



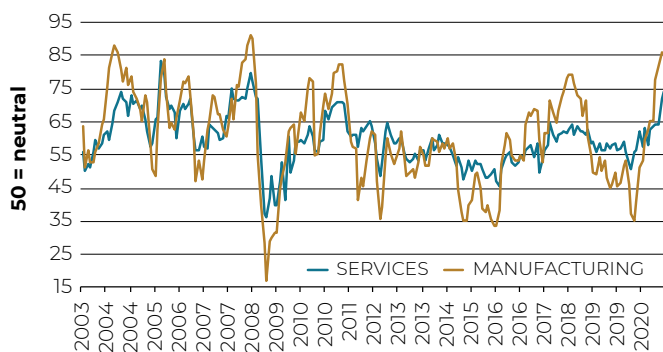
DON'T PANIC ABOUT INFLATION

QUARTER 1, 2021

For almost a week, the world was captivated by the giant Ever Given blocking the Suez Canal, a key artery of global trade. It was the ship that launched a thousand memes. It also piled further pressure on global supply chains that were already struggling with all sorts of bottlenecks, shortages and disruptions as global growth heats up and factories struggle to keep up. The predictable result has been increases in producer prices.

This has added to a widespread narrative that we are on the cusp of the return of meaningful inflation. Many global investors are positioning themselves for higher inflation, and it is one of the reasons why bonds have sold off sharply since the start of the year.

Chart 1: Input price pressure indices



Source: US Institute for Supply Chain Management

We need to take these concerns seriously, since changes in inflation regimes is one of the biggest drivers of long-term investment returns. The high inflation of the 1970s wrecked equity and bond returns across the world, while the low and stable inflation of the past decade was very supportive.

Different interpretations

Before getting to the market outlook, let's just clarify that there are different conceptions of what "inflation" is.

Firstly, in the strictly technical sense, inflation is the year-on-year change in a broad index of consumer prices such as the CPI. The annual rate of change of the CPI is the official inflation rate in SA, and the one the Reserve Bank targets. There are many advantages to this definition, but the one drawback is that it is very sensitive to base effects. If prices were artificially suppressed a year ago (think lockdowns) then the inflation

rate will be artificially high now. And that is partly what we are going to see in the next few months – higher inflation rates because prices collapsed a year ago. The oil price even briefly turned negative in April last year. Year-on-year oil inflation is currently in triple digits, but at around \$63 per barrel, the oil price is not much above its average of the past five years.

The second conception is that of consumers who care about increases in the cost of living, but not necessarily over any fixed period. For instance, someone might say that the cost of servicing a car has increased a lot since last time, but last time wasn't necessarily exactly 12 months ago. This is one of the reasons ordinary folk are so distrustful of inflation statistics. Another reason is that they don't account for quality changes. Servicing the car might be more expensive, but maybe the workshop is using fancy new machines that do a better job. This is certainly the case in healthcare, where the cost of treatments have gone up, but those treatments are substantially more effective. Similarly, a basic cell-phone has more computing power today than a state of the art computer did not long ago. The third reason is simply that consumers tend to notice – and complain – when prices rise but not when they fall or stay the same. Food and fuel prices are particularly volatile, and very noticeable since we make these purchases regularly, while you'll only buy new tires or a refrigerator once every few years. And while we all need to eat and move around, food and fuel together only account for 20% of SA's inflation basket. Finally, people tend to confuse 'inflation' with 'expensive' but they are two different concepts. Inflation refers to the change in prices. Something can be expensive without experiencing a change in its price (i.e. have a low or even zero inflation rate). For instance, the fuel price hit a new all-time high in April of R17.32 per litre in Gauteng. If it stays there for a year, it will still be expensive, but its inflation rate will fall to zero.

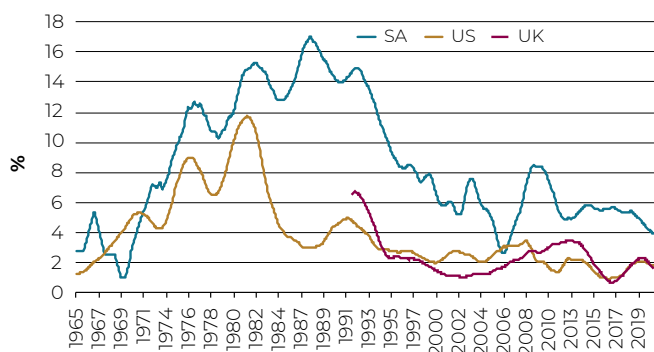
The third conception of inflation is analytical, and this is where we as investors need to concern ourselves. We need to think more broadly than just the year-on-year rate of change and focus on longer-term trends. In particular, we need to think about how inflation can feed on itself or not. To return to the example of fuel and food prices, our concern is not whether they rise and fall because they are inherently volatile. The concern is whether these price changes impact the behaviour



of firms and consumers. If the diesel price rises, can farmers pass on the cost to food processors? Can they pass on the cost to retailers who in turn raise selling prices to consumers? If they can, then the initial price change can ripple through the economy and we have a 'second round' impact. If the consumers then demand higher cost-of-living increases from their employers, employers will have to raise their own selling prices to maintain margins. Now we have a cycle where price and wage increases reinforce one another. This is one of the dynamics we saw in the 1970s when prices were regulated and unions strong.

For us to believe that there will be a "return of inflation", we will therefore have to see firms with pricing power and workers with bargaining power. In today's globalised world, it is hard to imagine. There is just too much competition everywhere, and technological innovation amplifies the competition. Think how easy it is to compare the price of anything – milk, shoes, insurance, holiday rentals, cars – online.

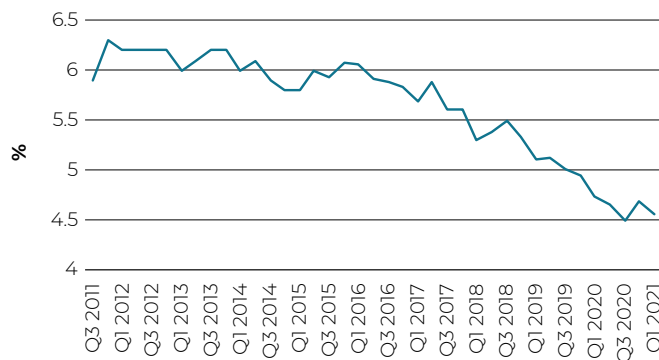
Chart 2: Consumer inflation, three-year moving average



Source: Refinitiv Datastream

People in developed countries now expect inflation to remain low and stable, and they behave accordingly. Locally too, inflation expectations are anchored. The Bureau for Economic Research's first quarter survey of households, businesses, unions and analysts show inflation is expected to average 4.5% over the next five years, which is in line with where the Reserve Bank wants it to be.

Chart 3: SA expected inflation over five years as surveyed



Source: Bureau for Economic Research

Too much money?

The other argument in favour of surging inflation is the unprecedented fiscal and monetary stimulus, particularly in the US, which has seen record growth in the money supply. Inflation is often said to occur when "too much money chases too few goods", but this oversimplifies the inflation process. Expectations play a big role. So does policy choices. But in simple terms, most of the money is trapped in the financial system and not circulating in the real economy. There is no automatic link between money supply and inflation, and it is often forgotten that the biggest component of money supply is simply bank deposits. Savings rates have shot up during the pandemic, and therefore the money has not been out in the economy chasing the goods, and credit growth certainly remains muted.

This might change, but for now there is no indication of households in rich countries drawing down savings to spend. Either way, the enormous fiscal injections in rich countries, especially the US, are not going to be repeated. A one-off boost is unlikely to set of sustained higher inflation.

In summary then, we should temporarily expect higher inflation rates at home and abroad for the next couple of months, but nothing suggests runaway 1970s-style inflation looms. This means interest rates should remain low, which ultimately bode well for investment returns.



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