EXPERT**INSIGHT**

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Food, energy and inflation

Inflation everywhere is rising sharply. In the United States, Consumer Price Inflation (CPI) has reached a 40-year high of 8.5% and in the Eurozone it has hit 7.5%; higher than at any point since the Single European Currency was created in 1999.

A variety of factors has combined to create a perfect inflationary storm: excessive monetary easing from Central Banks globally, a reduction in the available workforce post-COVID, supply chain disruption both during and since the pandemic, a significant increase in the price of crude oil and rising food prices due to war in the Ukraine. We look at each of these in turn.

Central Banks globally – and most notably the US Federal Reserve – were quick to slash interest rates as the COVD pandemic hit, but have been woefully slow to tighten monetary policy even as it became clear that inflationary pressures were building rapidly. Indeed, even as recently as February 2022, the Fed was increasing the size of its balance sheet; fully four months after Chairman Powell declared to Congress that it was time to retire the characterisation of inflation as 'transitory'. Official interest rates were raised by 25bp in March but this was only the first hike in more than three years and still leaves policy rates significantly below the current rate of inflation. To use economists' jargon, "the Fed is way behind the curve".

Chart 1: Inflation reaches multi-decade highs in US, EU and UK

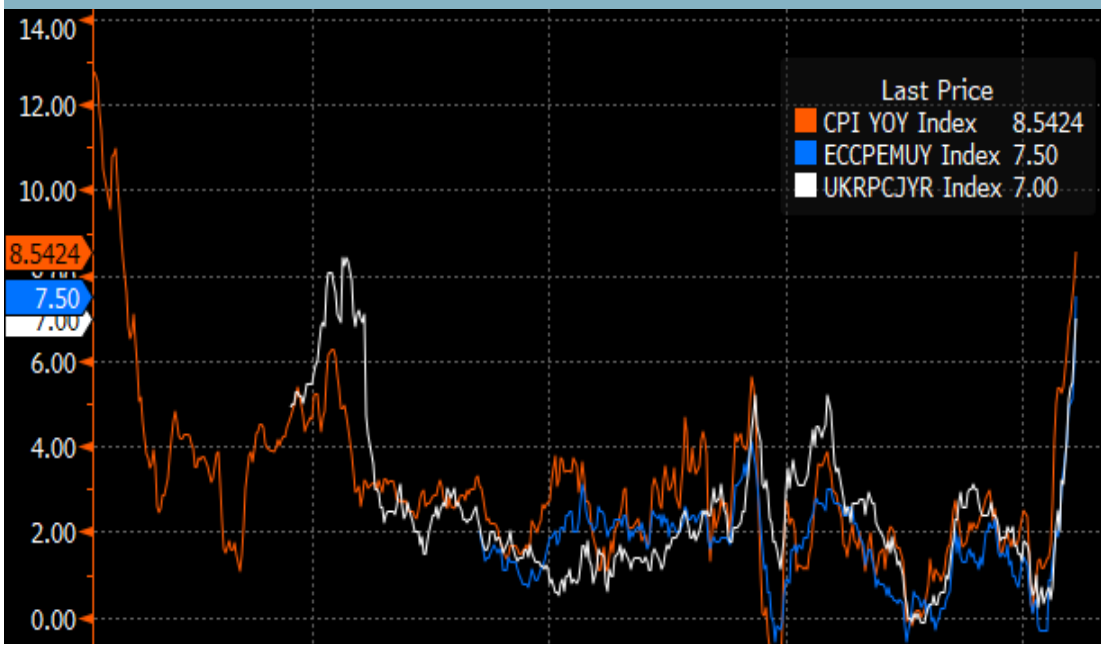
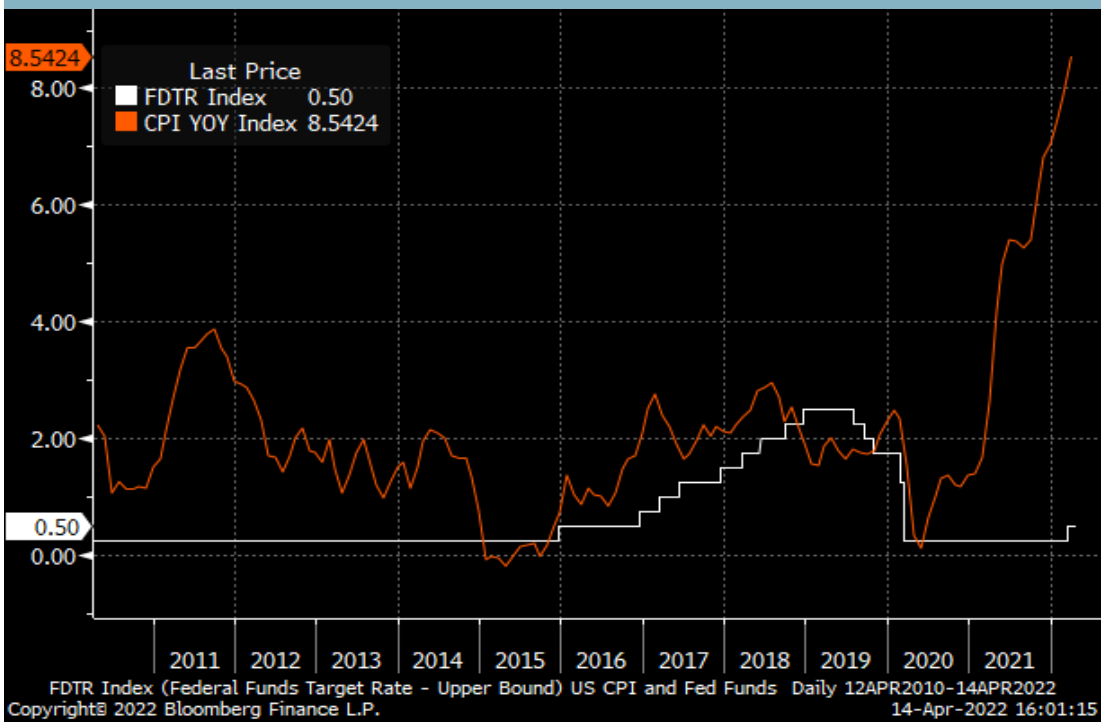


Chart 2: US Federal Funds rate and CPI inflation

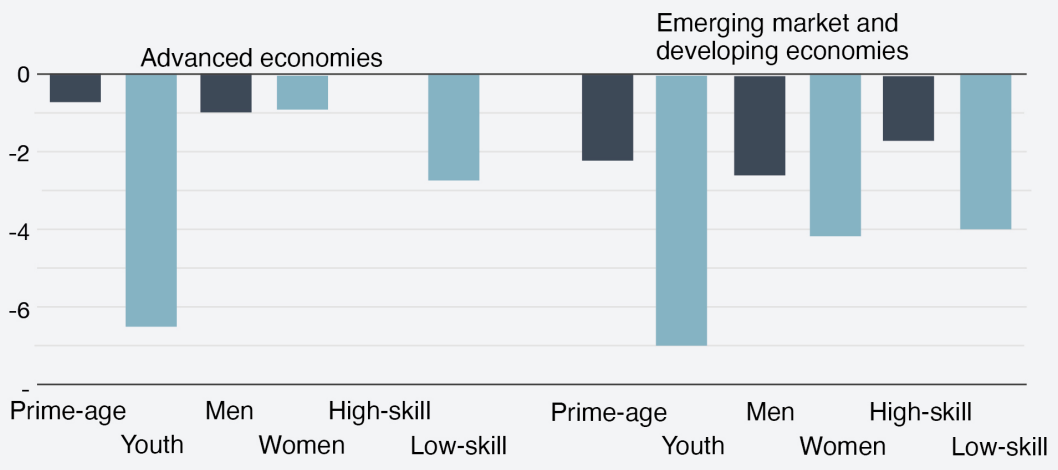


The COVID pandemic brought millions of job losses globally. As the International Monetary Fund (IMF) noted back in June 2020, "Global growth is projected at -4.9 percent in 2020, 1.9 percentage points below the April 2020 World Economic Outlook (WEO) forecast. The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated. The adverse impact on low-income households is particularly acute, imperilling the significant progress made in reducing extreme poverty in the world since the 1990s."[1]

"US official interest rates were **raised by 25bp in March** but this still leaves policy rates significantly below the current rate of inflation."

[1] IMF - https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

Chart 3: Labour Force Participation Rate (Average percent difference from 2019:Q4 to 2021:Q1)

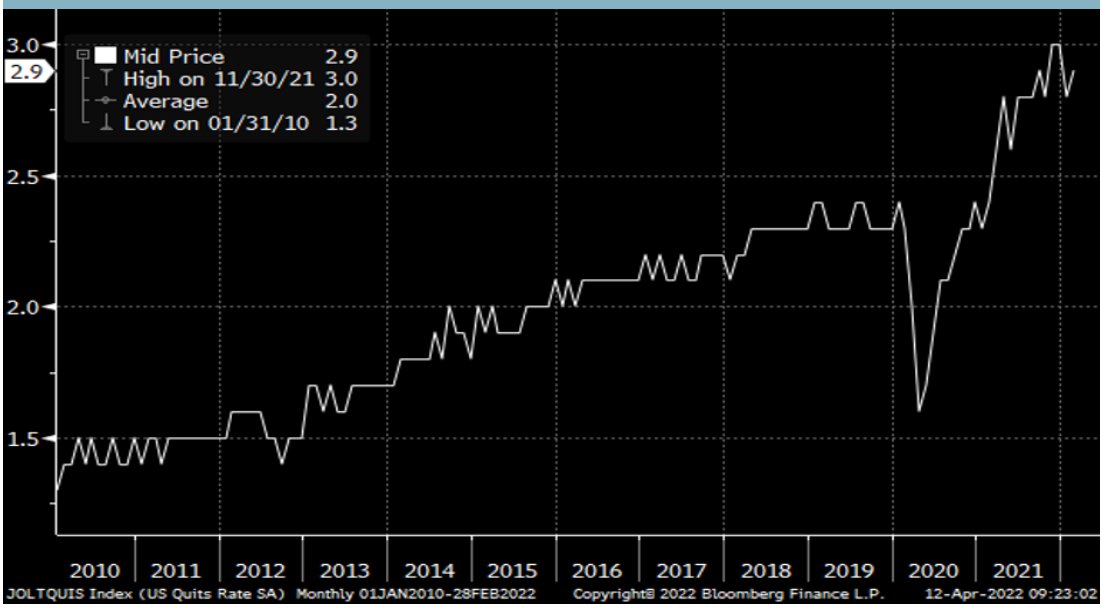


The Great Resignation

COVID has led to a major reappraisal of the work-life balance in many countries."

The fall in employment saw a drop in the labour force participation rate, which was proportionately greater in Emerging Markets and Developing Economies than their advanced counterparts and had a greater impact on youth rather than prime age employment.[2] But whilst youth employment has subsequently recovered somewhat, a phenomenon which has come to be known as 'The Great Resignation' has seen large numbers of older and skilled workers leave the labour force entirely. COVID has led to a major reappraisal of the work-life balance in many countries.

Chart 4: Share of US workers voluntarily quitting their jobs



[2] https://www.imf.org/en/Publications/WEO/Issues/2021/10/12/world-economic-outlook-october-2021

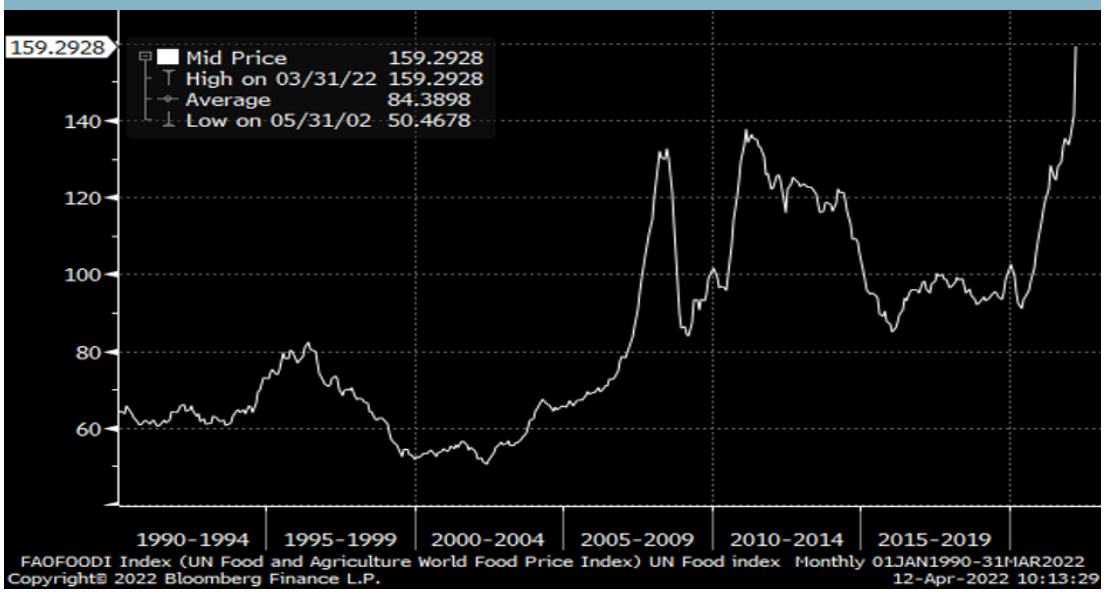
Chart 5: US Average Hourly Earnings All Employees (annual % change)

A shortage of available labour means that wages are now rising rapidly, across all age groups, genders, ethnicities and skill levels. Excluding the distortions from COVID (when the firing of lower paid employees initially boosted reported average earnings then reversed 12 months later due to base effects) US wages are now rising at the fastest pace in more than a decade. Indeed, the latest figures show an annual rate of 5.6%; almost double the pre-pandemic level.

Energy prices, too, have risen substantially. Even before the Russian invasion of Ukraine at end-February 2022, crude oil (WTI) had risen to $92.10 per barrel; its highest level in almost seven years and roughly double the average price for the five years preceding the COVID pandemic. It went on to reach a recent peak of $123.70 in early March 2022 before easing somewhat as the United States released supplies from its Strategic Petroleum Reserve (SPR). As fuel directly comprises 10-15% of the CPI basket in most countries and indirect effects can take this up to more than 20%, the impact on inflation rates has been sudden and dramatic.

> “A shortage of available labour means that **wages are now rising rapidly, across all age groups, genders, ethnicities and skill levels.**”

Chart 7: United Nations World Food and Agriculture Price Index



> "Another significant supply shock for food prices comes as a **direct result of the war in Ukraine.**"

Costs of the most widely used agricultural fertilisers have risen significantly over the past year as they are either by-products of or heavily dependent upon the refining of crude oil. Ammonia, urea, potash, diammonium phosphate and other commonly used products are at all-time high prices. Urea fertiliser has risen from $250 per tonne at the beginning of 2021 to a recent high of $885 per tonne; more than tripling in just 15 months. Farmers face the unenviable choice of paying higher input prices and passing them straight on to the consumer or using less fertiliser and accepting lower crop yields, which will also have the effect of raising prices.

Chart 8: Granular Urea Fertiliser (USD per tonne)

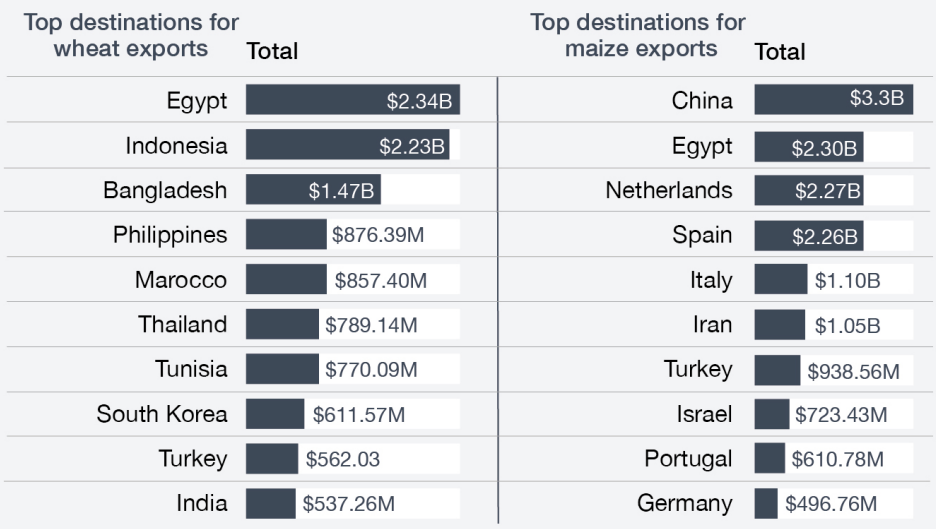
Another significant supply shock for food prices comes as a direct result of the war in Ukraine. In 2020, the country was the world's fifth-largest exporter of wheat with a total value of $3.59bn. There is considerable doubt about the summer harvest in 2022 and, indeed, whether the next season's crop can be planted at all. With total exports in 2020 of more than 18 million tons, there is a potentially large shortfall of global supply, especially given EU and US sanctions against Russia; the world's largest exporter of wheat by both value and volume.

Table 1: Exports of Wheat by country 2020 (USD) [3]

	Value in USD	Tonnes
Russia	7,918,294	37,267,014
US	6,318,111	26,131,326
Canada	6,317,889	26,110,509
France	4,528,591	19,792,597
Ukraine	3,594,217	18,055,673
Australia	2,698,498	10,400,418
Germany	2,105,865	9,259,493
Argentina	2,029,484	10,400,418
Kazakhstan	1,137,140	5,198,943
Poland	1,047,399	4,689,130

[3] FAO Statistical database
[4] https://www.investmentmonitor.ai/special-focus/ukraine-crisis/countries-exposed-ukrainian-food-exports

Figure 1: Top destination's for Ukrainian exports of wheat and maize[4]



Some of the world's most populous countries rely on imports of wheat from Ukraine with the Middle East and Asia the top export destinations. Maize is also a significant Ukrainian export as it is used as feedstuff for livestock across the world.

Interruptions to supply will have potentially huge negative impact in those countries where there is little or no potential for domestic crop substitution and where low income levels evidence a structural vulnerability to higher prices.

Conclusions

A 'perfect storm' of adverse impacts on inflation is currently in progress and is expected to push prices higher over the short and medium terms. The pace of cost increases might slow due to base effects but even as inflation may slow somewhat in H2 2022, prices will remain at or close to all-time highs for many products including food and energy. Indeed, the focus on the first derivative of prices – their annual rate of change – may well blind policymakers to the adverse social and economic consequences of the actual prices paid.

It is axiomatic that if prices double immediately and stay at elevated levels for 13 months, the annual rate of inflation at the end of the period will be zero. But a zero rate of inflation will not remove the burden of high prices which will continue to be borne by businesses and consumers alike.

Rising prices for fossil fuels – crude oil and natural gas – can only increase the relative attractiveness of renewable energy and we expect demand for this to continue to grow strongly, especially in those countries that are still experiencing high rates of both economic and demographic growth which ultimately drives the demand for electricity.

Energy security has become a hot topic since the Russian invasion of Ukraine but it has been a feature of policymaking in some Asian countries for many years. Reduced reliance on imported fossil fuel helps reduce strains on the balance of payments and improves economic resilience; the ability to withstand external shock. In India and the Philippines, this realisation has been one of the drivers of renewable energy policy and we expect it to be adopted elsewhere in the region.

"Energy security has become a hot topic since the Russian invasion of Ukraine but it has been a feature of policymaking in some Asian countries for many years."

Locally produced energy for local consumption has always been at the heart of our investment strategy. Given the likelihood of growing social tensions resulting from substantially higher world food prices, we believe this will also resonate as a pragmatic political programme. As governments focus on ways to alleviate food poverty, an emphasis on renewable energy will bring benefits in terms of job creation, family income, social stability and respect for institutions.

Higher raw materials and transport costs – polysilicon, PV panels, labour, energy etc – may pressure margins, though this can be mitigated both through volume growth and by the protection afforded by inflation-linked power purchase agreements.

In our opinion, a very difficult period lies ahead, both politically and economically. The world has lurched from a health crisis to an energy crisis and now stands at the brink of a food crisis. As ever, it is the poorest people who will suffer disproportionately and who will need the most support in these troubled times.

In our view, the very best support comes from investment which creates jobs and incomes and which does so whilst respecting the environment and delivering positive impact on health and other social outcomes.

More than ever, the current conjuncture favours investment in sustainable, renewable energy.

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