FUTURE INSIGHTS
ANDREWS·GWYNNE
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2022

£2.50 A LITRE PETROL

WHAT IT COULD MEAN FOR YOU (AND WHAT OPPORTUNITIES DOES IT OFFER?)

Soaring fuel prices are one of the most visible signs of an inflationary environment, something that has become depressingly clear since Putin's appalling invasion of Ukraine.

You will notice your supermarket shop seems more expensive, but it's hard to put your finger on exactly why, it's a penny here, a pound there, but when filling the fuel tank suddenly costs twenty pounds more you can see it clearly. But is the £2.50 litre likely? Well, there were real reasons to worry even before the war as global oil demand naturally followed the post-COVID economic bounce, yet oil production has stalled, and in some regions gone into decline. Why? Perhaps naïve ideology is at the heart of the problem.

The move to reduce CO_2 emissions has become big news recently, but it has been weighing on oil for a generation, putting oil companies off investing in new capacity, particularly as the glut of US shale oil came on the markets. The consequence is falling production capacity and reduced supply just as demand increases and it is possible that the recent reluctance of oil producers like Saudi, UAE and Venezuela to increase production (to cover the shortfall in Russian output) is not really about politics but simply because they have no spare capacity left. Price rises were then inevitable and although this does stimulate increased supply this is problematic on two levels because a). It can take years to bring production on stream and b). The one-dimensional thinking of the ESG movement discourages the necessary investment as oil companies lose the funding needed not only to find and exploit new oil reserves, but to help create the new energy infrastructure we all want.

So far, so bad, but does it have consequences beyond the fuel pumps? Naturally, with energy key to manufacturing and transportation the impact feeds directly into everything from the cost of making a toothbrush, to getting carrots to the supermarket pushing up US inflation to **an eye-watering 7.9%, a level not seen for decades and one that history suggests could easily result in a recession**. While such an outcome would upset many assets these trends naturally open up other opportunities as the chart demonstrates.

The gold line represents Crude Oil prices, which you can see has recovered all of their pandemic losses and more, while the blue line represents a, ahem, British petroleum company, whose share price despite lagging the raw material has made good gains in the past and has the potential to go much further.

With many major investors now cowed by the Environmental part of the naïve ESG narrative this story is found across the fossil fuel energy complex, which looks tremendous value, even if we see oil plateauing at current levels, let alone climbing further.

With technology many years from providing a comprehensive solution to the energy crisis the need for oil is not ending for many years to come and while this will hurt our wallets, and global growth, it also presents opportunities, particularly for investors in well managed specialist funds.

Crude Oil (Gold) Vs BP Share Price (Blue). Source: Koyfin, Andrews Gwynne

John Paul Thornber
Investment Manager

MARKET ANALYSIS IN THIS ISSUE: LIQUIDITY DRIES UP AS THE TAPS ARE TURNED OFF

LIQUIDITY DRIES UP AS THE TAPS ARE TURNED OFF

The importance of 'Monetary liquidity' is not well understood, however, it has been used by central bankers as a main tool to reinvigorate floundering markets since the stock market crash of 1987 when Fed Chair, Alan Greenspan, slashed interest rates and flooded the markets with money.

Since then, we have had relentlessly falling interest rates until very recently when, with the return of inflation, they have begun to turn up.

Interest rate cuts alone though were insufficient when the Great Financial Crisis (GFC) of 2008 hit and 'Quantitative Easing' (QE) was unleashed, whereby Central Banks create money to buy assets from commercial banks, boosting their reserves so they can lend more into the real economy. In reality most of the money flowed into assets, driving up prices in financial and housing markets, creating a feelgood factor that politicians like, while the negative impact of growing inequality and dangerous price bubbles were conveniently ignored.

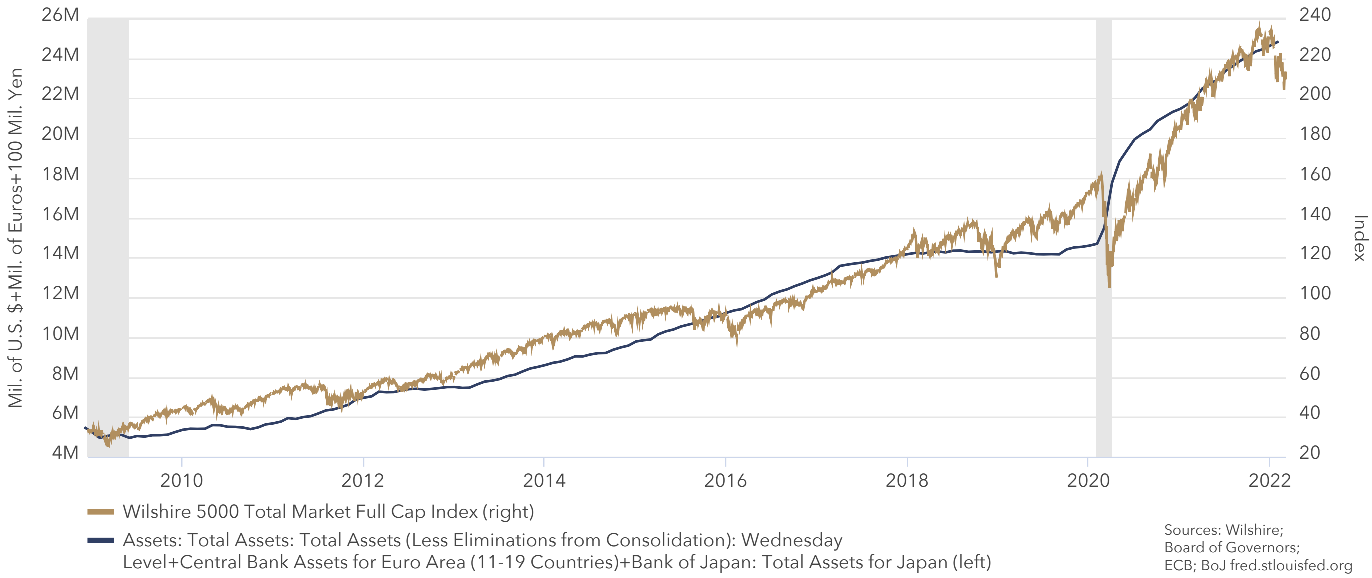
Since the GFC the US Federal Reserve, the European Central Bank and the Bank of Japan have seen their combined balance sheets grow by over $20trillion, around half in the last two years alone. This is highlighted by the blue line on the chart below. Overlaying this is the gold line of the Wiltshire 5000 Index representing US equities; the correlation is stark!

Unfortunately, there are risks in removing the liquidity that the market has become addicted to, as we saw in late 2018 when the US Fed tried to tentatively reverse its policy. In response the market fell sharply forcing a policy reversal. At that point, there was little inflation, and the political establishment was in full agreement, now things are different as the extremes of the post-pandemic money printing, combined with supply chain disruption, had already pushed up inflation dramatically even before the War in the Ukraine sent raw material prices stratospheric.

This is having a very real negative impact on overall wealth and income and the limits of liquidity may have been reached, with the Fed indicating recently that they will reduce the balance sheet *"sooner and faster"* and that they *"would not be dissuaded by declining asset prices in reversing course"*. Inflation is now the number one issue and central bankers face a stark choice; leave it to run rampant and cause major societal discord, or asset prices are allowed to fall.

The coming decade already looked very different even before the uncertain geopolitical landscape we will find in the aftermath of the Ukraine war. Investors will need to employ very different philosophies and techniques to achieve wealth accumulation and preservation some of which will not have been seen for a generation.

David Scott
Investment Manager



Sources: Wilshire; Board of Governors; ECB; BoJ fred.stlouisfed.org

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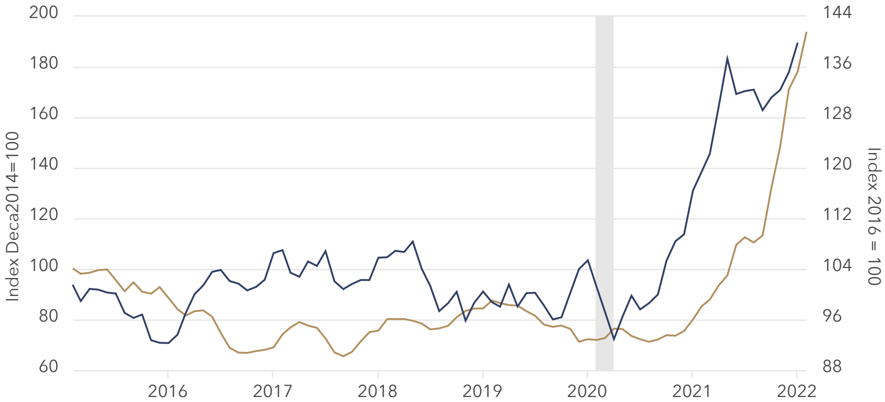
FERTILISER PRICE VS FOOD PRICE

The United Nations World Food Index has just moved to an all-time high as can be seen in the chart.

Its previous peak in 2011 was blamed for the Arab Spring uprisings, when the high cost saw decades old dictators toppled; an old saying is "we are only seven missed meals away from social anarchy".

Food is the energy that humans need, energy in the form of hydrocarbons is what drives global economic activity. For the global population to feed itself we need fertilisers to artificially boost crop yields. Most fertilisers come from nitrates created from natural gas in the energy intense Haber-Bosch process. This graph shows the close correlation between the cost of fertiliser (read hydrocarbons) and global food prices. With the Oil price forecast to rise further, depending on developments in Ukraine, food prices could rise further, possibly significantly. The result could be angry populations starting to vote for angry politicians. Starvation for many of the world's poor looks a growing certainty.

David Scott
Investment Manager



Producer Price Index by Industry: Nitrogenous Fertilizer Manufacturing: Synthetic Ammonia, Nitric Acid, Ammonium Compounds, and Urea (left)
Global price of Food index (right)
Shaded areas indicate U.S. recessions. Sources: BLS; IMF. fred.stlouisfed.org

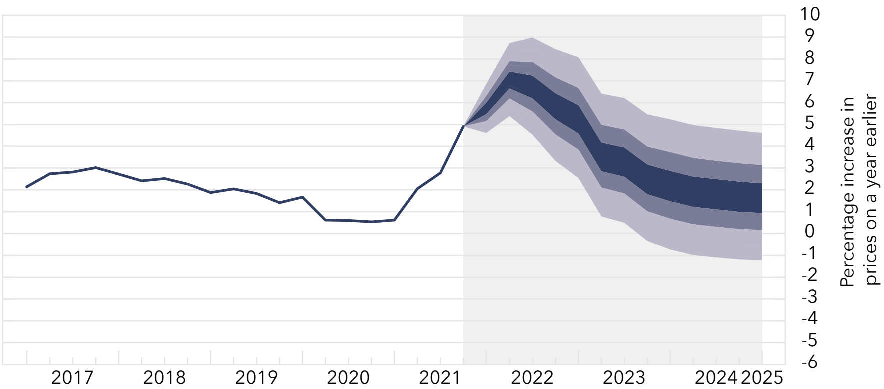
THE RETURN OF THE 70'S INFLATION?

It is not just energy prices but the cost of living generally is rising sharply, the chart showing how official CPI Inflation has taken off and is predicted to close in on double figures this year.

Meanwhile the old fashioned (and more useful for most) RPI measure of inflation has already reached 8.2% in February, the highest level since 1991 when the deflationary forces of globalisation mobilised after the fall of the Iron Curtain.

We can see this inflation all around us and there are few areas of life that don't seem to be getting much more expensive. Some believe we may be returning to the 1970's, a period of economic and social turmoil and a worry that cannot be discounted. However, while globalisation may be retreating, we see no signs of the income and price policies and the capital controls of that era, although this doesn't mean they can't return. Whatever, it seems likely that most wages will lag rising prices by some margin, making the risk of toxic stagflation and recession much higher.

Mark Smith
Partner



CPI inflation projection based on market interest rate expectations, other policy measures as announced

Source: Bank of England, Monetary Policy Report, February 2022

MORE SAVERS WILL FIND THEIR PENSION SHRINKING

First a caveat, Chancellors seem incapable of not tinkering with pensions so watch out for further change!

The Pension Lifetime Allowance applies to the aggregate of your pension pots and limits the value of those arrangements by applying tax on the excess over the allowance. What's in the pot are your contributions and hopefully some investment returns reflecting shrewd investment choices.

The LTA was introduced in 2006 set at £1.5 million, increased to £1.8 million in 2012 before falling to £1 million in 2017/18. The current level is £1,073,100 and this level has been fixed to 2026. Aegon a leading pension provider says that given 5% inflation to 2026 then the LTA should have increased by some £300,000, that is not going to happen. The LTA was supposed to apply to an estimated 5000 taxpayers, the former pensions minister reckons that it will now apply to about 400,000 taxpayers. The tax paid because of LTA in 2019/20 was £342 million up 21% on the previous year, its biting hard.

Pension funds are tested against the allowance when there is a 'Benefit Crystallisation Event' (BCE). Each BCE uses a percentage of the LTA and once the allowance has been used any further BCE will result in a tax charge. BCEs include the drawdown of a lump sum, putting a pension into payment, on death before age 75, reaching age 75 or transferring to an overseas scheme. The tax rate applicable will be either 25% or 55% so clearly this can have a major impact on retirement.

There are rumblings that penalising prudent savings and careful investment choices is simply wrong and that the fair way would be to apply an LTA to contributions, given the amount of tax collected we don't see any Chancellor giving into this pressure and will rehearse the argument that the contributions have attracted tax relief designed to provide a reasonable but not an excessive pension. If someone with a fund equal to the LTA was to purchase a joint life index linked annuity on commercial terms today, then the gross pension (before income tax) would be about £24,000 depending on health and other underwriting factors, remember you would need to save over £1 million to achieve this. Add the State Pension of just over £9600 from next month and your gross income would be £33,627.

David Scott
Investment Manager

As well as providing discretionary investment management services, we also offer tailored financial advice, including retirement planning. Please don't hesitate to contact us if you would like a review.