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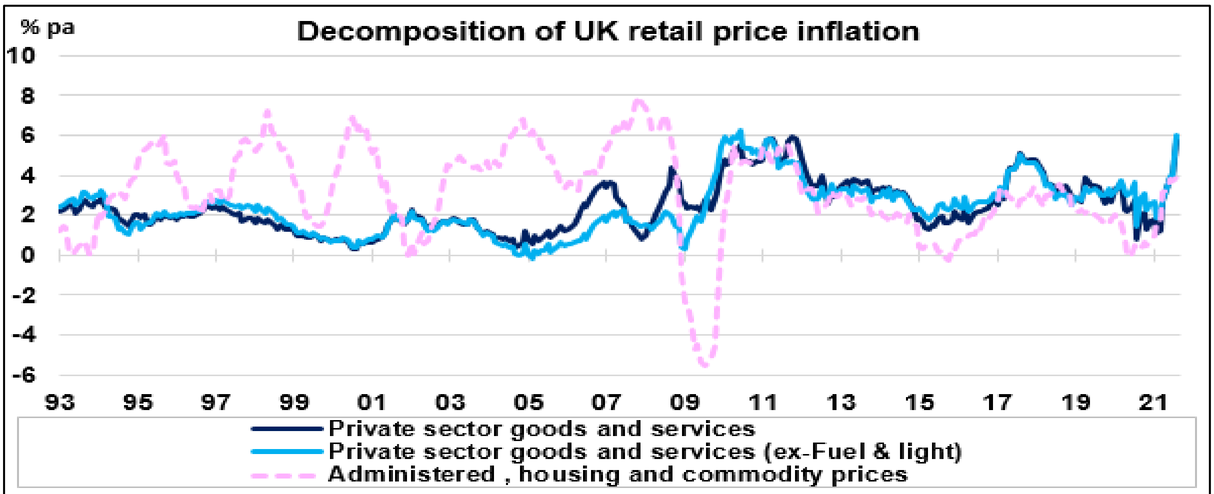
## UK INFLATION LIFTOFF

It has taken a few months longer, but the first half lift-off in US CPI inflation is being tracked by the UK CPI (3.2 per cent) and RPI (4.8 per cent). The retail price index, though discredited on a statistical technicality, permits a longer perspective. Many years ago, we decomposed the RPI into its market and non-market components to illustrate the distinction between policy influences (especially interest rates) and market-related pressures driving private sector pricing. The updated decomposition is shown below. This is already a comparable increase in private sector inflation (ex-fuel and light) to 2009-10, with non-market inflation forces also ramping up. The most striking jump in inflation in August was for restaurants and hotels – now sporting inflation of 8.6 per cent, followed by recreation and culture, now 2.4 per cent. Transport inflation remains stubbornly high at 7.8 per cent. The reopening of the services economy is clearly imparting a more significant boost to inflation than expected. Labour market frictions are becoming painfully evident in the UK as in the US. While the annual wage inflation rates are exaggerated by comparisons with the most depressed months of 2020, the return of double-digit inflation in wholesaling, retailing, hotels and restaurants and finance and business services cannot easily be explained away. The consolidation of inflationary pressures in the UK labour markets is the strongest argument for a more prolonged departure from central bank targets and objectives. The abundance of vacancies (excluding agriculture, forestry and fishing) – which have topped a million for the first time – has incentivised workers to forgo the ‘safe’ option of staying with their pre-pandemic employer and to switch jobs and sectors. Huge gaps are emerging in the staffing of retail and transport businesses as employers failed to anticipate the efforts that would be needed to retain key staff. As economic momentum fades and many furloughed workers discover that their jobs have vanished, the extent of the labour market skills mis-match will become clearer. In terms of inflationary dynamics, the UK is at the beginning of a modern monetary experiment, not the end.

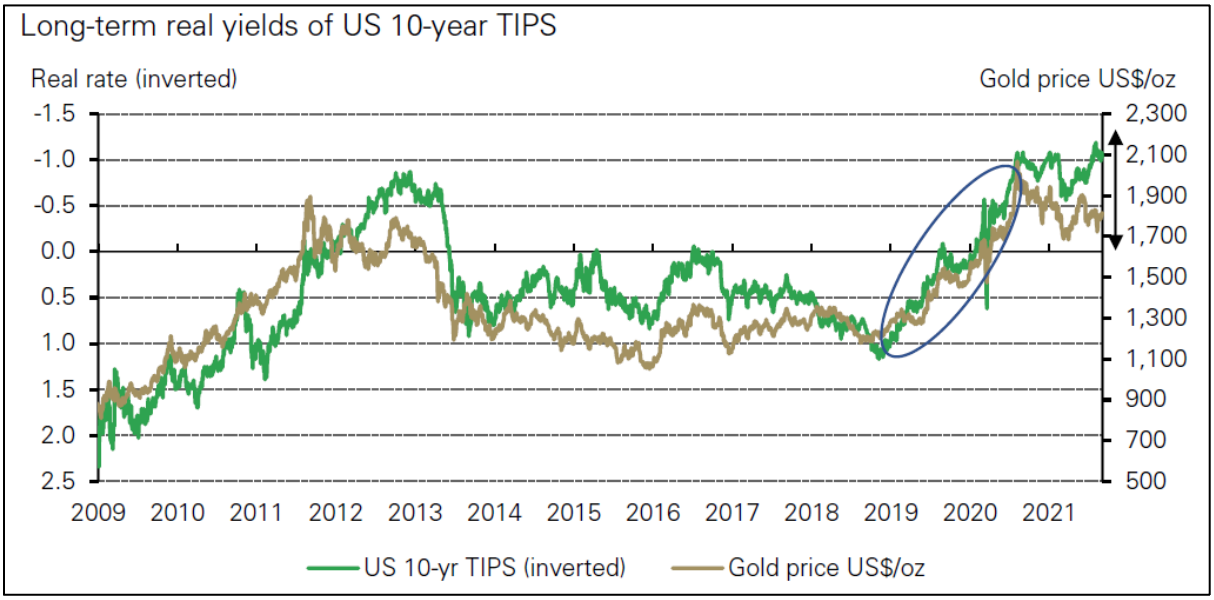


## THE UK'S ENERGY EMBARRASSMENT

S&P Global Platts reports that UK day-ahead power prices tripled to record levels this week due to tight generation margins, combined with soaring power import, natural gas and carbon prices. The UK's accelerated coal phase-out along with reduced nuclear availability and low wind generation have exposed the market to rising gas prices. Power prices have risen strongly across Europe but the UK has come under more intense pressure due to its high dependence on gas and renewables to generate electricity. S&P assessed UK day-ahead baseload prices at £540.15/MWh for delivery on 14th September, up from £171.15/MWh four days earlier. UK gas prices have soared since the start of 2021, with the month-ahead price on the UK NBP hub assessed by S&P on 10th September at just under 146 pence/therm. That compares with a month-ahead assessment of just 28 p/th a year ago, representing a 420 per cent increase year on year. The increase in gas prices has been replicated across Europe due to low storage stocks, competition with Asia for LNG cargoes, and Russian supply concerns. Adding to the strain of coal closures has been the UK's ageing and inefficient nuclear power plants. The UK has just two coal plants at West Burton A and Ratcliffe-on-Soar still in the wholesale market, although two officially closed units at Drax are still running for system support. UK coal plant capacity has fallen from 23 GW in 2011 to 5 GW today. At 39 GW, UK installed gas-fired capacity is the UK's dominant price-setting generation technology, but available capacity this year remains reduced by the absence of Calon Energy CCGTs. The UK's remaining nuclear capacity of 8 GW is increasingly unreliable, running at closer to 5 GW at present due to unplanned outages at Hartlepool and Heysham 11. Since the closure of the Rough gas storage facility, the UK has no large-scale storage sites and only a limited number of smaller storage facilities, leaving the UK potentially exposed to increased supply security risk. While the UK has a significant offshore gas industry of its own, three LNG import terminals, links to Norwegian gas fields, and two interconnectors linking it with Continental Europe (IUK and BBL), it has limited capacity to buffer spikes in international prices. UK electricity demand reached a record low of 330 TWh in 2020, down 4.6 per cent from 2019. A recovery is evident this year, with demand to end-August up 5 per cent year on year.

## WILL GOLD ENJOY A SEASONAL RALLY?

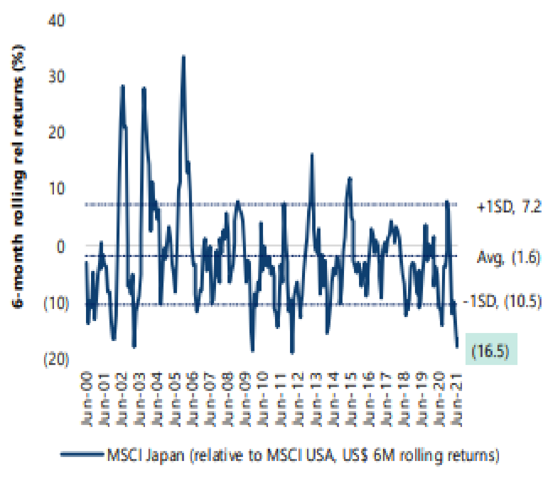
Given the explosive rise in US inflation and the corresponding fall in real government bond yields during 2021, gold's performance has been lacklustre, to put it mildly. Despite the US 10-year TIPS yield hitting all-time lows in early August, there was a worrying 'flash crash' in the old price on 8th August. Since then, it rebounded briefly to US$1835, but has not managed to hold this ground. Gold bulls wait nervously to see whether gold will re-establish its strong historic inverse correlation over the coming months, aided by favourable seasonal factors. These hopes revolve to a meaningful extent around Chinese demand. Inflows into Chinese gold ETFs continued in August, increasing by 0.8t to stand at 72t, the second highest month in history. Chinese gold ETFs' popularity among local investors was driven by the volatile CSI300 stock index weighing on local investors' risk appetite. Robin Griffiths reckons that gold is in a holding pattern until it breaks through US$1920.



## JAPAN: DARING TO BELIEVE THE NOMINAL RECOVERY

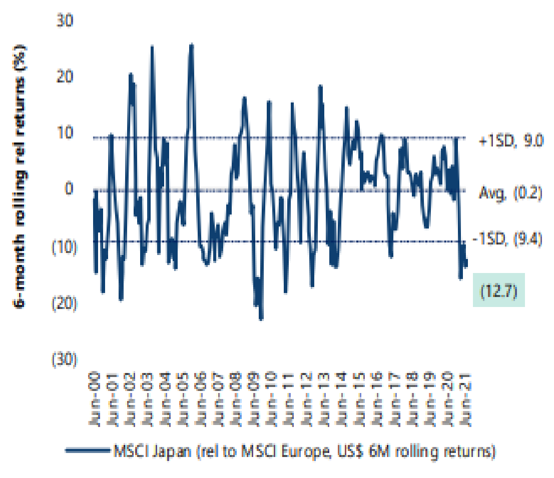
Last week, Japan’s Topix finally broke through its 1991 high, breaching the 2100 level. While Japanese politics is not usually a major influence on the stock market, the recent decision of PM Yoshihide Suga to step down ahead of the LDP leadership election later this month seems to have provided the trigger for a catch-up trade in Japanese equities. The charts below reveal that, from a historical perspective, the extent of Japan’s underperformance versus both US and Europe is highly stretched and unsustainable. Jeffries analysts calculate that MSCI Japan underperformed by 16.5 percentage points against MSCI USA and by 12.7 pp against MSCI Europe over the past 6 months. The recovery from the Covid-19 low was spurred on by unprecedented fiscal and monetary accommodation. However, almost all the 2020 gains were underpinned by re-rating while forward earnings were a consistent drag. Today, we see the reverse, with ratings slipping but earnings gathering momentum. Japan delivered record earnings beats in the first quarter of the new financial year, translating into a strong upgrade cycle across most sectors. A key development for Japan has been the return to nominal GDP growth since Shinzo Abe resumed office in late 2012, interrupted only by the pandemic. Nominal GDP growth should return to around 3 per cent in 2021. Japan was slow off the mark in the vaccination stakes, but now half the population is double-jabbed and this should reach 80 per cent by the end of the year if the current pace is sustained. Christopher Wood, a Zoom speaker earlier in the year, remarks on the continuing failure of Japanese domestic institutions to raise allocations to their own market. An extended period of outperformance is hard to imagine unless foreign purchases revive after a summer of modest divestment. Shrikant Kale forecasts that Japan’s return on equity will return to double digits by the end of the fiscal year, an improvement that does not rely on America’s leveraged share buyback model. Japanese corporations continue to hoard cash, valued at ¥665tn (US$6.08tn) at the end of June. Wood considers that the best argument for Japanese institutions to accumulate equities remains the massive outperformance of the Topix compared with the 10-year JGB. Domestic institutions are extremely averse to volatility – which is admittedly very low for JGBs under the Yield Curve Control policy – but the cumulative gain for equities is 154 percent since 2013. In summary, the investment case for Japanese equities, especially those expected to benefit from re-opening the economy, rests on nominal GDP acceleration, associated earnings momentum, an unwind of relative underperformance and a return of foreign investor purchases. A weakening Yen would also be helpful.

**Exhibit 3: MSCI JP vs US (Rel 6-month rolling, US$)**




Source: Jefferies, FactSet

**Exhibit 4: MSCI JP vs Europe (Rel 6-month rolling, US$)**




Source: Jefferies, FactSet

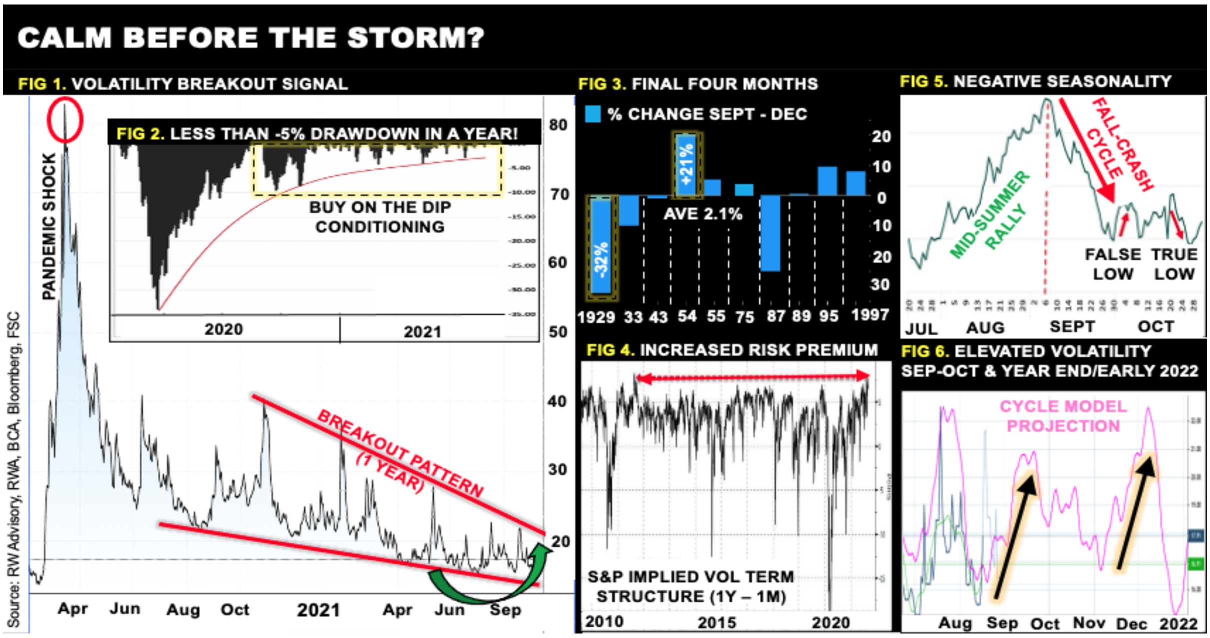
## DIARY DATES

Our next event will be a lunch on Thursday, 23rd September at El Vino’s with Chris Watling, of Longview Economics, who will address “What will change the central bank policies that underpin the notion that there is no alternative to equities?” On Wednesday, 20th October Dr Holger Schmieding, chief economist of Berenberg bank, returns to address the outlook for the German economy and stockmarket in the aftermath of the upcoming German elections. This will also be a lunch at El Vino’s.

**Peter Warburton**

## CALM BEFORE THE STORM?

Hurricane Nicholas made landfall in Texas early on Tuesday, 14th, bringing with it sustained winds of 75mph. Most paradoxical, was the previous day's orange sky, later panned across by a rainbow, which was described by an onlooker as the *"calm before the storm"*. This serves as a serendipitous omen for financial markets, with S&P500 recently triggering a 5-day losing streak, as we enter the negative seasonality period of Sept-Oct, amplified by an overheated *"wall of worry"*. Slowing economic growth, pandemic-related uncertainty, the likelihood that the Fed will soon be tapering asset purchases, Biden's tax plan and excessive valuations, are all among the factors being highlighted as sources of equity risk. Recall the insightful warning of Jeremy Grantham, *"What pricks the bubble…could be the most important category [risk] of all, which is <u>everything else that is unexpected!</u>"* One of great virtues of behavioural technical analysis, is knowing that ultimately all market forces are already priced into the chart, thereby offering a unique leading indicator. *Figure 1* highlights a potential volatility breakout signal on the VIX, based on a one-year compression pattern. On face value, volatility is historically low, signalling complacent investor sentiment. *Figure 2* shares part of the underlying reason, with S&P500 experiencing less than 5% drawdown in a year and giving unprecedented confidence in the *"buy on the dip*" strategy. If VIX breaks above 20%, then we should expect a sharp rise in volatility, back to the October peak levels, near 40%. In fact, a backtest of the record bull-run YTD, also highlights asymmetric risk in the last 4 months *(Figure 3).* There have been 10 other years in which the S&P500's gain through August surpassed 20%, according to Bloomberg data. The final four months of those years brought everything from a 21% advance (1954) to a 32% decline (1929), and an average loss of 2.1%. However, our base case remains negative, in-line with the late-stage cycle of the *"Roadmap model"* now, into 2022-2023. Tactical indicators, such as option market sentiment *(Figure 4),* also confirm, with an increase in risk premium of implied volatility (1-year vs. 1-month). Shorter-term market timing indicators, such as our quantitative models project negative seasonality in Sept-Oct *(Figure 5),* and also year end, into 2022 *(Figure 6).* This may argue against traditional expectations of a *"Santa Claus"* rally, driven by bouyant festive sentiment and year end portfolio rebalancing. All probabilities, not certainties, but the bottom-line is that prudence is key. Investors should take heed of evolutionary scientist, Charles Darwin on his teaching about surviving change. "It's not the strongest…nor the most intelligent…it is the one that is most adapatable to change." To position, it's best to adopt a diversified barbell approach, to hedge risk and beware of the calm before the storm.




**Ron William**