

# ‘En-flation’:

## The heightened risk of inflation in increasingly environmentally conscious economies

.... MARCH 15, 2022



**SEEMA SHAH**, Chief Global Strategist

As surging energy prices hit the headlines, limited renewable energy infrastructure means that, in the short-term, it is possible countries will shift back towards traditional fossil fuel extraction. Yet, in the medium-term, given rising appreciation for the importance of energy security, there will be a renewed focus and increased public capital allocated to the energy transition.

Nonetheless, renewable energy will not necessarily be the answer to reducing inflation pressures. A lot of ink has been spilled about the contribution of “greenflation,” the extent to which energy transition efforts have created a chain reaction resulting in higher energy prices and, ultimately, higher consumer costs.

However, the inflationary contribution of net zero initiatives from businesses and governments is wider ranging than rising energy prices. The rapidly changing way that companies across all sectors factor environmental considerations into their business models—and the rising costs of doing so—are potentially still being underappreciated by some investors.

This upward pressure on the cost of doing business in a more environmentally friendly manner—which we are terming environmental inflation or “en-flation”—involves several disparate factors:

1. Carbon credit inflation is a likely near-term scenario.
2. The reasonable expectation of tougher financial penalties for companies failing to meet United Nations targets.
3. Greening business models, increasing search for green talent, and greater “climate compliance,” including measurement systems, technology, and teams for non-financial reporting.
4. Capital expenditures (capex) directed to technology and R&D as businesses make fundamental shifts to their production, supply chain, and products.

These en-flation factors will not be felt equally across all sectors and, in some cases, the extent of their financial impact is very hard to predict. It is precisely because the latter is largely unknown and has the potential to be extremely unpredictable and variable that en-flation is not yet being fully factored into company valuations.

To give some examples of the potentially extreme impacts of environment-linked inflation on businesses, it is instructive to consider a number of each en-flation factor in turn and a number of pertinent datapoints.

### **Carbon credit costs are on the rise**

The European Union’s Emissions Trading System (EU ETS) mandates manufacturers, power companies, and airlines to pay for each tonne of carbon dioxide they emit. Currently, the EU grants many free carbon permits to industries, including the major emitters, to help them compete with international companies that are not subject to the carbon “taxes.”

Last year, the EU outlined a plan to phase out these allowances for major emitting industries beginning in 2026 and also to cut the number of permits granted to other sectors. In May 2021, Lazard estimated that, if EU-listed steel manufacturers were forced to pay to offset the carbon emissions that are currently allowed under the EU ETS, it would erode 60% of their profits. If the same rule were applied to global emissions, this would total more than 130% of their profitability.

## ‘En-flation’

... MARCH 15, 2022

Moreover, the cost of carbon offsetting is predicted to rise rapidly. Research from University College London last year estimates that the cost of carbon credits will climb by five to ten times by 2030 as surplus supply diminishes and demand increases exponentially.

### Tougher penalties for laggards?

As governments and regulators get tougher on businesses’ climate impact, it’s a reasonable expectation that the penalties will become tougher for those companies that fail to meet U.N. based targets.

The MSCI Net Zero Tracker, which analyses the collective progress of listed companies towards climate goals, recently found these firms are on track to cause a global temperature rise of 3°C (well above the 1.5°C temperature increase agreed in Paris in 2015) and that many are still failing to disclose crucial information on emissions. MSCI is calling on policymakers and financial regulators to make international standards mandatory but has not yet gone so far as to call for harsher financial penalties for laggards.

With the environmental commitments of governments themselves under increased scrutiny to hit the Paris goals, it’s likely not long before policymakers and regulators look to implement harsher punishments.

Indeed, it’s already starting; under the United Kingdom’s recently announced Net Zero Strategy, vehicle manufacturers will be mandated to sell a certain percentage of zero-emission cars and vans starting in 2024. The government will consult on this industry-wide mandate next year, but it could move to fine auto companies that do not move quickly enough to phase out traditional fuel models ahead of the 2030 ban on new sales.

### Green talent and climate compliance come at a cost.

Green companies need employees with green skillsets, and this is being reflected in hiring patterns. Analysis by LinkedIn shows that all sectors are increasing the hunt for sustainable talent. While demand is growing fastest in sectors like energy and mining, the research shows that searches for candidates with sustainable credentials has a higher overall presence in health care, agriculture, transportation, construction, and manufacturing. But this, too, takes a toll on the bottom line. New jobs created to help meet the U.K.’s net-zero commitments could pay up to 18% more than

the national average salary, according to the latest modelling from U.K.-based thinktank, Onward.

The labor market is already stretched tight; the U.K. recorded 1.3 million open jobs in the three months to January (a record high) and the average unemployment rate for the period fell to 4.1%. In addition, the government has promised to create 440,000 well-paid jobs in green industries by 2030. These are jobs companies will need to create and, crucially, fill to meet national targets.

Equally, companies need to find ways to disclose their sustainability risks with transparency and efficiency. To do this, they need access to high quality and consistent data and reporting capabilities, as well as enhanced regulatory and compliance oversight. But adding expertise in audit and compliance, as well as implementing potentially expensive new systems, comes with an increasingly high cost—at least in the short term until those which do it well establish a competitive edge that enhances their bottom line.

### Tech, research and development capex are expected to increase

Lastly, it stands to reason that, as business models adapt to become greener, investment in technology and research and development (R&D) spend will increase across the board. Constant innovation will be required and the cost of doing business in a climate conscious world will rise.

In 2020, global R&D expenditure on technologies to fight climate change was estimated at around \$80 billion—or less than 5% of the world’s \$1.7 trillion R&D budget—according to McKinsey, and this is only likely to accelerate. Companies across all sectors will need to invest in more sustainable technology, not only to drive down their emissions to meet global regulations, but also to help ensure that any changes they implement can start to deliver value rather than simply increasing costs and eroding balance sheets.

This will involve many companies taking big bets on new, perhaps untested, technical and long-term strategic opportunities. Some of these bets will pay off and others may not, but the fact that speculative investment is viewed as necessary in order to help ensure the cost of meeting carbon targets is both manageable and profitable suggests that implementation costs could be significantly underestimated.

## ‘En-flation’

... MARCH 15, 2022

### INVESTMENT IMPLICATIONS

#### Blue chip companies should prove resilient:

In an “en-flationary” environment, investment opportunities will be found in the companies that can flex their prices rather than wear the increased costs themselves. Luxury retailers, for example, can increase prices without significantly sacrificing customers. Companies with deep moats have greater pricing power and can exercise this to help preserve profit margins without risking losing market share to rivals. Modern bond proxies, like the FAANGs<sup>1</sup>, should also do well in this environment given the stable nature of their business. However, traditional bond proxies such as utility companies may not react the same way given how central the energy transition is to their business model.

<sup>1</sup> Meta (formerly known as Facebook), Amazon, Apple, Netflix, and Alphabet (formerly known as Google).

#### United States over Europe:

Some markets are likely to weather this en-flationary shock better than others. The U.S. is energy self-sufficient, while Europe is a large importer of energy, so the need to embrace green energy is considerably greater for Europe. As a result, Europe will continue to be exposed both to high energy prices as the economy transitions towards green energy, but also to the rising cost of doing business in a more environmentally friendly matter.

#### Growth over value:

More capex has significant implications for income investors who may find dividends curtailed by the green transition; increasing spend on innovation means less cash on the balance sheet for payouts. As companies take steps to green their business models, investors may see more opportunity from growth than traditional income sectors.

## 'En-flation'

... MARCH 15, 2022

### Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results.

### Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is intended for use in:

- The **United States** by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- **Europe** by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In **Europe**, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
- **United Kingdom** by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA").
- **United Arab Emirates** by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organization.
- **Singapore** by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- **Australia** by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS License No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- This document is marketing material and is issued in **Switzerland** by Principal Global Investors (Switzerland) GmbH.
- **Hong Kong SAR (China)** by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- **Other APAC Countries**, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
- Nothing in this document is, and shall not be considered as, an offer of financial products or services in Brazil. This presentation has been prepared for informational purposes only and is intended only for the designated recipients hereof. Principal Global Investors is not a Brazilian financial institution and is not licensed to and does not operate as a financial institution in Brazil.

Insurance products and plan administrative services provided through Principal Life Insurance Co. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities are offered through Principal Securities, Inc., 800-547-7754, Member SIPC and/or independent broker/dealers. Principal Life, Principal Funds Distributor, Inc., and Principal Securities are members of the Principal Financial Group®, Des Moines, IA50392.

© 2022 Principal Financial Services, Inc. Principal®, Principal Financial Group®, and Principal and the logomark design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and services marks of Principal Financial Services, Inc., in various countries around the world. Principal Global Investors leads global asset management at Principal®.