

Tackling inflation

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This week we had our quarterly investment conference where we review global macro-economic data with a view to gauging the impact of emerging economic trends on our investment strategies.

One of the observations that came out of the meeting was that the actions taken by central banks this year to combat rising inflation are beginning to bear fruit. Inflation in most jurisdictions appears to have peaked. In the world's most important economy, the US, the Personal Consumer Expenditure Index (PCE) has declined from its peak in June 2022 of 7% to 4.2% today.

One of the problems with measuring inflation is that there are many different measures of it. The Federal Reserve targets the PCE rather than the more familiar Consumer Price Index (CPI) because "It is a measure of the prices people living in the United States pay for goods and services."

In the UK, CPI excludes housing costs, but the more recent CPIH which is regarded by the Office for National Statistics as more comprehensive does include housing costs. The media tend to focus on the more dramatic number, quoting CPI or CPIH according to whichever is the more eye-catching. It is notable that this week's release has focussed media attention on CPI which breached 8.7% rather than the more comprehensive CPIH which was nearly a point lower at 7.9%.

Nonetheless, these numbers are still high and, more worryingly, point to the UK diverging from both Europe and the US where key inflation numbers are declining. The UK now has the highest inflation of all the major developed nations.

This is disappointing because since the crisis in Ukraine exploded, the world has proved to be unexpectedly adept at finding new sources of supply. So much so, that key basic input prices have retraced most of the war-induced price rises: natural gas has fallen 90% from its war peak, lumber 76%, coal 64%, wheat 50%, Brent crude 39%, iron ore and steel by 32% and copper, a key ingredient in the "green" revolution by 23%. (All price calculations as at 11/5/2023).

The culprits this month for higher British inflation are found in services rather than goods. Rising prices for "air travel, recreational goods, and services along with higher second-hand car prices" resulted in the largest upwards contribution to inflation. These more than offset slower food price inflation and outright declines in petrol costs. (The rise in used car prices is a rare bright spot since the UK car market is effectively financed by residual values on PCP contracts. It's worth bearing in mind that higher rates will feed into this, often poorly understood, form of consumer borrowing).

The UK does seem to have painted itself into a difficult corner from which it is difficult to see a painless exit. Equally, the credibility of policymakers, particularly at the Bank of England, is coming under increasingly critical scrutiny.

As recently as May this year, the minutes of the Monetary Policy Committee (MPC) contained the assertion that the "BOE now expects UK inflation to be "a little over 1%" in 2025 and 2026."

The problem is that the market simply doesn't believe that to be credible and therefore the Bank is having difficulty communicating its monetary policy to the market. That might seem arcane but as we have seen only too clearly this week, these channels have a real impact on the price of money: mortgages, loans and even the external value of the currency. It is Andrew Bailey's bad luck to have inherited the Chair in a period where any Governor would be hard pressed to provide a simple solution to an increasingly restive Parliament and country.

There is some good news in this mix in that Goods price inflation does appear to have peaked. But there is no question that despite wage growth averaging just under 6% to April 23, real incomes have fallen by some 3%. As the Chief Economist at the Bank, Huw Pill, put it recently, UK living standards have declined.

The outlook for the UK is for interest rates to trend higher for some time. Financial markets are tipping the UK bank rate to peak around 6%, from 4.5% today, which puts mortgage rates around 7.5%-8%.

The long run solution to a UK-specific inflation problem is investment: higher investment drives higher productivity, which drives wealth creation.

In the meantime, as investors, we can look domestically and globally. 5% gilt yields at the short end offer a certain cashflow and absolute capital security.

Equally, we know capital flows to where it can be used most productively; the US is the prime example, but the fast-growing economies of Asia, outside China, also offer important opportunities to put capital to effective and profitable use whilst the UK must continue to rely on the Bank to bring its house to order.

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