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INVESTOR COMPASS

INFLATION: TRANSITORY OR PERSISTENT?

Inflation - transitory or persistent?

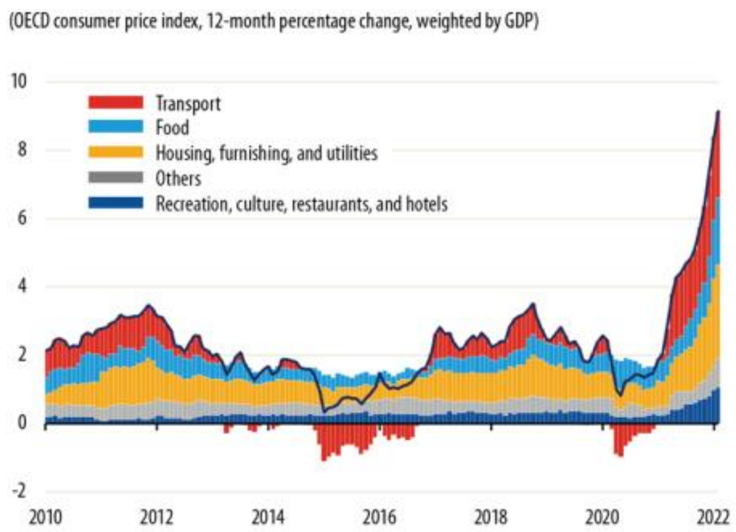
The world, since the last couple of years, has just not been the same. Physical, emotional and financial hardships aside, there is one more long term impact of the pandemic which is now starting to become visible: ***De-globalisation***. The war in Ukraine, which bought upon the West's collective response, is the latest event to trigger a wave of claims that globalisation is dead. It has been on the decline since the global financial crisis of 2008 but got exacerbated by Brexit, Trumpian nationalism and the Covid-19 pandemic.

Many Wall Street biggies such as BlackRock Inc. chairman Laurence Fink and Oaktree Capital Group co-founder Howard Marks see the era of expanding global trade and financial ties coming to an end. The world is now increasingly becoming more and more inward looking, America for Americans or Atma-nirbhar are different sides of the same coin. The current dislocation of supply chains could force inflation to be higher for a much longer period than expected – because businesses will speed up the shift in procurement of raw materials, energy, components to locations much closer to home. So by turning global markets into local ones, could protectionism lead to a high inflationary environment?

As of early 2022, both headline inflation (price of all goods and services) and core inflation (excluding food and energy) were significantly above target in most advanced and emerging markets **(Refer to Exhibit: 1).**

In this note we try to analyse the monster currently wreaking havoc around the globe – INFLATION – and see how India and Indian companies are positioned vis-à-vis earlier such instances. We believe that sticking to industry leaders with strong pricing power will help weather near-term headwinds far better while compounding wealth in the longer term for investors.

Exhibit 1: Hardline inflation in OECD countries is at record high



Source: IMF
Note: (1) Authors' calculations based on OECD data. (2) The OECD dataset includes data from the US from 2012 and Canada from 2016

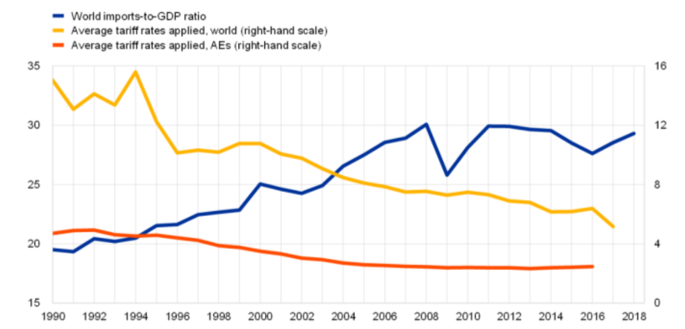
1. Globalisation changed inflation dynamics

Historians have been debating when exactly globalization began. Some argue that it began with the earliest human migratory routes such as the Silk Road that traversed through China, Central Asia and the Mediterranean; others say it started with Columbus's voyage to the New World in 1492. Regardless of the differing views, globalization has helped to develop an inclusive economy marked by free trade, free flow of capital among countries and easy access to foreign resources. Since the early-1990s, total trade volume (exports plus imports) of the world has risen from around 39% of GDP in 1990 to 58% of GDP in 2019. Cross-border capital flows have reached to incredible amounts in both developed and developing economies.

The most visible economic outcomes of globalisation have been increased trade and growth of outsourcing & offshoring

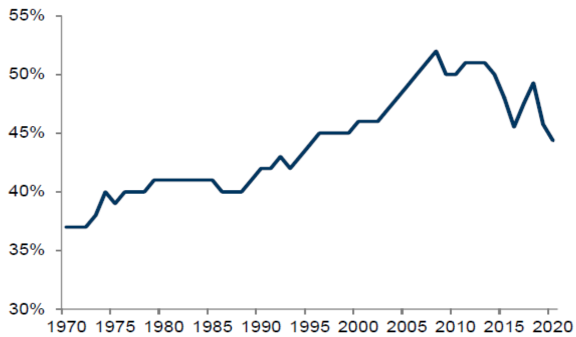
- **Trade intensity** (ratio of world imports of goods and services to GDP) has been on an upward trend since the 1970's with countries reducing tariff and taxation rates, and having lenient regulations **(Refer to Exhibit: 2)**.
- **The growth of global value chains (GVC) –** through progress in technologies and lower trade barriers reflecting the increased fragmentation of global production processes **(Refer to Exhibit: 3).** Advances in technology have made it possible to coordinate and track production through international supply chains.

Exhibit 2: Trade intensity has increased from 30% in 1980 to more than 50%.



Source: OECD TiVA, IMF, World Bank and ECB staff calculations
Note: The average tariff rate applied is the un-weighted average of effectively applied rate for all products subject to tariffs calculated for all traded goods in percentage terms

Exhibit 3: GVC share of global trade rose from 36% in 1970 to around 48% in 2018

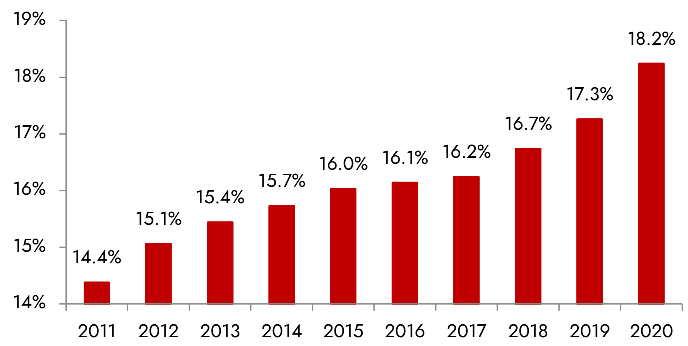


Source: World Bank, ADB, and Goldman Sachs GIR

China – the biggest beneficiary of Globalisation

China's GDP expanded from $302bn in 1980 to $24tn in 2020 (in US$PPP), accounting for 18.24% of global GDP **(Refer to Exhibit: 4)**. China's growth has been attributed to the capital investment (new machinery, better technology, and more investment in infrastructure) it made that enhanced its total factor productivity and manufacturing prowess. From accounting for less than 2% of global trade in 2001, China now contributes 13% of global exports and 28% of global manufacturing value-added as of 2019 **(Refer to Exhibit: 5)**. Over the years, it has cemented itself as the heart of global manufacturing and made the world economically dependent on China.

Exhibit 4: China's share of GDP adjusted for PPP



Source: Ambit Asset Management

Exhibit 5: Sharp rise in China's share of global exports and manufacturing

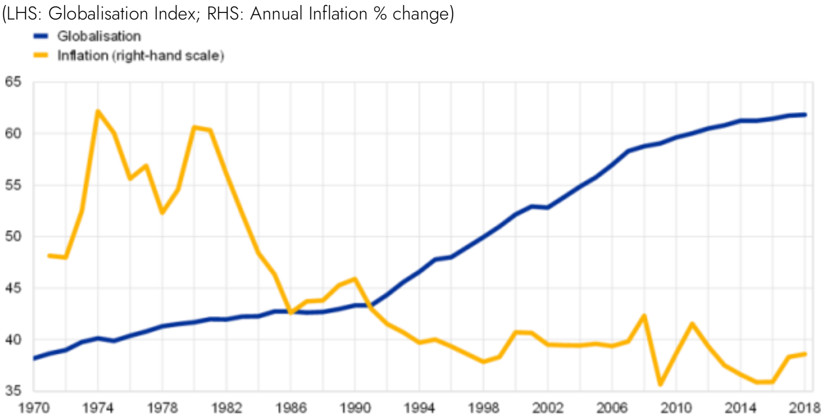
Source: Haver Analytics, Goldman Sachs Global Investment Research

2. Global - flation

Over the last three decades, the level of inflation in developed economies has moved lower and then stabilised towards the end of that decade **(Refer to Exhibit: 6)**. The average headline inflation rates in advanced economies have declined from around 10% in the 1970s to rates <2% since 2014, well below the targets set by Central Banks around the world. Technological advancements, astute monetary policies by the CB's, and better inventory management have driven the inflation lower. Another key driver has been the on-going globalisation, which has increased linkages between countries and restrained inflation. This co-movement of inflation rates amid the growing interconnectedness of goods, services and financial markets has piqued the interest of economists towards the globalisation of inflation hypothesis.

Exhibit 6: Median inflation rates in advanced economies and the KOF Globalisation Index

(LHS: Globalisation Index; RHS: Annual Inflation % change)



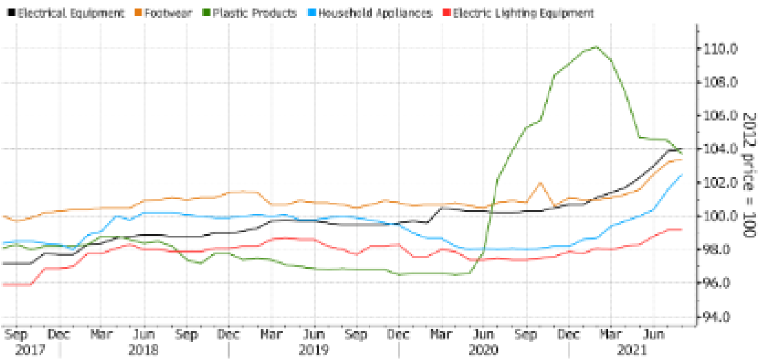
Source: ECB staff calculations, KOF Swiss Economic Institute and national sources
Note: Headline median inflation of 22 OECD countries and the KOF Globalisation Index

The globalisation of inflation hypothesis argues that the factors influencing domestic inflation have become increasingly global.

- **Greater trade in goods and services** – With increased share of imports to GDP, domestic inflation will be more affected by the prices of imported goods simply due to their higher share in the price basket as their prices will partially be determined by foreign demand conditions
- **Increased role of emerging markets** - Emerging markets have achieved greater economic heft and power. The opening up of China and India, in particular, represents a potentially huge increase in the global supply of mainly lower-skilled workers.
- **Advances in technology -** Made it possible to coordinate and track production processes in geographically distant countries. As a result, companies such as Apple, do not own most of the manufacturing plants in their supply chains.
- **Price competitiveness** - Millions of consumers and businesses have greater price transparency and more competition for local businesses thereby limiting price increases **(Refer to Exhibit: 7)**.

These developments have led economists to believe that impact of globalisation on inflation is more structural than temporary. However, not much of the global factors are currently captured in the standard models (mainly the Phillips curve) that are used to forecast inflation in major countries. These models focus majorly on domestic factors, such as variables for domestic slack, inflation expectations, import prices (for all international developments) etc.

Exhibit 7: Exported inflation – Import prices for Chinese made goods in the US

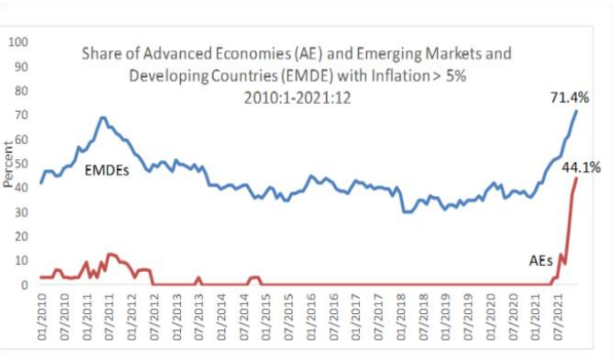


Source: U.S. Bureau of Labor Statistics, Bloomberg

3. The surge in global inflation

The surge in inflation was significantly above target in most economies. In **15 of the 34** countries classified as Advanced Economies & **78 out of 109** classified as Emerging Markets and Developing Economies by the International Monetary Fund's World Economic Outlook, 12-month inflation through December 2021 was running above 5% **(Refer to Exhibit: 8)**. This steep rise has become the focal point of all policy makers and central banks. However, the drivers for this elevated inflation don't seem to be uniform across countries.

Exhibit 8: Advanced and Emerging Economies with >5% inflation



Source: Project Syndicate
Note: The sample consists of 34 advanced & 109 emerging economies

Exhibit 9: Flexport Ocean Timeliness Indicator (OTI) stays near high

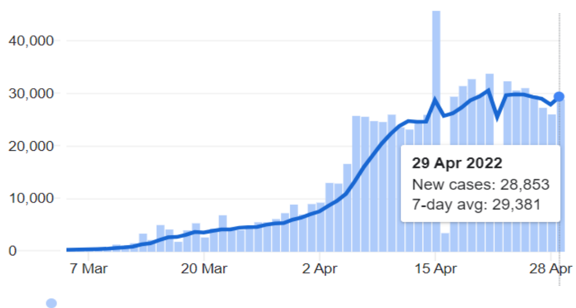
Source: [Flexport]

This rise in inflation has been attributed to –

1. **Commodity shortage because of Russian invasion of Ukraine –** Both countries are major exporters of commodities, and the disruptions from the war and sanctions have global prices hitting the roof, especially for oil and natural gas.
2. **Large fiscal stimulus combined with easy monetary conditions –** ~$16.9tn globally in fiscal measures and stronger-than-expected economic recovery led to a surge in aggregate demand.
3. **Shift towards goods and away from services –** Post the lockdown, spending on durable goods rose dramatically (pent-up demand), while service inflation increased only moderately.
4. **Disruption of global supply chains –** Covid has had two separate effects on the supply chain.
   - Lockdowns and mobility restrictions led to disruptions in the global supply chains, causing short-term supply shortages.
   - Transport costs have skyrocketed and the duration to ship goods by sea are close to all-time highs **(Refer to Exhibit: 9)**

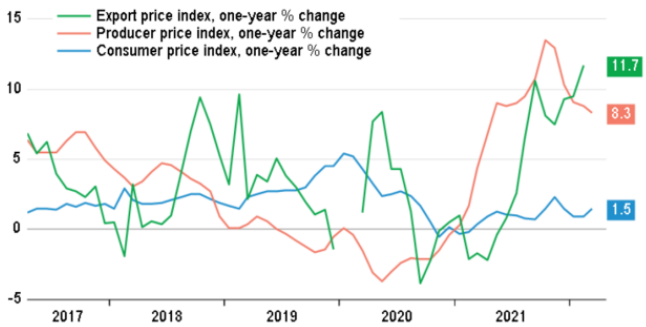
Inflation has proved to be more stubborn and persistent than major central banks initially thought. Some Economists had initially argued that inflationary consequences of the government stimulus would likely be "TRANSITORY" in nature. However, the conflict of Russia-Ukraine and now with China's battle against Covid-19 (China's zero Covid policy) delivering another blow **(Refer to Exhibit: 10)**, inflation has become more structural in nature rather than transitory **(Refer to Exhibit: 11)**. Despite talks about diversifying supply chains, the world's dependence on Chinese factories has only increased. According to estimates, China's share of world exports climbed to 15.4% last year, surpassing pre-pandemic levels of 13.1% in 2019. All of these have focused attention on supply chain sovereignty and domestic production facilities.

Exhibit 10: Covid on the rise in China



Source: Our World in Data, Google Analytics

Exhibit 11: Global inflation could be aggravated by Chinese inflation



Source: Refinitive Datastream, data to Mar 22; Reuters

In the absence of global policy options to resolve supply-chain disruptions, the task of addressing inflation is left to the major central banks. Nevertheless, if inflation is largely determined global economies, central banks may also have limited ability to stabilize it in the future and global factors, such as trade wars, could put more pressure on inflation than initially anticipated.

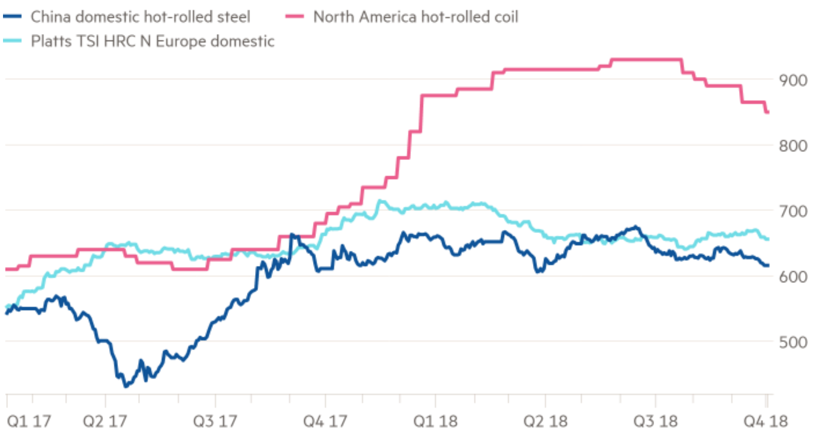
4. A permanent shift in the world order?

"The Russian invasion of Ukraine has put an end to the globalisation as we have experienced over the last three decades," Larry Fink, chief executive of BlackRock, the world's largest asset manager, wrote in his annual letter to shareholders.

- Sanctions on Russia after the conflict with Ukraine will give rise to Russia +1 narrative similar to the China+1 narrative during COVID
- Investors are pointing to **(1)** the trade war between the US and China, **(2)** a vulnerable supply chain which can be disrupted by external events as seen last year during the Suez Canal, and **(3)** Increase uncertainty in light of the pandemic which will prompt companies to pull production closer to home.

For decades, cheap offshore manufacturing and slick global supply chains has brought down costs for companies and fostered low inflation. By turning global markets into local ones, protectionism could lead to inflationary shocks. We have seen over the last 5 years, that the US steel prices have increased compared with those of the Chinese and European steel prices since President Trump's imposition of tariffs **(Refer to Exhibit: 12)**. Every manufacturing industry, industrial and construction-related, in the USA would have to pay a premium on the key input material. Protectionism will force the machine shops to offer a higher salary to lure engineers from competitors, despite the fact that their productivity will not increase. This will create a chain reaction where other engineers will demand higher salaries.

Exhibit 12: Steel prices in China, Europe and The US ($ per tonne)



Source: Ashmore, Bloomberg, FT times

Case in point: Mobile phone manufacturing in India

In 2014, India was one of the largest consumers and importers of mobile phones (>$8bn), with overall electronics imports threatening to exceed oil imports.

- However, the PLI scheme was introduced to reverse this trend by allocating incentives of Rs41,000 cr for mobiles manufacturing over the next 5 years; Global giants such as Foxconn, Samsung, Wistron & domestic companies such as Dixon have signed up for it.
- Samsung, now, runs the world's single largest location for mobile handset manufacturing in UP.
- Mobile phone manufacturing value has jumped >8x from Rs0.3tn in FY14 to Rs2.2tn in FY21, surpassing US & South Korea to become the second-largest globally.
- The next frontier is to boost exports & increase value addition from current 15-20% vs. 40% of China. Exports are limited to feature phones & low-value smartphones. China exports $200bn & Vietnam's export $60bn worth of mobile phones whereas India will be exporting ~$5.5bn worth of phones this fiscal as per industry estimates.
- Value addition in the mobile phone manufacturing is currently limited to 15-20% vs. >40% in China.

The scheme for promoting the manufacturing of electronic components & semi-conductors is a step in the right direction. Many parts such as display panel assembly, camera modules, batteries, chargers, PCB assembly etc. are being manufactured or proposed to be manufactured in India. This will increase the value-addition and the setting up a fabrication plant to manufacture semiconductor chips will help facilitate vertical integration.

The PLI scheme, introduced for 13 strategic sectors, will help the government to reduce dependence on imports by making India self-reliant. Going forward, it could be a key driver behind an even greater surge in exports leading to higher foreign exchange and help the government control the current account deficit.

Is Inflation here to stay?

High inflation doesn't seem to be going away. With shipping bottlenecks and some critical supply shortages persisting, global price inflation will remain high in 2022. Many leaders around the world have resorted to the old mantra of self-reliance. From America to India, leaders have indicated that the virus offers an opportunity to make their countries manufacturing powerhouses and make them less dependent on others thus looking inward to make up for the shortages.

Recent events such as congestion at China's ports due to the covid outbreak along with agri-commodity bans imposed by India and Indonesia on fears of scarcity in the domestic market have resulted in countries looking at **CERTAININTY over COST**. These crises have exposed the downsides of global integration and have questioned the belief that the world is flat as stated by globalisation guru, Thomas L. Friedman.

India is doing its bit to restrict Global-flation and become self-reliant. The PLI schemes announced in the last couple of years will not only help make India Atmanirbhar but also create jobs for huge labour force transitioning away from agriculture, as highlighted in our October newsletter on India's US$10tn opportunity. In addition to this, it will help tilt the Current Account scale favourably by reducing the import bill. All these will go a long way in helping India achieve the US$10tn milestone over the next 12-13 years. Maybe a decade down the line, we will see this Global-flation as a blessing in disguise for the Indian economy

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