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Beyond COVID

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Energy Transition

We are seeing signs of an energy transition as the world scales back its reliance on fossil fuels to focus on renewables.

This is already being played out in Europe, as a rapid uptick in energy demand coincides with an adjustment to cleaner energy sources. Gas prices have shot up in response, adding fuel to the inflationary fire. With winter approaching in the northern hemisphere, it is likely the shortage is being felt even more acutely.

In China, where increasing environmental concerns have played their part in reducing their use of coal, a lower domestic coal supply (combined with geopolitical spats such as blocking energy imports from Australia) comes at a time when the country is also facing increased energy demand post-COVID as it seeks to boost economic activity.

The global move to renewables requires an enormous amount of transition investment and thus could lead to more persistent inflation as this isn’t a short-term issue - we believe the transition could last well over a decade.

Yet even as we fight the battle against climate change, changes in the weather are making it harder to generate predictable renewable energy, leading to further shortages. There is unlikely to be a simple solution to the supply/demand gap.

Effects of Already Observed Climate Change

Alongside increased difficulties in energy generation, climate change is also driving up the cost of food. South American crops have suffered this year due to drought and/or flooding.

The destruction of the Amazon rainforest along with other habitats that act as carbon sinks is resulting in further climate change, which will have impact on crop production and drive prices higher still.

Deglobalisation

Another trend accelerated by COVID is the increase in deglobalisation. The rise in autarkic governmental policies is exacerbating supply bottlenecks and highlighting how stretched interdependent supply chains have become.

Events such as Brexit and the deterioration in US China trade relations is resulting in additional supply chain disruption and consequently inflation.

Employment

Structural changes due to the pandemic are also feeding through into second round inflationary pressures from higher wage demands. We have seen this particularly in the US where there is a reduced workforce at a time of higher demand.

With the cost of living increasing while wages stagnate, we are likely to see more cases of higher wage demands while employers struggle to attract labour.

Meanwhile many populations are ageing, and retirees are not being replaced. We believe the education system has focused on a narrow range of employment options that often leave the less education-focused careers exposed to a lack of new entrants into certain sectors.

Do politicians and central banks have the power to control inflation in the face of so many conflicting pressures? For many years, the European Central Bank struggled to hit its ‘close to’ 2% inflation target, with an average of 0.9% p.a. since 2013.

The question is whether those responsible for fiscal and monetary policy have the stomach to risk provoking a possible recession in the face of already rising uncertainties generated by the noted supply side shocks and other global transitional forces.

This time last year we faced the uncertainties brought about by COVID. This year, and probably beyond, inflation appears to be among the primary topics of debate.

As bond investors, the macroeconomic environment remains a key consideration. We continue to assess valuations and our positions against an uncertain inflationary backdrop that we believe is the result of a powerful convergence of factors that will not easily be controlled by current monetary and fiscal thinking.

8. NPR, as of 22 April 2021.
9. CNBC, as of 2 June 2021.
10. CNBC, as of 29 September 2021.
15. Reuters, as of 7 September 2021.
17. The Economist, as of 17 July, 2021.
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