

A butterfly flaps its wings.....

South Africans can be forgiven for having a wry smile last week. The news was filled with pictures of long queues for petrol as forecourts ran dry and supermarket shelves were empty. Was this a rerun of July's riots? Far from it. The scenes were from the UK where a series of events have conspired to cause chaos. It is a bit like the Butterfly Effect – the idea that a small event can have a disproportionate impact on a complex system. To some extent, the global economy is increasingly being caught up in this phenomenon, and it's not limited to the UK. This article explores some of the issues and their impact on markets.



**Michael
Porter**

As Winter approaches, Europeans are facing a winter of discontent. Thanks to a confluence of idiosyncratic factors, Britons in particular, are facing two issues that are causing widespread chaos across the country. But these issues are not limited to the UK. Europeans are vulnerable as well.

The first is a widespread natural gas shortage across Europe, which is causing gas prices to rise exponentially. Gas fields across Europe (but especially in the UK) have been in decline for years, thanks to limited investment in new capacity. The result is that the UK is far from self-sufficient in gas. Only 50% comes from domestic sources – the rest is imported from various other countries. But why the shortage? Firstly, last year was an extremely harsh winter, where demand for heating soared (85% of household heating is fuelled by natural gas). Consequently, stocks were drawn down. These stocks were not replenished in the summer months due to lengthy shutdowns of key infrastructure as the maintenance backlog caused by Covid was addressed. Secondly, worldwide demand for gas has soared as reopening demand exceeded expectations and supplies came under pressure. Thirdly, renewable sources of power have under-delivered. Thanks to an unusually calm summer, wind speeds have been low, resulting in a drop in power generated from offshore wind farms. Finally, a fire in a large subsea cable that supplies the UK with electricity from France will take 6 months to repair, putting further pressure on domestic supplies of power – a lot of which are gas-fuelled. The consequence is that gas prices are up almost 400% over the past 15 months, and still rising.

Higher gas prices are forcing industrial users to scale back production or close altogether. One of the casualties is the fertilizer industry, which in turn has impacted such diverse industries as abattoirs and carbonated soft-drink makers, as a

SPEED READ

- A global energy crisis is unfolding, thanks to several isolated, individual events that are now spreading like a domino rally.
- Shortages are becoming more commonplace, which is driving up prices.
- Consequently, inflation is rising. Whilst everyone has assumed that inflation will be transitory, shortages are testing this theory to the limit.
- Markets are jittery because higher inflation typically implies higher interest rates.

NATURAL GAS PRICES



Rising demand and limited supply have caused gas prices to rise exponentially. Consumers are facing higher bills, but there are other knock-on effects as well.

by-product of fertilizer production is carbon dioxide. Across Europe, consumers are facing soaring utility bills – both for electricity and gas. Regulators are passing price increases of between 12% - 15% - unheard of in countries that have enjoyed

stable and predictable pricing for years. Not surprising, consumers are up in arms, so Governments are being forced to step in to subsidise bills and limit price increases. This is on top of the fiscal drain from covid relief. There is a real chance that some European countries could face load-shedding over the next 6 months. The second issue facing Britons is empty shelves and empty petrol forecourts as a shortage of truck drivers upsets the just-in-time logistics industry. A combination of Brexit policies and the furlough scheme has seen thousands of truckers leave the industry. We know from the July riots how quickly shortages can develop if there is a chink in the logistics chain. Supermarkets cannot source sufficient stock to keep the shelves stocked, so aisles are empty and prices are rising. Hence the queues for petrol. Unfortunately, this is not an issue that will be resolved overnight. It requires visa regulations to be relaxed – and drivers to be enticed back. But that will come at a higher cost – driver salaries are literally doubling!

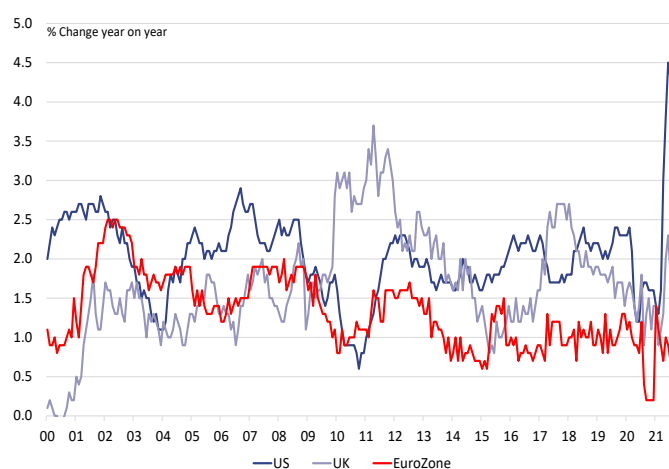
On the other side of the world, in China, there is also a power crunch, but for completely different reasons. Three factors have conspired:

1. At the beginning of the year, China's Government set targets that energy intensity per unit of GDP should fall by 3% this year – an effort to move towards a greener economy. However, over H1, a third of all provinces saw their energy intensity increase, not decrease. Local officials have 3 targets to meet this year – energy intensity, GDP growth and Covid control. With the latter two targets “in the bag”, officials have focused all their attention on energy intensity.
2. Coal prices have soared, which has made it uneconomic for many older coal-fired power stations. Consequently, electricity production has dropped significantly.
3. Geopolitical reasons ahead of the COP26 Summit later this month. China will be keen to show that it is “doing its bit” for climate change.

The net result is that large-scale industries in China have been shut down by overzealous local officials – especially energy-intensive ones such as steel-making and large manufacturers. This in turn has caused some commodity prices to collapse – the price of iron ore has dropped from \$220/ton in July to \$110 now. That collapse has caused the share prices of our mining companies to fall dramatically. It is also causing shortages of goods and congestion at ports as shortages ripple across an ever-widening array of industries. Readers will be familiar with the global chip shortage, which is impacting the supply of everything from new vehicles to wifi routers and portable devices. Given the events above, these shortages look likely to not only be more widespread but also to persist for longer than expected. There are two consequences of these seemingly unrelated incidents – a short-term slowdown in GDP growth but also a rise in inflation. The slowdown in GDP should be temporary – any weakness over the remainder

of this year should be offset by higher growth next year as supply normalizes. Markets are likely to look through any weakness, provided there are no further surprises. Of more concern is the rise in inflation. For the past 6 months, investors have fretted over whether the rise in inflation was transitory or permanent. Most believed that it was just a temporary reaction to reopening and that it would soon pass. That view is being tested to the limit. As I noted earlier, wage inflation across the logistics industry is rising exponentially, as are utility prices. And we have yet to even mention oil prices – which are back at \$80 per barrel as demand surges. Oil prices were last at this level in Q4 2018. Even core inflation – which removes the impact of fuel and food prices from the inflation calculation – is at the highest level this century in the US. In the UK and Europe, core inflation is rising at the fastest pace in ten years.

CORE INFLATION



Core inflation – which removes the impact of food and fuel (two areas where prices are rising most aggressively) is still rising at the fastest pace in years.

Why is this important? The key tool to fight higher inflation is higher interest rates. With rates at record lows, the only way is up, but many believed that rates would stay low for an extended period – important in a world drowning in debt. Not only would higher interest rates drain money out of the economy and consumers' wallets, but interest rates are also a key variable in the calculation of fair value for equities. So higher interest rates generally imply lower share prices. Consequently, markets are jittery – they are swinging wildly day by day in reaction to every data release. Ultimately, the best protection for your investments against higher inflation is an investment in equities and property – bonds and cash fare particularly poorly. This is even more the case when higher inflation is accompanied by reasonable rates of economic growth, as we expect over 2022. Investors should expect markets to be volatile, but recognize it for what it is – and not make rash decisions. In the meantime, we can watch Sky News with a sense of bemusement as pampered Brits grapple with issues that hardy South Africans have long learnt to cope with.



Please note, due to the concerns over the 3rd wave of Covid, Harvard House has decided to cancel our Insight presentations until further notice.



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Topic: n/a

Natal Midlands

Date:	TBC
Venue:	Fernhill Hotel Midmar / Tweedie Road Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg

Date:	TBC
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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