KMG CHARTERED FINANCIAL PLANNERS
SERIOUS ABOUT WEALTH

ROUGH BEECH COURT
DOWLANDS LANE
SMALLFIELD
SURREY RH6 9SD
T: 01342 840 100
KMG@KMG.CO.UK
WWW.KMG.CO.UK

August 2023

Deflation anyone?

No, we haven't lost the plot, and this may be an early call on the future, but we thought it worth sharing with you some thoughts from various economic indicators.

To set the scene, investment returns are stagnant for many different reasons that we have highlighted in previous Bulletins, but this does not mean they will remain in their current torpor for a long time. Much comment has been made as to the possibility of recession here and in the developed world which has not materialised; on the other hand, earlier this year we also had much comment that markets would move ahead strongly for various reasons including lower energy costs, a lot of liquidity and onward evolution of technology - all of which remain (with conflicting possibilities) and yes, the crystal ball on the future economic trajectory is very clouded.

Most people spend their time thinking about the future while examining the rearview mirror. We take the opposite approach by thinking about what is happening and then translating this into what is likely to happen. So here are some key thoughts about deflation:

- The current rise in energy costs, in the greater scheme of things, will not have a significant outcome on headline inflation because the world is now on a decarbonizing trajectory. Every time the Saudis or Russians think they can tweak the price by reducing supply the rest of the world move faster to get away from being hijacked by oil nations. Correspondingly, the faster we decarbonize the lower the energy cost, because once the infrastructure is in place energy production cost is remarkably small. We have yet to see the numbers for consumption of carbon in the UK in June but given the sunny weather and reasonable winds (Britain is the second largest windmill generator in the world after the Chinese) the chances are that Britain burned very little carbon in that month.

- Cheap labour has come to an end and although we are in the midst of a wage price spiral the reality is that advances in technology and artificial intelligence are coming on-stream so rapidly that wage price spiralling simply advances automation and just about everything and anything we can think of: take the debate about ticket offices in railway stations as a simple example.

- We may be fixated on migration but the reality in the greater scheme of things is that the number of people arriving in the UK is relatively very small (especially by comparison with the rest of Europe) and in general the lack of migrant labour, particularly in agriculture, is simply advancing automation at a rapid pace.

- Recycling is accelerating phenomenally with more and more facilities and means by which raw materials can be upcycled and used again, with downward pressure on consumption of raw materials across the spectrum. Many basic material costs particularly in metals have fallen dramatically this year and demand for basic materials has returned to pre-COVID levels, while at the same time shipping rates (which in the middle of COVID reached astronomical levels) have now declined to levels well behind those which we saw leading up to COVID. This all suggests that the amount of movement of raw materials around the world is declining significantly as developed economies find more ways of using what they already have and, of course, onshoring a lot of productivity.

- Infrastructure-spending, particularly in America, is accelerating because of huge government intervention and whilst on the one hand this puts pressure on raw material prices, the outcome of infrastructure-spending around energy, supply, transportation and just more efficient living, becomes deflationary.

- China, the world's second largest economy, has entered deflation. This in part is due to the contraction in exports to the rest of the world, technology driving down prices in that country and high youth unemployment. At the same time saving rates are accelerating because of worries about jobs and property prices (a foretaste of things to come in Europe), and don't forget Japan has struggled with deflation for a decade due to demographics.

- Productivity may be completely misunderstood because of automation and robotics and the speed at which both these factors are influencing all our lives. Take ChatGPT and the ability of artificial intelligence to manage data and produce enormously positive, as well as very worrying, results. This is advancing at speeds beyond our wildest imaginations; just look at the speed at which ChatGPT was taken up in the first month of its release.

- Artificial intelligence is also creating new forms of education, new ways of learning, new ways of retraining and upskilling and of course new ways of living our lives, which in many cases are now much less centred on materialism and consumerism, simply because it has become much easier to enjoy life with so little human interaction.

Many of these observations will manifest in the investment themes we have in our portfolio. We do not discount the possibility that interest rates may remain higher for longer - but probably not much longer than the back end of 2024 - and that short-term inflation may surprise and remain very challenging. But it seems reasonably clear to us that the long-term trends are deflationary and therefore we must continue to think about investment themes which allow for this extraordinary turn of events.

We look forward to seeing you all at our investment seminar in the autumn. Before then you will receive a more comprehensive Bulletin, but we felt that in the middle of August it was important to have a reality check on what appears to be going on at the grassroots.

Patrick McIntosh
Chartered Financial Planner