EMERGING MARKETS UPDATE

CHINA, ESG & THE INFLATION DEBATE

WITH NORTH OF SOUTH CAPITAL

INFLATION: 2021'S BOGEYMAN?

If Covid19 was the market's bogeyman of 2020, it seems that in 2021 Inflation has taken its place. While most observers dismiss a pick-up as transitory, we believe there may also be structural changes in the works.

The first few months of this year have certainly supported an inflationary narrative. Global inflation prints, most notably in the US have been way ahead of economist forecasts. The April month on month (so not in comparison to last year's lockdown period) increase in US Core CPI was the highest since 1981 when US interest rates were at 15%. Commodity prices have shot up almost universally – whether corn or copper, steel or shipping, polysilicon or PVC, lithium or lumber. The same is happening in many asset prices – Miami condos or Ethereum. Meanwhile central bankers are hellbent on ignoring it all and maintaining negative interest rates at any cost.

As always, however, the picture is more nuanced. Measures of inflation that strip out outliers such as the jump in second-hand car prices or airfares associated with post-Covid adjustments have remained well behaved. Measures of wage growth like the Atlanta Fed remain modest. There is a significant pool of labour at least potentially available to employers. While stories abound of struggles to hire, this may be an overhang from Covid lockdowns – lack of childcare options and disincentives to work thanks to expanded benefits. Both should be temporary and resolve themselves gradually as people return to the workforce. Central bankers and governments are keen to emphasise this as well as the inevitability of sustained low interest rates. Given extraordinary high government debt levels, this is perhaps not surprising.

So should we breathe a sigh of relief and continue with business as usual – as financial markets have largely done so far?

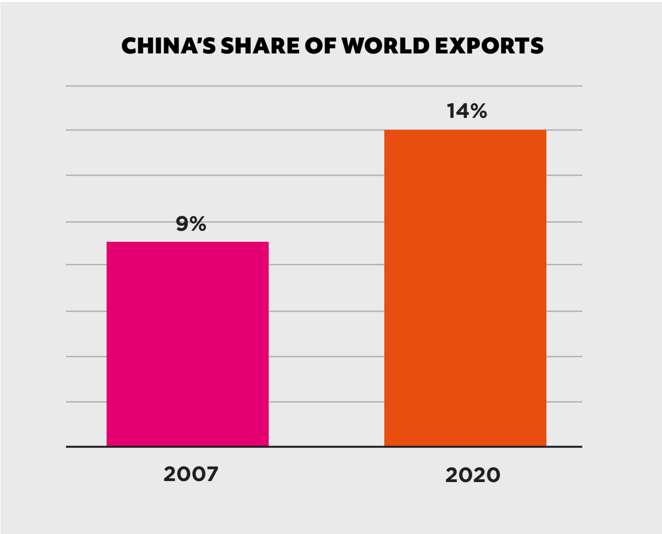
The answer will lie in understanding some more structural shifts that may not be immediately obvious.

CHINA'S DISINFLATIONARY IMPETUS

First of all, the continuation of a disinflationary trend despite the post-2008 money printing has been enabled by China. Global consumers could be confident that the price of manufactured goods would always decline, moderating any inflation expectations.

China's share of world exports continued rising from 9.2% in 2007 to around 14% by 2020 (although the trend had slowed since 2016). For decades the world has benefitted from outsourcing its manufacturing to low-cost China, initially attracted by low wages.

However, wage growth in China has been running at 10%+ annually and while investment in automation has helped, this is no longer a major differentiator. Chinese companies are busy moving production of labour-intensive goods such as shoes to lower cost but smaller neighbours.



Source: North of South Capital

PRICING EXTERNALITIES, EVEN IN CHINA

China's second manufacturing cost advantage has been cheap energy from plentiful coal power. Effectively the world was also outsourcing its pollution to China. It is why 90% of the world's polysilicon used to generate "clean" and competitively priced solar energy in Europe comes from China - where it is produced by burning nearly free coal. Similar arguments apply to steel, chemicals and other essential feedstock.

While one may not consider China a global ESG champion, the environment is now at the top of the CCP's agenda. China's citizens are fed up with choking on smog and the Party has abandoned its focus on growth regardless of costs. For example, in recent months around half the steel furnaces in Tangshan were shut down, helping drive up steel prices. This city accounts for 27% of China's flat steel output. Many other polluting industries are being targeted. Effectively China is addressing the externality of environmental costs that the West had previously gotten for free.

At the same time international companies are seizing on the idea of an ESG premium. The Russian aluminium giant Rusal is proposing to sell "green" aluminium powered by hydroelectricity. Malaysia is capping its palm oil production to maintain 50% forest cover and address critics – palm oil prices have surged this year.

IMPLICATIONS OF ESG ON SUPPLY CHAIN

Provenance matters and suspicion of poor worker conditions or even forced labour is disrupting trade with China. Better pay and worker conditions will come at a higher price, whether through more costs in China or by moving elsewhere. Deglobalization has a price tag. If energy production is to become cleaner, huge investments need to be made and paid for by consumers. The growth in electric vehicles will only serve to accelerate this need as power grids adapt.

If manufactured goods prices start rising noticeably, there is a risk of inflation expectations rebuilding. These can become self-fulfilling – especially with plentiful money in the system creating an urgency to spend it. We are not there yet and in the very short term, headline inflation may moderate as widely expected. However, cost pressures from structural change may sustain increasing prices for longer and make central bankers look like they are behind the curve.

FINAL THOUGHTS

Whether post-Covid inflation effects are transitory or not, they coincide with some more permanent inflationary undercurrents caused by ESG and geopolitics. One day, free and plentiful renewable energy may deliver another deflationary impulse but this is not yet imminent given outstanding investments to achieve it. Meanwhile, we may see nominal growth rates remain strong as prices adjust to a new global supply chain. Such sustained inflation is the only way for governments to deal with their bloated debt levels. It is not far-fetched to assume that central banks will therefore tolerate inflation and wilfully ignore it. Such an environment is likely to be good for the stocks of companies with pricing power that produce scarce resources, ideally in an ESG compliant manner. They should enjoy relatively better margins amid strong demand in coming years. Meanwhile, expect the purchasing power of cash to be eroded.

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