MAY 2021

ATLANTIC CAPITAL MARKETS

Inflation Beating Stocks

01872 229 000
www.atlanticmarkets.co.uk

Introduction

As we (hopefully) wave goodbye to the pressure on the economy caused by the lack of activity during the pandemic, we then fix our view ahead and accept that inflation is now being discussed and to some degree is looming on the horizon. (Granted more of a concern for the US at this point than the UK) however, the storm has been brewing for a while fuelled by ongoing fiscal and monetary stimulus which in turn means cash continues to be printed and it appears that pent-up demand is just itching to be released once lockdown restrictions ease and economies reopen.

What is Inflation, and what does it mean

Inflation is the decline of purchasing power of a defined currency over a set period. This can be reflected in the increase of an average price of a basket of selected goods and services in an economy over a defined period. The rise in the general level of prices, often expressed as a percentage, means that a unit of currency effectively buys less than it did preciously.

The basket (more commonly known as price indexes) generally includes the following mix:- commodities like metal and fuel, food grains, utilities, and services like healthcare and entertainment. Inflation aims to measure the overall impact of price changes for a diversified set of products and services and allows for a single value representation of the increase in the price level of goods and services in an economy over a period of time.

Types of Price Indexes

The two key price indexes are The Consumer Price Index and the Wholesale price index:-

The Consumer Price Index

The CPI is a measure that examines the weighted average of prices of a basket of goods and services which are of primary consumer needs. They include transportation, food, and medical care. CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them based on their relative weight in the whole basket. The prices in consideration are the retail prices of each item, as available for purchase by the individual citizens. Changes in the CPI are used to assess price changes associated with the cost of living, making it one of the most frequently used statistics for identifying periods of inflation or deflation.

The Wholesale Price Index

The WPI is another popular measure of inflation, which measures and tracks the changes in the price of goods in the stages before the retail level at the wholesale level. While WPI items vary from one country to other, they mostly include items at the producer or wholesale level. For example, it includes cotton prices for raw cotton, cotton yarn, cotton gray goods, and cotton clothing. Although many countries and organizations use WPI, many other countries use a similar variant called the producer price index (PPI).

Impact on Cash and Bonds

Whichever way you look at it, inflation is not good for cash. Money kept under the mattress will find its value eroded as prices rise and with it near impossible to find a savings account offering an inflation beating (or even equalling) interest rate, money held in a bank account could and probably will suffer. Inflation is not really that positive for bonds either. If prices rise at a rate greater than the interest you earn on a bond, you'll find the value of your fixed income fall in real terms. Consider a five-year bond paying 2% nominal interest. If inflation rises to 2.5% for those five years, your bond won't be able to keep up.

Causes of Inflation

An increase in the supply of money is one of the key root causes of inflation, though this can play out through different mechanisms in the underlying economy. Money supply can be increased by the monetary authorities either by printing and giving away more money to the individuals, by legally devaluing (reducing the value of) the legal tender currency, more (most commonly) by loaning new money into existence as reserve account credits through the banking system by purchasing government bonds from banks on the secondary market(Quantitive easing). In all instances of money supply increase, the money loses its purchasing power. The mechanisms of how this drives inflation can be classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation.

Types of Inflation

Demand-Pull Effect

Demand-pull inflation occurs when an increase in the supply of money and credit stimulates overall demand for goods and services in an economy to increase more rapidly than the economy's production capacity. This increases demand and leads to price rises. With more money available to individuals, positive consumer sentiment leads to higher spending, and this increased demand pulls prices higher. It creates a demand-supply gap with higher demand and less flexible supply, which results in higher prices.

Cost-Push Effect

Cost-push inflation is a result of the increase in prices working through the production process inputs. When additions to the supply of money and credit are channelled into commodity or other asset markets and especially when this is accompanied by a negative economic shock to the supply of key commodity, costs for all kind of intermediate goods rise. These developments lead to higher cost for the finished product or service and work their way into rising consumer prices. For instance, when an expansion of the money supply creates a speculative boom in oil prices the cost of energy of all sorts of uses can rise and contribute rising consumer prices, which is reflected in various measures of inflation.

Built-In Inflation

Built-in inflation is related to adaptive expectations, the idea that people expect current inflation rates to continue in the future. As the price of goods and services rises, workers and others come to expect that they will continue to rise in the future at a similar rate and demand more costs/wages to maintain their standard of living. Their increased wages result in higher cost of goods and services, and this wage-price spiral continues as one factor induces the other and vice-versa.

Stocks to buy

If rapid inflation sets in, some product and service categories can pass inflation on to their customers in the form of a price increase. A lot of utilities can do so, as their pricing agreements with regulators tie price increases to the inflation rate. Similarly, tobacco companies have a lot of pricing power because consumers crave their product so they can pass on inflation by way of price rises. Luxury brand's also offer a form of defence against inflation as the purchasing power of the consumer doesn't usually get dented as much and of course gold which has historically been an inflation hedge largely based on historic data showing gold values increase as the value of the USD decreases.

British American Tobacco

Despite a constant barrage of regulation changes, the latest comments from Biden, Duty free reductions due to severe travel restrictions and a traditional industry in decline you'd be forgiven for thinking the long-term outlook for tobacco companies is bleak! The reality is the tobacco sector still has a lot going for them and are still making inroads into new world products. The sector has always been Intune with the income investors due to the large yields on offer and recent figures have highlighted BAT's is still in rude health despite the backdrop.

Recent figures highlighted the strength as they generated £9.8 billion of net cash for the year, with pre-tax profit rising 9.6%, underpinned by adjusted operating margin of 44%, itself up 1% in the period. Earnings per share rose by 12%, and revenues from traditional cigarette sales rose 2.8% despite a volume decrease of 4.5%, further proof if it were needed of the company's pricing power.

Meanwhile, the level of income also allowed for an additional investment of some £430 million in new category products.

Hochschild Mining

As of yet, the rally in gold linked to inflationary fears has yet to present itself and with this in mind it has left a lot of the gold miners lagging the broader stock market and even the more focused mining sectors. If inflation does take hold then it would be expected to see the price of gold rally, thus providing a catalyst for the share price of gold miners. Gold has historically been an excellent hedge against inflation because its price tends to rise when the cost of living increases. Over the past 50 years investors have seen gold prices rally and the stock market drop during high-inflation years. This is because when fiat currency loses its purchasing power to inflation, gold tends to be priced in those currency units and thus tends to rise. Moreover, gold is seen as a good store of value so people may be encouraged to buy gold when they believe that their local currency is losing value.

Hochschild flagged a "strong operational recovery from 2020 Covid-19 disruption". First-quarter total gold equivalent output in 2021 was more than double what it was in the second quarter of 2020, one of the periods worst-hit by the pandemic. The company added it is "on track" to deliver its 2021 output target of 360,000 to 372,000 gold equivalent ounces. Total gold equivalent output in 2020 was around 344,540 ounces so at a minimum, Hochschild expects growth of 4.5%.

Mulberry

Mulberry is a luxury fashion company founded in the UK. Luxury brands are generally seen as a safe haven against inflation, this comes from the firm's ability to increase prices to combat inflation with relatively little push back from the buyers. Mulberry's consumers are usually wealthy and happy to pay a little extra if indeed they even notice. Certainly, it would be less of an issue for a wealthy consumer buying a luxury handbag that's had a modest cost increase that a consumer who is watching the purse strings and seen a price increase in more staple products. The company says that sales during the year to 31 March have been better than expected. This is due to stronger online sales and reduced discounting.

The Group recently highlighted to investors that the business has seen continued strong growth across the Group's Asian markets, strong sales across its global digital platforms as well as improved margins due to lower mark-down sales. Digital sales increased 68% to £23.4m, compared with £13.9m the previous year. As a result of this growth, the Board said it now expects that the Company will outperform expectations and report a small underlying profit before tax for FY21.

About Atlantic Capital Markets

We are a multi-Asset brokers offering clients the ability to buy the shares either in a traditional fashion with standard shares or taking advantage of leverage and purchase via a CFD.

Call us on 01872 229 000.