FLASH UPDATE

Latest views from the investment team

UK inflation cools (finally)

7am this morning provided the most recent yearly rate of UK inflation; the figure came in at 7.9%. This was below market expectations and marked the first time in over a year the figure was under 8%. Markets have been buoyant following the news; however, we caution that there is still a serious inflation problem in the UK. In this flash update we will consider the drivers of UK inflation and the market moves following the release.

Despite falling, UK inflation is high, especially relative to our peers and the Bank of England's target of 2%. Consumer prices are still 7.9% higher now than this time last year. The reaction to the news doesn't seem to reflect this reality. However, all that matters right now is that the number is falling. And the fact that it fell more than analysts were expecting, has lifted animal spirits on UK assets. Economists forecasted this month's inflation figure to be 8.2% with a range of estimates between 7.9% and 8.7% and so this figure was a -0.3% surprise.

The market is reacting to a surprise that feels like good news. The primary policy implication of cooler than expected inflation is that the Bank of England may raise interest rates less aggressively. Broadly, this morning saw investors start to pare back their bets on a further surge in interest rates.

Sterling is weaker as the gap between UK and global interest rates appears less stark. Lower interest rate predictions are leading to lower gilt yields, meaning the UK government is facing lower borrowing costs and benefiting existing gilt investors. UK equities opened strongly across all sectors; this is especially true in the property sector which benefits directly from lower rates. In our portfolios we will see the benefits through our overweight allocation to UK Gilts and our structural exposure to physical assets such as property and infrastructure investment trusts.

Despite the seemingly more positive outlook for the UK economy, it is worth noting that we are not out of the woods yet. The equivalent inflation number for the United States, released a week ago, was 2.9% and in the Eurozone (released this morning) it was 5.5%. We currently have the highest inflation in the G7. The impact on the UK is more stark. Real household incomes haven't increased for 15 years, and the average UK household is 20% poorer in Northwest Europe. Moreover, our mortgage market relies more on variable loans so more consumers are facing the stress of now higher payments.

Reducing inflation is critical but is proving difficult for policymakers. Labour shortages have led to especially high wage pressures. There are increasing fears that companies are increasing their profit margins under the cover of inflation. Moreover, the built-up savings and demand for services following the pandemic continues to be unleashed. Our portfolios remain positioned for an environment of persistent inflation, but that benefit from some softening in the high levels we have seen.

Bottom Line

Today's news is certainly a positive step for the UK's inflation problem. But we suspect the Bank of England will keep interest rates elevated for the next 6-12 months to ensure inflation embers are extinguished and not just lying dormant.

For more information, please contact your adviser.

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