these economies increase their manufacturing capability to produce higher value goods this will put downward pressure on global prices. The other side of this argument is if this also generates strong economic growth within these developing markets. Could the increase in domestic demand offset some of the deflationary impact? I think this is too early to call in either direction.

5) Business Attitudes – cost plus approach

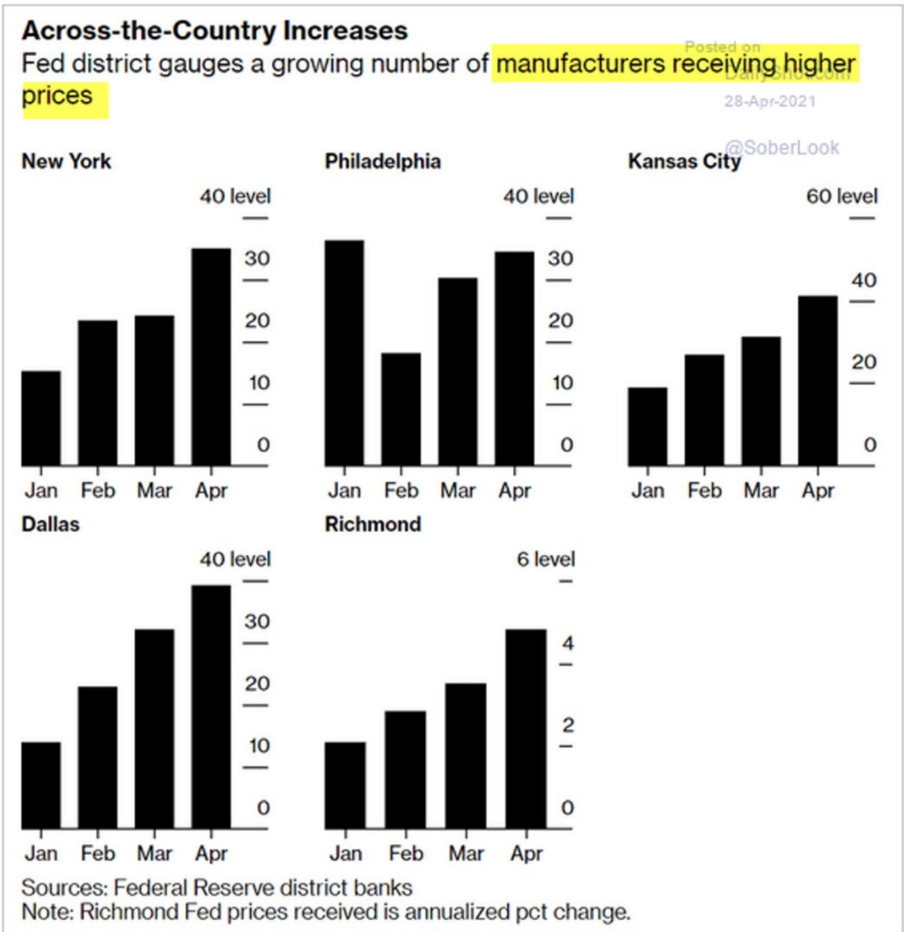
Whilst we are currently experiencing higher prices from supply side issues and pent-up demand, will this translate to business passing this through to higher prices over the longer term? Most expect the issues the globally economy is facing around commodity or material shortages to be transitory, and therefore the ability for firms to pass on these cost increases will be a challenge. The constraints on supply have not only impacted the price of the raw inputs themselves but packaging and freight as well.



Whilst most of can see there will be some reversion to the mean in a lot of the charts shown. It is hard to see firms pricing reverting to the pre-COVID business model. Why is this?

a. Firms like charging higher prices and will be slow to discount even when their costs go down. A demand side negative shock would change this.
b. Firms will need to charge higher margins up front to pay for potential uncertainty around government lockdowns and travel restrictions resulting in a higher cost to store the commodity or manufactured good closer to demand centres
c. Within consuming countries, the increase in online shopping has led to a higher demand distribution efficiency to reduce delivery times. This is beginning a trend of more local distribution centres in higher rent locations, leading to higher costs and more storage style packaging.
d. Generally, firms will be inclined not to invest in new manufacturing or distribution infrastructure for some time whilst the uncertainties around COVID-19, trade relations and forward demand persists. This creates an environment where supply is slow to respond to demand signals.
e. With wage pressures building, firms will look to pad margins where possible to allow for future wage rises.

This is an environment where businesses will be more likely to charge a convenience margin to assure supply and delivery of the goods or services they produce. This is a different business environment from what we have witnessed over the past decades.



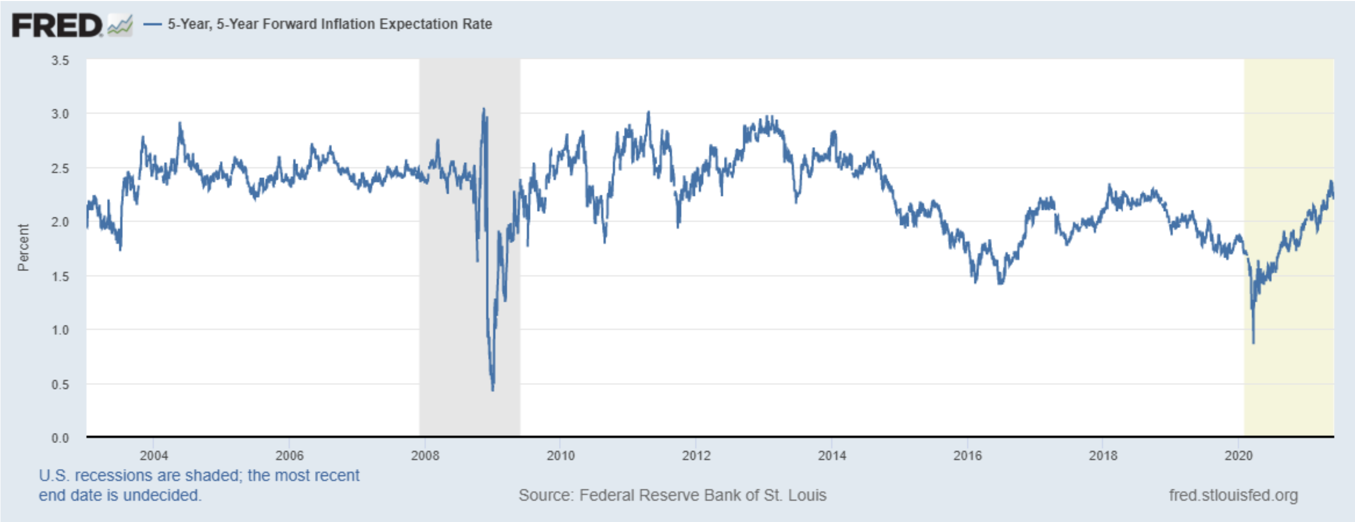
It starts from the suppliers of most commodities who have for a number if years been very disciplined on exploration for new supply. Since 2015/2016 oil & gas exploration and mining exploration as a percentage of capex has been declining. This was done by management to return faith in the sector, and use free cash flow to re-purchase shares or pay dividends.

Today, with much higher prices you are not seeing the majors make a lot of changes to that strategy. More recently, higher prices have encouraged junior miners and E&P companies to take the risk on new ventures as investors are now willing to take greenfield risk in the search for yield. The current situation is not the same as 2003-2013 period where large projects were undertaken across natural gas, iron ore, oil and base metals. We are at a much slower pace with more cautious approach from those with the capital to allocate. With projects that are approved today, it does not translate into meaningful new supply for a number of years for most commodities or raw materials.

This has ramifications across the supply chain and mean the cost-plus business model can persist for longer than most believe.

6) Inflation expectations

Inflation expectations are tied to a number of points above. We are now seeing a jump in inflation expectations. Similar to changes in commodity prices, will this prove to be transitory or a more longer-term feature of the economy?



Whilst too early to say for certain, in my view we will see inflation expectations run above longer-term trends until at least the end of 2022. After that time, you will have seen a supply response in some commodities as well as a slow-down in demand relative to the current fast paced demand recovery we are seeing in H1 2021. The cure for high prices is high prices after all.

However, where we land post 2022 will be somewhere in between what we are experiencing in H1 2021 and the environment prior to COVID. Where companies are incentivised to, they will try to compete away excess profits, but it will not be as easy to compete with the large monopolies that control a large part of the customer facing interaction today. What could accelerate a move lower in prices is a normalisation in shipping container capacity and pricing. This will allow smaller players to compete more easily and allow a return to more delivery times and buying patterns from businesses.

Regulation could be double edge sword to inflation expectations. Regulation could break up monopolies and allow more competition and lead to lower prices. Other types of regulation around ESG, government sourcing programs, strategic reserves and trade protection are more inflationary in their impact.

My sense is a global economy with a more heavily involved State is going to be less concerned about seeking the lowest cost and more about trying to achieve policy outcomes. This leads back to the certainty or convenience premium. And consumers will tend to pay a premium for that.

Conclusion

In putting this piece together over the past couple of months (it has taken much longer than I thought) we have seen some interesting price action across several key commodity markets. From lumber, iron ore and copper to soybeans, corn and coffee, a lot of markets are suggesting inflation is returning. However, most commodity markets are mean reverting over time so to a certain extent and for the purposes of this piece I consider it noise. Good trading opportunities but ultimately higher prices solve higher prices. For metals it will take a lot longer for supply to catch up which adds to theme of a persistently higher base rate of inflation.

In commodity markets, you could easily experience a 20-40% correction lower in the key commodity markets and it will not change the longer-term trends. The world is trying to reorganise its supply chains to not be so reliant on China. At the same time, the ESG movement is placing increased emphasis on the environment & climate, treatment of employees and the impact of business on the broader society. These two trends are likely to lead to an economic environment that has a higher base rate of inflation than what we have experiences since the early 1980's.

I am not a proponent that we will see hyperinflation – I certainly hope not anyway. But I think the trend of deflation is at the very least flat lining and starting to turn back in the other direction. Two of the main sources of deflation, firstly, technological innovation and secondly, demographics have not changed. The interesting part about demographics, is as the working age population becomes smaller, the western world will still desire a similar amount of the same goods and services, so it is any wonder wages are on the rise (for now). In some sectors of manufacturing, automation and robots will replace humans but perhaps this is not such a bad thing. If the humans can have a better chance of doing something they want to do via starting their own business or working for corporates that are not just about paying minimum wages, society, as a whole, should benefit.

Whether inflation is a good thing or a bad thing I will leave for others to argue. It will adversely impact the disposable income of workers whose wages do not keep pace with inflation. This has been the case under a deflationary environment anyway with the cost of essentials such as food, healthcare & shelter (rent) outstripping wage increases.

If inflation results in a higher interest rate environment, if that ever eventuates, it will reduce the amount of speculation on highly risky ventures. As Josh Wolfe describes, to paraphrase, zero interest rates have pulled forward the future. Higher interest rates would have to make asset allocation more selective and the VC and unicorn landscape could look very different going forward.

In the coming years, the housing market is the biggest problem for politicians and central banks alike. I think they will do their best to keep the residential housing market from declining too quickly if interest rates do rise. A kind of goldilocks scenario where nominal prices remain largely intact (+/-10-20%), whilst in real terms some geographical areas will not fare so well.

For now, I think it is something we need to be aware of on our own behaviour towards consumption of goods and services and our assumptions of what certain asset classes will do over the coming decade.

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