

Will the lights stay on this winter?

7th September 2022

In summary

- The factors contributing to inflation in the Eurozone and the US are significantly different
- Assessing carbon intensity highlights the sectors that are most at risk to higher energy prices
- Europe announces support packages for energy crisis, Truss expected to outline support in the UK

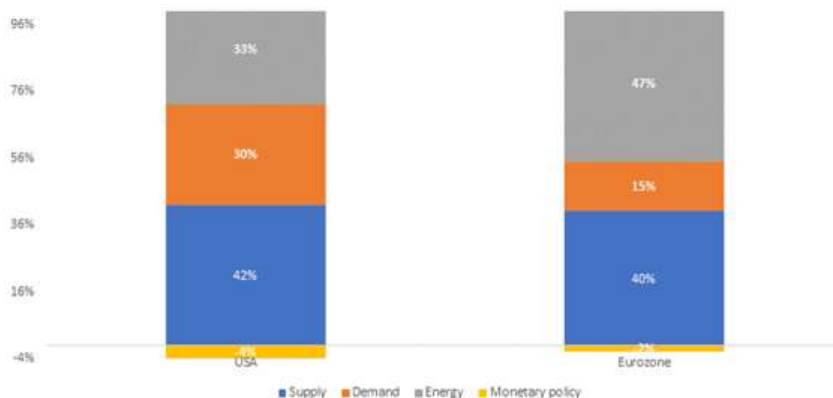
For many, the dramatic cost of energy has become a constant worry. Here in the UK, average household energy bills are hitting £3,500 in October with further increases expected next year. It is also being reported that local businesses are having to close due to trade being unviable at current energy prices. These issues are real, tangible and the cost-of-living crisis is a visceral reminder that previous governments have under invested in important infrastructure. However, for an investor, there are ways to assess this risk for the companies impacted by these challenges.

Europe under pressure

According to data from Refinitiv, almost 50% of the contribution to the change in inflation in Europe is made up of energy, with 40% attributable to supply and 15% to demand factors. In the US, the picture looks different with double the contribution coming from demand factors and a third less coming from energy. This demonstrates the challenge faced specifically by European (including UK) based businesses. Unsurprisingly, the market has already begun to discount this risk, taking the share prices of a number of businesses reliant on a European/UK consumer and energy intensive manufacturers with it.

Inflation decomposition by factors

Contribution to annual change of CPI Index (in%)



Source: Refinitiv, Allianz Research

Sector vulnerability

Some businesses and industries are much more impacted by the price of energy than others. Companies with pricing power and the ability to pass on costs to end customers are in a stronger position, as are those with inflation linked clauses built into contracts. Many of these businesses have publicly confirmed the existence of these, which has provided comfort to investors. From an end consumer perspective, high energy prices are causing a squeeze on household spending. To look to insulate against this, the majority of the equity funds we hold in the LGT WM Model Portfolios favour companies with persistent earnings streams and tend to have a defensive bias. At portfolio level, we are underweight consumer cyclical and overweight consumer defensive stocks versus the MSCI World.

Assessing the risk

Energy intensity can be assessed by looking at the carbon intensity of companies, the individual funds in the portfolios, or the portfolio as a whole. We can compare carbon intensity to a benchmark, which demonstrates whether there is exposure to the sectors that are most at risk to higher prices. We can also assess within an industry which companies have higher carbon intensity (scope 1 + 2) than others. This is an analysis we run on an ongoing basis on the funds and holdings in the model portfolios, enabling us to assess those that are more directly exposed to higher energy costs. Chemical manufacturers and packaging producers are examples of sectors with which energy is a high proportion of overall costs. The model portfolios are underweight these segments relative to our respective benchmarks, and overweight companies where the cost of energy is a smaller part of their input costs.

Spotting the rubies in the rubble

Interestingly, some of the companies that are perceived to be most at risk are corporates with high capital intensity (plant, property and raw materials). However, as investors we need to be discerning as one's crisis may be another's opportunity. On one hand, BP and Shell (held in funds in the model portfolios) are beneficiaries of high energy costs, on the other hand, there are industrials with high capital intensity that are enabling businesses to transition to a lower carbon operating model. These are companies which improve energy efficiency e.g. building materials or can enhance electrical efficiency and automation solutions (these are held in funds in the model portfolios and sustainable model portfolios). With the current cost of energy across the world, there is considerable demand for these services. Given that up to 75% of energy is currently lost in generation, transmission and distribution, and end use⁴¹ there is significant opportunity to reduce the clear inefficiency that exists.

UK midcaps PE projections



Source: Jefferies, Bloomberg

Fundamentally, markets are pricing mechanisms and negative sentiment around the health of the UK consumer has been priced in. To the left is a one year forward P/E chart of a custom basket of UK midcaps reliant on consumer spending (basket stocks: Marks & Spencer, Next, Kingfisher, B&M, JD Sports, Dunelm, WH Smith, ASOS, Currys, Pets at Home, DFS, Halfords and Debenhams). On this metric, the stocks are approaching the lowest valuation since 2009. Various support packages have been announced in Europe, and if Truss is as 'radical' as she has claimed we need to be, it will be interesting to see how this changes the

picture.

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