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The future of inflation has a green hue

JAMES DE UPHAUGH, MANAGER OF THE EDINBURGH INVESTMENT TRUST

'Greenflation' is a recently coined term that has gained currency in the last quarter to denote the surprisingly powerful and potentially persistent knock-on effect of ESG in its widest societal sense, and especially of one of its key tenets, the energy transition. Each of the 'ESG' constituents has the potential to be inflationary, at least in the short to medium term, in many cases due to temporal mismatches between the desire and ability to transition quickly. Examples of the S might include increased aggregate wage costs associated with closing the gender pay gap, increasing workplace diversity and ensuring fair pay and conditions for supply chains. Meanwhile, under G the costs associated with increased reporting and oversight have potentially inflationary consequences. Some of these additional costs will lead to an initial price adjustment, which may be inflationary in the short term but not over a longer period.

The price of the energy transition

When it comes to environmental issues, the spike in energy and commodity prices has in part been a consequence of the pace at which investors are now demanding change. The decision of many institutional investors to shun large parts of the energy sector does potentially pose risks in terms of how smooth or disruptive the transition will be, which is likely to be borne out in economic disruption such as inflationary spikes in the cost of energy. Going green will take vast amounts of energy. The phase-out of unfettered coal is urgent. However, despite the obvious lock-in risk associated with prolonging the global dependence on fossil fuels, transition fuels like natural gas are vital to allowing low-carbon energy sources and technologies (and their associated infrastructure) to achieve scale.

And, indeed, the dash to achieve scale has led to inflation across the commodity complex. The price of copper, which is an essential ingredient in electric cars and renewable energy, has more than doubled from its lows in 2020, and the price of aluminium has also risen sharply. The energy transition won't happen without minerals and metals. Solar, wind, hydro, geothermal, nuclear, electric cars: they all variously rely on copper, aluminium, cobalt and lithium. The move to electric mobility is expected to cause a fivefold increase in demand for lithium and cobalt which suggests persistent price pressure for these increasingly vital metals.

This is driving new opportunities for mining groups, such as Anglo American, which is held in the Edinburgh Investment Trust. Its main lines of production are iron ore, copper, nickel and platinum group metals. Energy companies, such as TotalEnergies, also held in the portfolio, have been investing in hydrogen networks across continental Europe. Banks that are financing the transition are also key beneficiaries of the pace of change, and the associated inflationary environment. Of course, investing in the extractive industries comes with responsibility, increasing the imperative to carefully scrutinise ESG risks and opportunities.

Technology’s deflationary role

There is little doubt that advances in technology that improve productivity and operational efficiency are deflationary. One of the exciting aspects of the energy transition is the fact it can and has the potential to bring down the lifecycle, also known as the 'levelised', cost of energy. Indeed, costs of wind and solar power fell rapidly and became cost-competitive with fossil fuel technologies in the early 2010s.

Some technologies are easier to implement than others - larger wind turbines are low-hanging fruit, for example. Carbon capture and storage (CCS) has been much harder to implement, in part due to expense, as well as general logistics - it is an inflationary technology that reduces the cost competitiveness of fossil fuels. Mini-nuclear reactors have great potential to bring rapid change to the energy mix at a relatively lower cost than larger nuclear plants,

Wind, solar, tidal, hydro, geothermal and traditional nuclear power, along with new technologies such as green hydrogen (if achievable at a competitive cost) and bioenergy carbon capture and storage (BECCS), as well as innovations that improve energy efficiency, are likely to remain the dominant growth areas as the world seeks to decarbonise to reach 2050 goals. But in the very short term, they will offer little relief to higher fuel prices that are challenging some businesses and households, especially against a backdrop of a strong impulse to quickly cut reliance on fossil fuels.

This dynamic is creating opportunities for companies providing best-in-class technology and processes for improving energy efficiency and network efficacy. Genuit, Weir and Centrica, which are held in the Trust, are all extremely well positioned to benefit over the medium to long term from the energy transition and sustainable trends.

It's inflation Jim, but not as we know it

Few believe there will be a return to the hyperinflation of the 1970s, but it is possible that levels will remain above the 2% target rates of the Bank of England and the US Fed for a considerable time to come. There are, of course, short, medium and longer-term pressures on both sides of the supply and demand complex. An easing of supply chain bottlenecks, which should occur within the next 12 to 18 months (if not sooner) will alleviate some inflationary pressures, and the rebasing of inflation data will flatter the headline numbers later this year, although CPI rates are likely to rise further in the short-term. AI in supply chains, autonomous vehicles, robotics in healthcare, will mean technology will continue to be a formidable deflationary force. However, the energy transition and the widespread shift to stakeholder capitalism could continue to have inflationary consequences in the medium term.

However, climate change itself is inflationary and is already presenting cost pressures in terms of addressing food and water security, shoring up infrastructure and managing the risk to human health. While greenflation may be a short-term challenge for policymakers and society; the alternative of not dealing with the climate emergency could be much worse.

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