



8<sup>th</sup> August 2022

## A Challenge and an Opportunity

- **Markets challenged by central banks determined to squeeze out inflation**
- **The Bank of England delivers a very sobering assessment of the UK economy**
- **The possibility of fiscal easing by a new UK Prime Minister only pressures the BoE to raise rates still further than previously envisaged**
- **Despite higher rates sterling is likely to remain under pressure**
- **Investors show increased interest in the long-term growth of EV**

The last few weeks have presented a number of contrasts that investors need to reflect on in earnest. Amidst surging inflation and the resulting concerns about central bank tightening, risk assets have staged a sharp rally. Last week's US employment report had investors fretting about tight labour markets and the persistence of reasonable growth. Meanwhile, the Bank of England, in the looming backdrop of what it believes will be a protracted recession, has warned of more bad news, indicating the need for increases in interest rates beyond its previous forecast. The BoE expects inflation to shoot up to above 13% in the final three months of the year and remain elevated next year.

### A Reality Check from the Bank of England

**The BoE served up a set of gruel for markets last week – the first 0.5% rate hike in 27 years and a forecast for an extended period of 'stagflation' including a five-quarter recession starting from the end of this year.** Based on its assumptions for natural gas prices, the BoE expects CPI inflation to peak at 13% in the final quarter of this year, remain worryingly elevated in 2023 and early 2024, and only return to its 2% target in late 2024. The Bank's August Inflation Report was more pessimistic than the May version, underscoring the impact of the energy price shock on real post-tax household incomes, which are now forecast to decline by a record 4% in 2022/23. The BoE's Monetary Policy Committee (MPC) is cautious about pre-committing to any specific path for future rate hikes. The Bank's forecasts are based on the convention of assuming policy rates will follow the current futures market pricing, at 3% in Q2 2023, which is 125 basis points above the current level and 50 bps above its May forecast.

**Central banks rarely forecast a recession, never mind prolonged 'stagflation'.** What lies behind the Bank of England's latest candour, then? To us it is crystal clear that the **Bank wants to send a strong message that targeted inflation *must* return to 2% p.a. after the energy shock has passed through.** It now sees the risks to the upside on inflation. The MPC has strongly signalled that a recession may have to be the price paid to ensure that inflation falls back to desirable levels.

The pipeline of price pressures is concerning. First, the Office of Gas and Electricity Markets, the energy regulator, is expected to raise its price cap by about 75% in October, compared with a 40% rise anticipated in May. The prospects of a halt in Russian energy supply into the European markets and consequent inflation may lead to an escalation in wage demands, especially in the public sector entities. Second, the BoE clearly feels that structural issues (impact of the pandemic and post-Brexit immigration rules) imply a continued tightness in the labour market relative to earlier cycles. They are already factoring this into their policy settings around wage inflation expectations. Finally, as has been the case conventionally, the Bank assumes no further easing in fiscal policy from here. **The MPC is sending**

**message that any significant fiscal stimulus will be met with further monetary tightening, setting markets up for an imminent confrontation if Liz Truss, as widely expected, becomes Prime Minister.**

Where does this leave sterling, which has suffered from the US dollar's lightning ascent this year, but proved resilient against the euro? Sterling is hardly overvalued on a trade-weighted basis. We expect a combination of higher interest rates and loose fiscal policy to benefit the pound. However, we don't see that support being enough to offset the UK's growing external funding requirements and a damaging struggle between the two institutions of macroeconomic policy. **Post an emergency budget in September, further weakness in sterling is highly likely.**

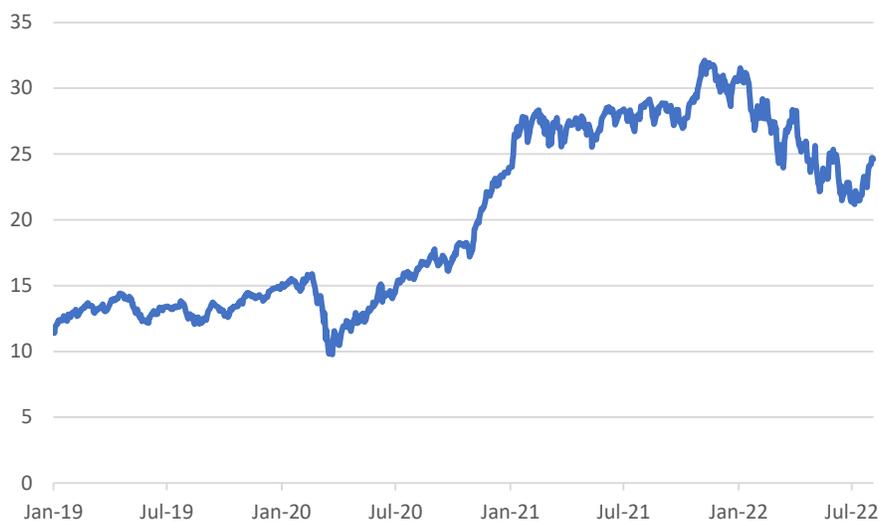
### Looking for Electrifying Growth

**Rather than getting embroiled in short-term sentiment, we would strongly encourage investors to think about long-term growth opportunities.** One aspect of the recent market rally has been investors' quest to find stocks that can navigate the challenges facing the global economy and show some robust growth. Some technology stocks have rallied hard but that has not been a sector-wide phenomenon, suggesting that investors are discerning about where they see true growth. One area that caught our attention last week was electric vehicles (EV). Ford's quarterly results showed second-quarter sales of electric vehicles had risen 168.7% year-on-year, which worked as a catalyst for greater scrutiny of the long-term growth opportunity that EVs present. Ford is now North America's second best-selling EV brand behind Tesla. The automaker expects 90% compounded annual growth from EV models through to 2026.

We would draw parallels between the boom-bust-boom cycle that we saw with technology stocks from 1998 to 2007 and where the EV industry finds itself today. At the beginning, too much fast money entered the IT sector leading to extremely high valuations that eventually collapsed as the tech wreck hit in the year 2000. Roll forward to 2002, and the sector made a strong comeback registering stellar revenue growth as companies with real, commercially viable business plans emerged. From the base in 2002 – after an 80% correction from the peak – the sector doubled and more over the subsequent four years.

**Chart 1: EV ETF (DRIV)**

US\$



Source: Bloomberg

EV sales doubled in 2021 from 2020 and were up a further 75% in the first quarter of 2022. At this juncture, we need to remind ourselves that these growth rates have been achieved through the pandemic and severely tested by supply disruptions. Tesla produced 1 million cars in 2021, is at a current rate of 1.5 million, and aims to exit 2022 at a run rate of 2 million. At one point in May Tesla's share price had plunged 50% from its October 2021 peak. The stock is now up 37% from its all-time low but 30% below its all-time high. EV maker Rivian, the hot stock of last year's frenzy in the markets, is down 80% from its (heavily inflated) market debut. But as a sign that good news can pay off,

Ford's stock is up close to 40% in recent weeks as analysts have started to appreciate the EV growth in Ford's stable of products.

But cars aren't the only thing where all the opportunities lie. In recent weeks a coalition of 17 US states announced that they plan to electrify 30% of new trucks and buses in their jurisdictions by 2030. A reminder here that combustion trucks and buses make up only 10% of total vehicles but one-third of climate disrupting greenhouse gases.

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