Why is Inflation such a big deal?

This question assumes relevance because our sense is that the market participants around the world have been unwilling or unable to fathom what is transpiring. The perma-bulls, which control the major part of the narrative in financial markets around the world, have tried to clutch on all available straws to make light of the problem.

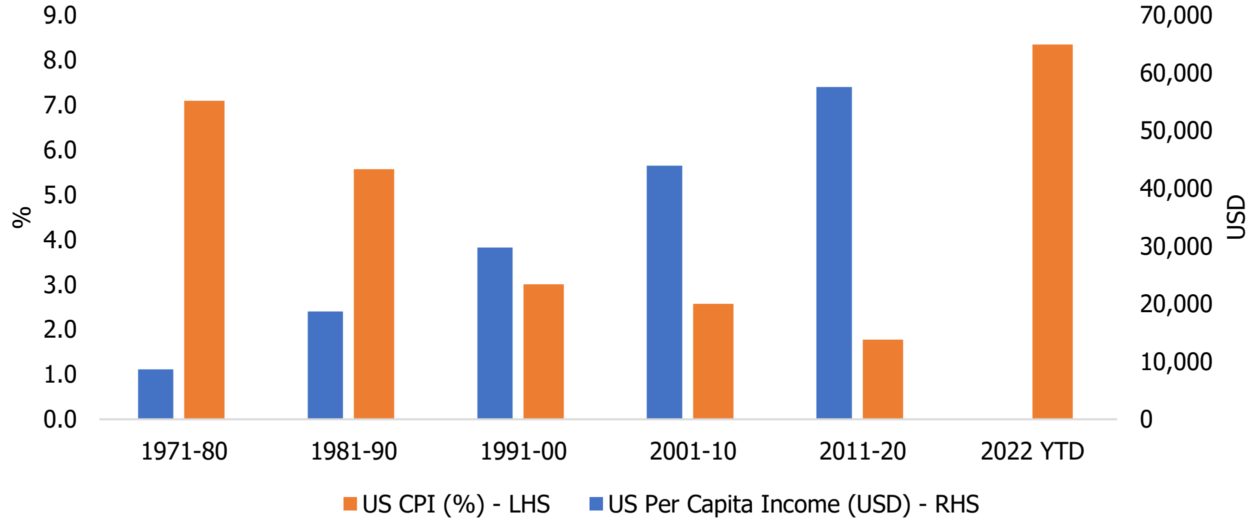
The problem is not going away and may not go away easily. The statement from the Fed chief late in August is not surprising to us. It should not have rattled anyone. The markets went into some contortion. Lopsided expectations are once again at work. It needs to be emphasized that the Fed is mandated to control inflation and not to please the markets.

This also begs the question – is inflation such a big deal?

The answer is simple – YES IT IS. Here is why

1. Low and predictably low levels of inflation have coincided with and contributed to a never-before increase in prosperity in the developed world (and in recent times in China).

CPI and Per Capita Income over the decades



Source: Bloomberg, Spark Fund Research

Stock market returns and inflation

Year Range	CPI – Annual (%)	S&P 500 return (%)
1951-80	4.2	6.5
1981-21	3.0	9.3

Source: Bloomberg, Spark Fund Research

How valuations have moved with inflation

Decades	S&P 500 - Average PE
1950's	14.1
1960's	17.6
1970's	12.1
1980's	12.9
1990's	22.7
2000's	18.9
2010's	18.5

Source: Bloomberg, Spark Fund Research

Low inflation has enabled consumers to retain their faith in paper money and plan their savings and consumption habits. Businesses need the low and predictable cost of capital to ratchet up risk taking. In recent times, investors have become dependent on low rates (low inflation) for the valuation expansion.

2. Today's Savings = Tomorrow's consumption. If you don't know how much your savings will be worth after 10, 20 or 30 years, you don't know how to plan your spending today. After all, for those who have the opportunity and inclination, savings represents what is not spent from their income.

The simple numbers below drive home the point:

Cost of a bottle of water (Rs) - 30 years from now	**Inflation @**
20 (Today's cost)	
201	8%
65	4%
36	2% (Goal of the Fed)

The implications are all too obvious. Nothing determines the ability of consumers to maintain their standard of living as much as inflation.

3. For businesses, the low cost of capital we have seen over the last two decades or so was in large measure due to the ability of the Fed (other major central banks have basked in the reflected glory of the Fed) to keep inflation low. In reality, many forces at work kept inflation low and Fed was not called upon to do much heavy-lifting. Now, the tide has turned decisively. Without low cost of capital, we might as well forget about innovations in areas like tech space and in healthcare.

4. For investors, low inflation is increasingly akin to life support. High valuations are oxygenated by low inflation. The tepid attempt by investors in recent weeks to ignore the elephant in the room is possibly to try their hand at an ultimate act of denial; assuming that the problem will go away.

The problem is not going away. The Fed Chairman made that clear. Why or whether they chose to sleep at the wheel for long will be debated for generations to come. For the moment, the Fed is reading the riot act. It does not sound pretty.

Why is inflation so sticky?

There are many reasons. Obviously, the complacency that followed a forty-year hibernation is all too apparent. But that is not the cause. That has made investors refuse to get real and instead take solace under cliches mostly involving why Fed is a die-hard bull and why they will go back to massaging the valuation bubble.

A few reasons stand out which will likely keep inflation a challenge for longer than the world would love to

1. De-globalisation

This has led to supply chains seizing up. The phenomenon of super-efficient supply chains gathered momentum when China entered the global trade system in the 1990s. With the advent of technology, the productivity gains from debottlenecking the supply chains paved the way for cheaper goods. After the rise and rise of China, trade friction reared its head. Things started going downhill under Donald Trump. Covid made the situation even more difficult. Ukraine has now completely laid bare the weak under-belly of the global trade system.

As supply chains get clogged, it is unleashing cost pressures. This is not an easily reversible phenomenon.

2. Changing labour dynamics and services inflation

US unemployment is low but the work force is shrinking. It is not as if the people who left the labour force are living happily thereafter. There are skill mismatches all over. As for China, it has rolled over the demographic sweet-spot. China is no longer the world's factory for things that are cheap.

Perishable services like hospitality/airlines/visa processing have all seen bottlenecks. Historically, these services were in over-supply. But even with lesser demand, supply has shrunk not because of lack of capacities but due to a dislocation that seems to be never-ending. The recent advisory from the US dissuading certain categories of workers with work visa from travelling out is a stunning admission that they are not able to handle the mere administration of even some routine services.

3. Commodities constraints

Persistent under-investment in hard commodities followed the crash in prices that came about in the aftermath of the 2007-08 crisis.

Year (MT)	Global cement production	Global crude steel capacity	Global copper refinery capacity
2012	3,821	2,088	24.6
2013	4,034	2,261	25.7
2014	4,150	2,301	26.5
2015	4,071	2,322	26.9
2016	4,153	2,275	27.3
2017	4,083	2,240	27.8
2018	4,058	2,290	28.1
2019	4,197	2,362	29.0
2020	4,281	2,400	30.0
2021	4,400	2,414	30.3

Source: IEA, CRISIL, Statista, Spark Fund Research

In general, capacity creation has slowed down and where capacities may have come up, they have come up at a high cost. Further, the capacities in regions with high geo-political risk remain unavailable or are available at sub-optimal levels from time to time.

While the spectre of a US/Developed market recession and the Chinese slowdown have resulted in a price correction over the last few months, commodity prices may not remain benign, not at least across the board.

4. The world is running out of steam

Energy sector has been one of the worst-hit in the aftermath of the Ukraine war. Look at the energy dependency of the European countries.

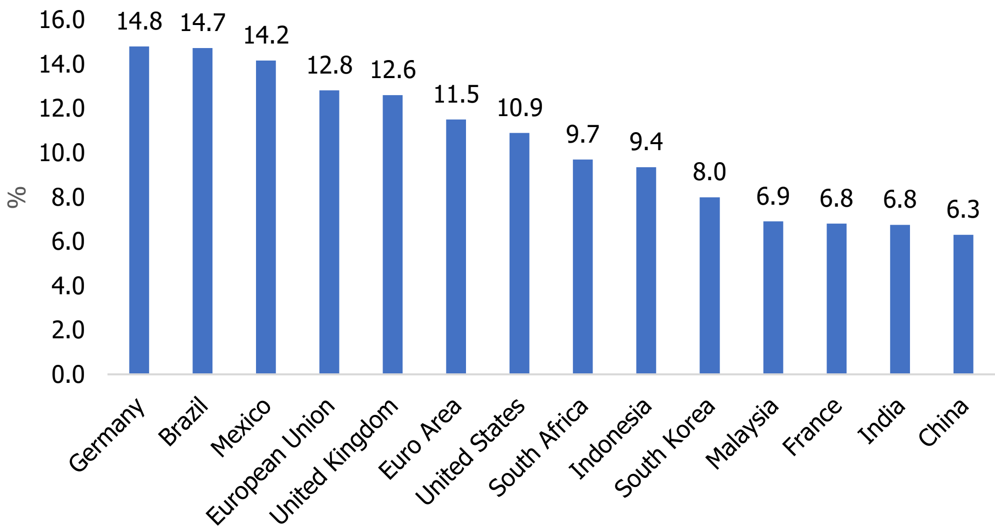
Country	Net energy imports as % of final consumption (2019)	
	Total energy	Total energy ex crude & oil products
Italy	104	97
Belgium	124	90
Spain	118	87
Greece	121	77
Germany	94	76
Thailand	69	61
United Kingdom	50	60
France	80	51
Denmark	52	43
Netherlands	99	43
Poland	65	40
India	58	38
Finland	57	33
China	36	16
United States	-1	-12

Source: IEA, Spark Fund Research

5. The end of food as we know it

The food supply chain has also been impacted. Food inflation has been a serious issue within the overall inflation mix.

Food Inflation (% YoY) – July' 22



Source: Trading Economics, Spark Fund Research

The food miles which denote the distance travelled by food from farm to reach the plate, has been on the rise over the last few decades. Some of the developed countries have taken the availability of food for granted perhaps because the expenditure of food in household spending has been coming down with rising incomes. But as countries become dependent on imported food and currencies get to be volatile, food inflation becomes a thorny issue. Demand elasticity can only go so far when it comes to food. Food security can quickly snowball into a major political issue as well.

These and other factors have a problem in that they are not easily reversible. One way to rein in inflation would be to allow demand decimation. That is what a recession would do but then, no one wants one. The reasons are not hard to find. Most of the imbalances may not even correct easily with a recession – viz. debt problem, income inequality, skewed asset prices, supply chain bottlenecks, shortage of specific skills et al.

In a sense, the world is having to pay a price for kicking the can down the road whenever a macro-crisis came about and the central banks decided to throw money at the problem. The paper money mountain is now trembling. The fall of global currencies against the USD exemplifies the problem. There is no reason to believe that the USD deserves to be strong currency on a standalone basis. But the fiat currencies are all about relativity. The flight to the abyss or the flight to nowhere that global capital is embarking on finds its way to USD as the perceived safe haven.

India and the current inflation scare

From a historical perspective, India has been a higher inflation economy than the other large countries. While that is no solace, it does give space for expectations management. There are other factors that favour India when it comes to inflation management

1. India is less globalized than the rest of the world or at least the bigger countries

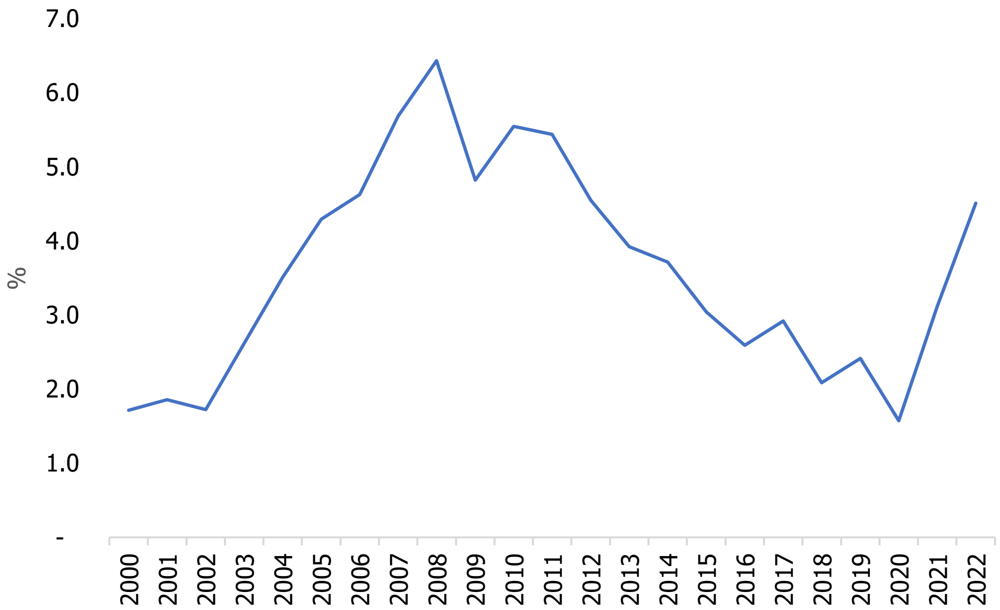
While the share of imports and exports in India's GDP has been rising, India is reasonably self-reliant on a variety of essential goods and most services. While oil imports are a source of worry, domestic power demand is met internally and the Indian energy grid has a history of managing swings in demand. Indian households can manage shortages which many other nations cannot.

When it comes to the banking system, the lending is met substantially from domestic savings. While India is far from insulated, it has several layers of shock absorbers.

2. The Covid recession has strengthened that part of India that was anyway strong

Corporate India and the formal economy have emerged stronger from the Covid recession which was an economic sudden shock. Any recession extracts efficiencies and this has been evident in the profit story for India.

Profits as % of GDP



Source: ICICI Securities, Spark Fund Research

NPAs in the banking sector have come off and credit quality has behaved better than the expectations of the Central Bank. Credit conditions are very favourable for a new credit cycle to start in India.

3. Narrowing inflation differential

We have talked about this in the last many months. As the western world (particularly Europe) remains challenged, the positive real interest rates in India will be a magnet for investments. It is perhaps the first time that India is in this situation. It is a great positive force for India while it lasts. It is a matter of time before India gets into some of the global bond indices. **Capital flows to India are bound to pick up and India is likely to face its usual problem of how the economy will be able to absorb the capital without over-heating**.

4. Incipient investment cycle

The investment cycle has the best chance of taking off that it has enjoyed in years. Rising profit share in GDP and the other factors mentioned can lead to the long-awaited revival of the moribund investment cycle in India with private capex as one of the drivers.

It will be far-fetched to make a case for de-coupling or for India to stand aloof from the global turmoil. However, India is differently positioned in the current crisis and is in a better place than in the past. If India does not make policy blunders – and the signs are not too bad this time around – India should remain a reasonable-growth economy in a world which lags triggers even if it tides over the current crisis. Global inflation is likely to be higher for longer if the 2% target of the Fed is retained. That is no great news for the World. For India, its stars may be aligning better.

Warm regards,

P Krishnan (CIO) and Team Spark Fund