Equity Research; Cost of Living – we can relate

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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Cost of Living – we can relate

- There is evidence that 2022's 9% CPI increase has triggered a re-think on consumer spending priorities. Post C-19 and during geopolitical upheaval, many are realizing that higher inflation, possibly a function of too much money printing during the pandemic is not 'transitory'.

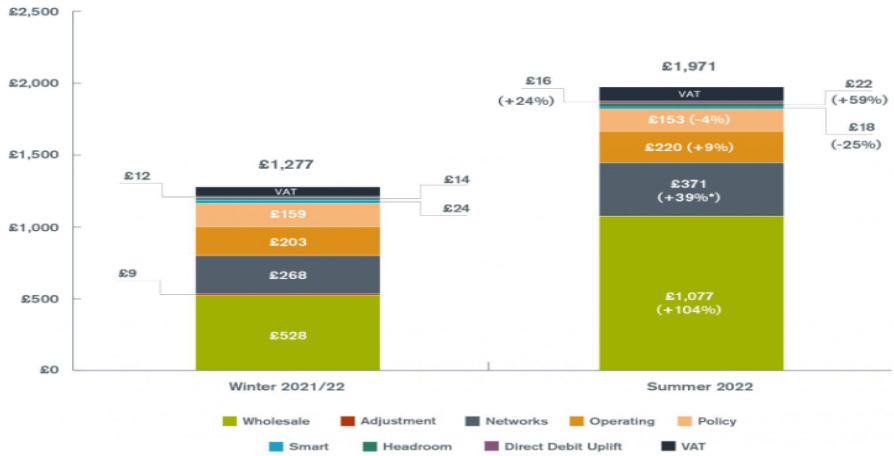
- Economic time lags are a vital concept. Whilst consumer income & expenses broadly match in the 'long term', in the short-term, costs can rise quickly whilst pay increases lag. An inflationary spiral (2022 so far) therefore creates a cash drain, reducing consumer disposable income as income stays the same, but costs go up.

- During C-19 consumers saved on transport, holidays, leisure activities, restaurants, debt servicing costs. They spent on food deliveries, online shopping, streaming. The UK government's measures to shore up consumer income via the furlough scheme and other support initiatives created a savings cushion, now being frittered away.

- In 2022 the expenses going up, energy, petrol, insurance, mortgage rates, are not those that consumers can do much about. What offsets are there? Typically to cut discretionary costs, so far lockdown purchases. But cost cutting may have to become more drastic.

- How will consumers manage lagging expenses, the timebombs that catch up? The Ofgem energy cap is predicted to rise from £2,017 p.a. to £2,800 p.a. by October 2022 equating to a £230 monthly bill.

Dual fuel customer paying by direct debit, typical energy use (GB £)



	Ofgem Price Cap	Change	Comment
Q1 2019	£1,136	-	Initial price cap
Q2/Q3 2019	£1,254	+£118	
Q4 2019/ Q1 2020	£1,179	-£75	Warm winter causes lower prices
Q2/ Q3 2020	£1,162	-£17	Significant challenger bankruptcies begin
Q4/ Q1 2021	£,1042	-£120	Colorado Energy, Pure Planet, GOTO Energy bankrupt
Q2/Q3 2021	£1,138	+£96	Re-opening triggers higher demand
Q4/ Q1 2022	£1,277	+£139	Bulb bankruptcy / Russia – Ukraine war pushes up BTU prices
Q2/ Q3 2022	£1,971	+694	Ofgem adjustment to higher market prices
Q4 2022	£2,800	+829	Ofgem estimate based on current prices

source: www.ofgem.gov.uk

Energy savings can be generated by reducing consumption, not having TVs on standby, turning off lights, hanging damp clothes out to dry, not using dryers. These simplistic measures can help, alongside the UK government's cash handback package.

Broadly, c. 8m vulnerable households will receive £1,200 of support including a one off £650 cost of living payment, universal support has increased to £400 and the repayment requirement has been scrapped. All households will get a £400 discount. This £15bn support measure is by nature, inflationary as it amounts to a direct cash injection, a C-19 era 'helicopter money' payment. It will increase inflation expectations.

As everyone realizes, the global zero interest rate policy (Z.I.R.P. 2009-2022 RIP) is over. Office chat has focused on the remaining mortgage fix, how long before the fix ends and payments rise? 74% of mortgages are on fixed rate repayment terms, 26% on variable rate. Of these, c. 55% are 2 year fixes and 45% are 5 year fixes, so 53% of mortgages will see rates change in the next 12 months. This should slow mortgage demand and increase mortgage arrears.

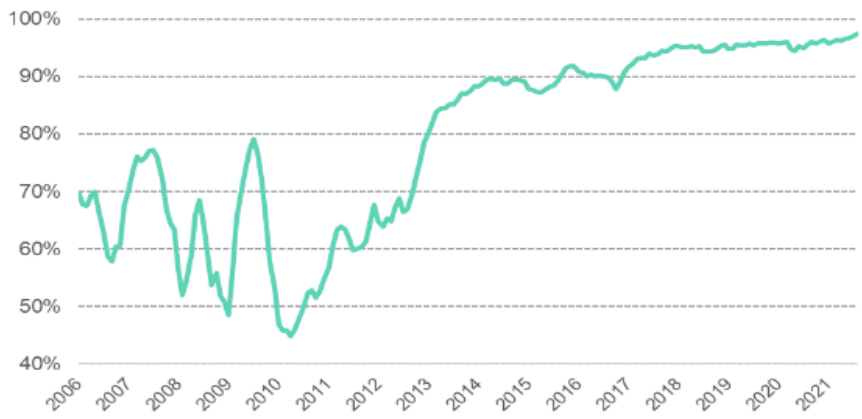
£138k average mortgage	2021	2022	2023	2024

2YR Mort. Fix	2.28% (average)	3%	4%	5%
Monthly Cost	£1287	£1325	£1397	£1463

www.moneynerd.co.uk

- The mortgage problem has some levers. Mortgage terms can be lengthened, reducing payables. There may be switching opportunities to lower cost providers. There may be more liability management via pension and equity portfolio financing. As those who lived through the 80s and 90s will recall, an inflation problem can lead to sharply higher interest rates that create snowballing financial pressures. Our expectation is the Bank of England will have to get base rates to at least 3% to dampen inflationary pressures. The risk is that interest rates might have to go up far more.

Chart 2: Proportion of new homeowner mortgages taken out on a fixed rate



www.statista.com

- Demand for variable rate mortgages from new owners was already very low pre-February 24th. However the expectation must be even higher fix demand as BoE raises base rates.

Savings run-down

- So far consumers have been cushioned by savings built up during C-19 and by more prudent behaviour over C-19 via reducing borrowings. How long can a cash run down last? Some commentators have said that C-19 savings provide possibly a six month cushion, broadly to end 2022.

Cost of Living 'winners & losers'

Countries, sectors have bifurcated (diverged) in 2022 – it is worth looking at the main movers in the last 6 months.

Portugal 20	16.33%
Norway 25	11.84%
UK 100	7.96%
Spain 35	6.73%
South Africa 40	1.90%
Australia 200	-0.20%
Japan 225	-3.37%
France 40	-3.51%
Switzerland 20	-4.04%
US 30 Wall Street	-4.28%
Germany 40	-4.34%
Belgium 20	-4.96%
Italy 40	-4.97%
EU Stocks 50	-6.34%
Netherlands 25	-7.90%
Sweden 30	-8.10%
Hong Kong 50	-9.02%
US 500	-9.41%
UK Mid-Cap 250	-9.55%
Denmark 25	-10.39%
Germany Mid-Cap 50	-11.36%
Germany Tech 30	-16.69%
US Tech 100 NAS	-21.60%

Source; www.saxotrader.com/d/research/stocks/stockview

Both UK & Norway are leading global stock indices owing to their crude oil linkage. Amongst other global indices, it is no surprise that the Russia/ Ukraine war has mostly impacted neighbouring countries who are facing multiple issues ranging from refugees, the adequacy or otherwise of its defence industries, and helping to fund Ukraine.

We continue to see US technology stocks are representing 'yesterday's bubble' a constituency reliant on very low interest rates, boardroom hype and faith in sky high valuations. There are both similarities and distinctions with the 2001 internet bubble.

Sector Winners/ Losers (12 months)

UK Oil, Gas, Coal +67.2%

UK Pharma & Biotech +26.8%

UK Aerospace & Defence +23.4%

UK Industrial Metals & Mining +0.22%

UK Tobacco -2.86%

UK 300 technology -4.06%

UK Banks – 4.31%

UK Life Assurance -11.68%

UK Industrial Transport -16.96%

UK Retailers -18.87%

UK Travel & Leisure -28.31%

Source. www.ft.com

The 'winner' sector movements tend to confirm that investor preferences have a strong 'macro' feel – a bias towards companies with inflation proof businesses, strong pricing, or experiencing higher demand factors.

Both US petrol prices ($4.62/ US gallon) and UK petrol (173p/ lt) have increased to record levels and will continue climbing if/ when Russian oil is sanctioned.

The EU and in particular Germany is changing energy policy to address the problem of EU foreign policy compromised by an energy industry reliant on a malevolent and aggressive foreign power. As the spigots turn, there is likely to be volatility as alternative sources are found and possibly struggle to entirely replace lost supplies.

The 'loser' sector have a more discretionary feel where demand factors can be exposed to lower disposable income. The decline of online streaming/ cinema demand is a good example

Conclusion;

UK and global consumers are in the same boat and facing an expense problem in 2022 - 2023. Consumer discretionary businesses are likely to be pressured. We see existing trends as remaining intact for H2 2022.

A related issue is whether today's inflation problem, the war, the global response to the war, leads to a GDP slowdown that stabilizes inflation in 2023. This could result in a 'soft landing' where the economy slows down enough to put out inflation without causing a recession. Alternatively, the world continues with 'stagflation', i.e. weak GDP growth and rising inflation.

My recollections of the 1980s and 1990s are varied. Mortgage rates were far higher, but debt levels were far lower. In those days, people focused on the right hand side of the balance sheet, debt and liability management – a skill that not everyone possesses these days. A tangible difference between then and now is that central banks are able to live with negative real interest rates (i.e. having inflation exceed nominal interest rates). This was not the case in the 1980s-1990s. Given this reality consumers' 'real' inflation adjusted debt is allowed to shrink naturally. So challenging times are ahead, but also a period when sound financial advice makes all the difference.

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