Real People, Real World, Real Businesses, Real Values

Inflation- Unless your Money is Beating it You are Losing

The October Consumer Price Index (CPI) data for October was red-hot and notably greater than what was forecasted by the Federal Reserve. While the concern for higher inflation continues to worry consumers and how it impacts their wallets, it's also a concern for investors. We want to offer another perspective regarding rising inflation that we believe may be going overlooked and factors that we are paying close attention to as we manage a portfolio of small and midcap stocks.

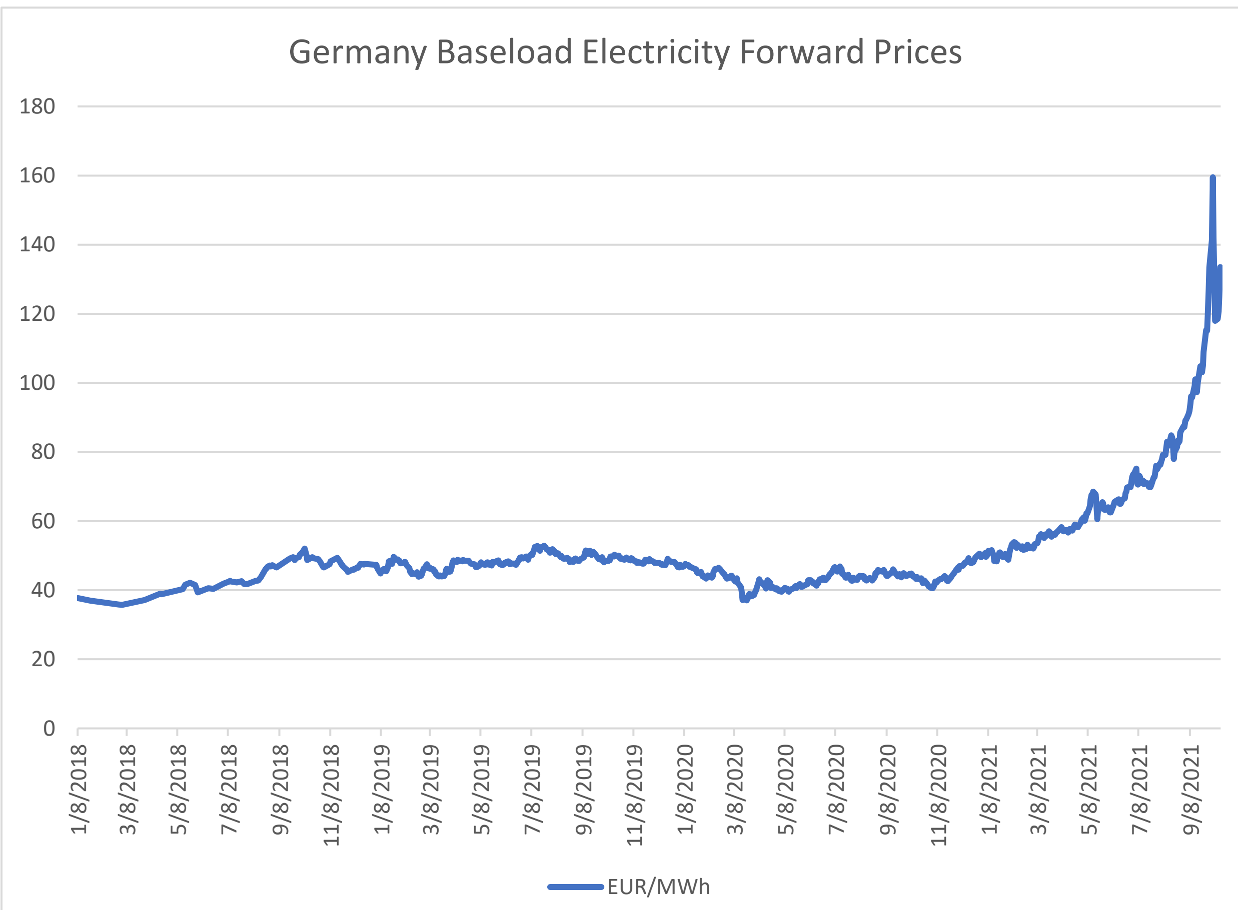
PAY ATTENTION TO THESE FACTORS WHICH WE BELIEVE ARE DRIVING INFLATION

Increased inflation initially stemmed from low levels of inventory and disruptions in the global supply chain- this has been extensively reported- and in some cases, impacting this most recent quarter of company earnings releases. That was followed by higher energy prices resulting from a dramatic decrease in drilling new wells and the natural decline in production from existing wells. So where do we go from here?

While global supply chains will eventually get sorted out, and higher commodity prices should prompt more drilling (the US rig count has nearly doubled in the last year, albeit still ~50% lower than 2019 levels), we believe there is an underlying cause of persistent inflation: Sustainability. We believe the global shift to greater sustainability and lower carbon emissions is inflationary.

According to Bloomberg, assets managed under ESG standards will total ~$38 trillion by the end of this year. That is expected to climb to $53 trillion by 2025. By definition, those assets generally avoid companies with significant exposure to carbon – especially fossil fuels. The Sustainable Finance Disclosure Regulation (SFDR) in Europe, which is aimed at ESG funds that are "greenwashing" their investments – using crafty reasoning/marketing to make people believe that a company is doing more to protect the environment than it really is – will likely further erode the aggregate amount of capital available for investment in traditional energy production. That means the cost of capital in traditional energy production will remain high and will likely continue to go up.

We believe this higher cost of capital, along with a more recent trend of investors requiring E&Ps to generate free cash flow (as opposed to just showing production growth and earnings), will stymie production growth of fossil fuels. In fact, that is the point of the sustainability initiative. The reason that will likely be inflationary is because global movement of capital away from fossil fuels into ESG is occurring faster than the build-out of alternative energy sources. As an example, in 2011 Germany got about 25% of its power from nuclear energy. By next year, Germany plans to have shut down ALL of that nuclear capacity, which will eliminate about 11 gigawatts of electricity production, on top of the 10 gigawatts already scuttled over the last decade. The pace of the transition is largely responsible for the spike in electricity prices in Germany and throughout Europe.



Source: Bloomberg

To be clear, we are not arguing this shift to sustainability is the wrong thing to do, only that the mismatch between capacity coming offline from traditional sources of energy versus capacity coming online of new, renewable sources of energy is causing a spike in energy prices that we believe will persist in the medium term.

The transition to electric vehicles further exacerbates the problem because it increases demand for electricity. All the while, we believe the cost of gasoline will remain elevated due to the aforementioned headwinds facing E&Ps. That puts consumers in quite a pickle.

That phenomenon is also why we are concerned inflation will be less transitory than the Fed keeps professing – or at least that this represents a reset in prices rather than a short-term spike. Traditionally, economists view inflation "ex food and energy." Ignoring the irony in the fact that we actually need those things to live, this calculation was reasonable in the past because those prices tended to be volatile and would revert after some short period of time. While we may see the price of gasoline spike for a year or so, increased production solved the problem in fairly short order. We are concerned that will not be the case this time around. Often producers choose (or are forced) to eat the higher costs in the near term. The longer higher energy prices persist, the more likely we will see those higher costs make it into the products that require that energy – like almost everything.

The other tailwind to inflation from the sustainability shift stems from the cost of this new capacity. Those nuclear power plants, once shut down, are worthless. Actually, they are less than worthless because they have ongoing liabilities associated with them. Conversely, the new sources of energy to offset that nuclear production and growth with increasing demand comes at a significant cost. Even with massive help from governments, there will likely be some sort of demand for a return on the money spent to build that capacity. In fairness, the operating costs of solar/wind production is much lower than coal, gas or nuclear energy and this will eventually sort itself out – but we think we could be decades away from that. We cannot say what the Fed's definition of "transitory" is, but years/decades feels more to us like actual inflation.

Solutions

We will not wade into the solution for the sustainability shift paradox. From an investment perspective, we believe the two most viable solutions is to invest in: 1) Levered Real Assets and 2) Companies with pricing power.

While we are not calling for this type of hyper-inflation, during the Weimar Republic between 1921 and 1923, which witnessed rampant inflation, one of the single best performing assets was leveraged real estate. The reason is simple – the "value" of the debt on the real estate fell dramatically, while the value of the underlying asset increased with the inflation.

The second way to protect against inflation is a bit more difficult. Identifying companies with the pricing power to thwart elevated inflation requires fundamental analysis of competitive position, necessity of the product, substitutions available, etc. For example, a grocery store effectively has no pricing power – while we certainly need their products, their competitive position is terrible and there are ample substitutions available within their product set. In contrast, consolidated industries supplying necessary products with limited substitution risk are more protected – like a software company.

Further, we would avoid fixed income – especially bonds with fixed interest rates. Here you get the double whammy of the value of the principal diminishing because of inflation, and the price of the bond itself falling as a result of rising interest rates that will surely occur in conjunction with the elevated inflation.

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