

Unintended Consequences

Most folks understand what is causing inflation to run hot these days. Supply chain failures, COVID-related manufacturing limitations, empowered workers demanding higher wages are all well-known drivers of higher prices. But would you cite policies designed to combat global warming as a reason? How about the quest for cheaper manufacturing? While they may not be seen as the most proximate causes of higher prices, unintended consequences of “greener” energy policies and profit maximization are both contributing factors.

How could environmentally friendly policies cause higher inflation? Or even geopolitical instability?

Since the beginning of the millennium, much of Europe has been attempting to lead the way on combating climate change. Taking leadership on this front has meant acting in a more ecologically responsible manner at home. European nations – Germany, in particular – have been limiting their production of oil and gas in order to be “greener.” Germany has been the leader in reducing its reliance upon nuclear energy as well, in an effort to appease those who consider nuclear energy unsafe or environmentally unfriendly.

The result of these actions has been dramatically reduced oil and gas production. European oil and gas production is down roughly 40% from its peak about 20 years ago – similar to levels from the early 1980’s. Germany’s reliance on nuclear power has been cut from a total of 30% of its electricity to essentially nothing by the end of this year (when its three remaining reactors are scheduled to shut down).

So as Europe has been taking steps to be more environmentally friendly, it is no longer producing its own energy. Thus, it has to import energy from somewhere else – somewhere that presumably doesn’t share this same level of concern for the environment.

Enter Russia.

For years, Vladimir Putin has been expanding Russia’s production of oil and natural gas, as well as nuclear power generation. These days, Russia produces roughly twice as much oil, gas and coal than it consumes. The surplus finds its way to European countries. Europe, for its part, thought that perhaps increased trade with Russia could ease Putin’s grip on the Russian economy and ease his authoritarian handle on the country. “Wandel durch handel” is what the Germans called this policy idea – “change through trade.” Europe has latched onto this idea in a big way, and today 47% of all natural gas consumed by the European Union comes from Russia, compared to less than a third in 2016.

In good times, such energy dependence might not be an issue. But relying on a potentially hostile neighbor for essential goods is a bit like building a henhouse and then hiring a fox to be in charge of security.



This energy dependence has put the European Union in a difficult spot. The “banks over tanks” strategy of weakening Russia via economic sanctions seems to be taking a toll on the Kremlin, but the most damaging sanction – banning Russian oil & gas – is effectively off limits to the EU. Given the level of dependence on Russian energy and the fact that it’s still “heating season” in much of Europe, a ban on Russian oil & gas would be particularly damaging.

With Russian energy imports now unreliable and politically unsavory, Europe will have to find other – and more secure – energy providers. This will undoubtedly lead to structurally higher energy prices for the EU – an unintended consequence of the admirable goal of becoming more environmentally conscious.

The desire to maximize profits is nothing new. But for centuries, the inability to transport raw materials forced manufacturers to produce their wares close to the source. With the advent of railroads, materials were able to be transported hundreds of miles in order to take advantage of cheaper, more readily available (or even more specialized) labor.

Following World War II, Japan became a prolific exporter of electronic goods and automobiles. Japan’s proficiency in manufacturing and assembly lured companies from all over the world to shift their operations to Japan. From there, the search for lower costs and greater efficiency led expansion into China and across Asia.

As Asian manufacturing continued to grow, it became more apparent to American companies that it would be cheaper to set up shop in Asia. So they built factories and hired local teams to run the operations. The result of this labor shift was more jobs in Asia, higher living standards, economic growth for the countries involved, and cheaper goods for American consumers.

According to the St. Louis Federal Reserve, offshoring manufacturing to Asia caused the price of consumer durables – appliances, furniture, automobiles, etc. – to fall 40% between 1995 and 2020. This price drop – roughly 2% per year – helped keep inflation low during that same 25-year period.

While the offshoring of production helped drive prices down, it also removed millions of jobs from the American economy. For example, Ford said that in 1992 over half of its employees worked in the US and Canada. By 2009, North American workers (now including operations in Mexico) made up less than 40% of its work force.

The semiconductor industry is another example of how the desire to maximize income and the search for cheaper production had a significant impact. As you may know the semiconductor industry was essentially born in the United States, with early developments in transistors, integrated circuits and semiconductors spearheaded by American companies like Bell Labs and Fairchild Semiconductor. This early technological



lead resulted in the majority of early 1990's global semiconductor production (roughly 80%) happening in the US and Europe.

By 2020, American and European market share had dwindled to 20% as Taiwan and South Korea have taken the lead. While this shift caused prices to decline significantly over the past few decades, the unintended consequences of this shift to foreign production were felt during the pandemic. COVID-related shutdowns and snarled supply chains have created significant knock-on effects throughout the global economy. As a result, many leading semiconductor companies have announced billion-dollar plans to "bring home" manufacturing to secure a more stable supply chain in the future. Of course, this increased security comes with a cost – higher prices.

We continue to believe that the macroeconomic picture is likely to be one of positive – yet moderating – growth combined with elevated inflation. As such, we will continue to focus on "value" and "quality" as this economic cycle matures. Stock market volatility, thus far, has largely been due to valuations resetting lower rather than a significant deterioration in the fundamentals. Throughout the past year, we have trimmed "riskier" assets in client portfolios (stocks and alternatives) in order to maintain a relative balance with lower volatility securities, like fixed income and hedges against market volatility.

We have become more neutrally positioned across equity classes, though we continue to favor "value" and "quality" within the large-cap domestic market. We've also taken steps to become more defensive in terms of our sector weightings in our individual equity portfolios.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates.

Within the alternative market segments, we have maintained an emphasis on "real assets" (think commodities and, to a lesser extent, real estate) as a hedge against the potential for continued inflation. We have recently increased our exposure to the diversified alternative sector as a hedge against market volatility.



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