Elston

Insights

16th December 2021

UK inflation and rates tightening

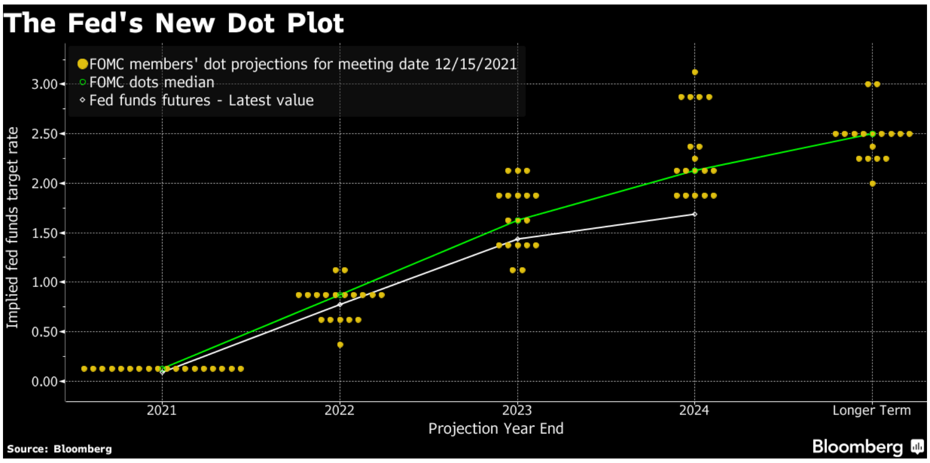
- US Fed signalled tightening, but markets expectations were ready
- UK inflation hits 11 year high and could remain at ~5% through 2022
- Bank of England raises rates +15bp to 0.25% to avoid "inaction"

Fed signals tightening

Fed Chairman Jerome Powell signalled that inflation is now the biggest risk to growth, and getting the labour market back to pre-pandemic levels.

The US will accelerate "tapering" or reduction of supportive asset purchases, and set out the potential for rate hikes in coming years (although no change in long-term target rate).

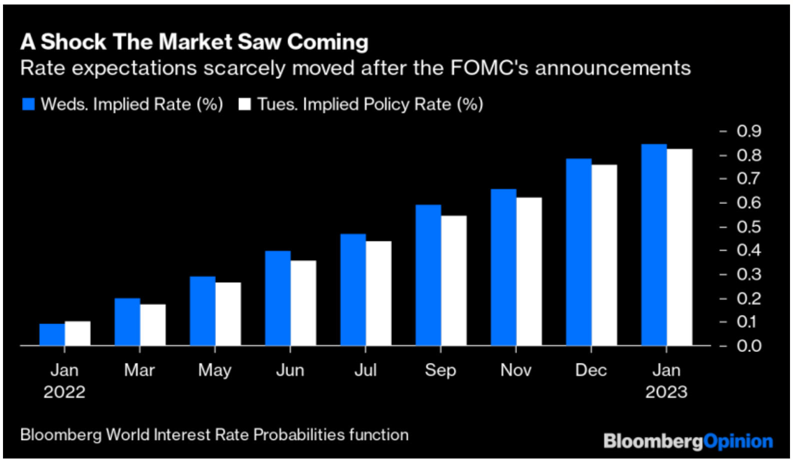
The change in Fed rate hike expectations is illustrated in the "dot plot" below:



Source: https://www.bloomberg.com/news/articles/2021-12-15/the-fed-s-new-dot-plot-after-its-december-rate-meeting-chart

And despite rate hikes usually spooking markets, markets rallied: why? Because the bigger concern was that the Fed was behind the curve and not getting on top of inflation. The risk of a so-called "policy error" had investors concerned.

The fact that market-implied policy rates did not change before and after the policy announcement, suggests that this was a case of the Fed catching up with the market, than the market catching up with the Fed.



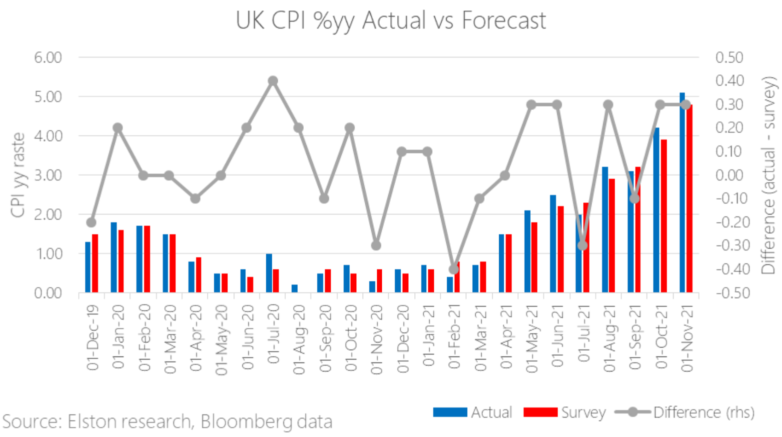
Source: https://www.bloomberg.com/news/articles/2021-12-16/powell-declares-inflation-big-threat-as-fed-signals-rate-hikes

UK inflation

Meanwhile, UK inflation pressure continues, with November inflation data coming in at +5.1%yy, ahead of +4.8%yy forecast, the fastest rate in a decade. Transport, clothing and food were the main contributors.

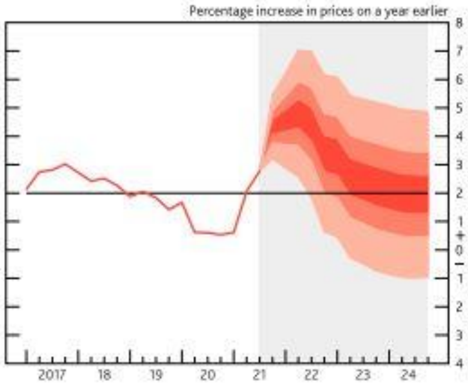
The risk is that inflation creeps into wage growth which would make it harder to bring inflation down to long-term target of 2.0%.

This is the second month in a row of an upside surprise (see chart).



The figure is also at the upper end of scenarios envisaged by the Bank of England at the November MPC meeting.

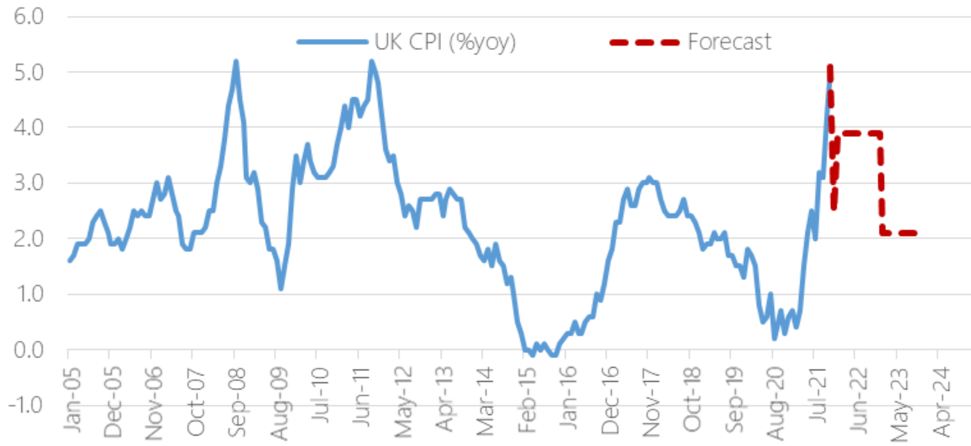
Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in **Table 1.A** footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Source: Bank of England, MPC Minutes

Whilst close to 2011 levels, economists still expect inflation to moderate to trend rates. We are concerned that they are behind the curve.



Source: Elston research, Bloomberg data

Following inflation figures, traders priced in a likely rate hike of ~8bp by the Bank of England at today's MPC meeting. Separately the [IMF urged the Bank of England to raise rates and end QE](), and not to allow "inaction bias" to govern policy.

Bank of England raises rates

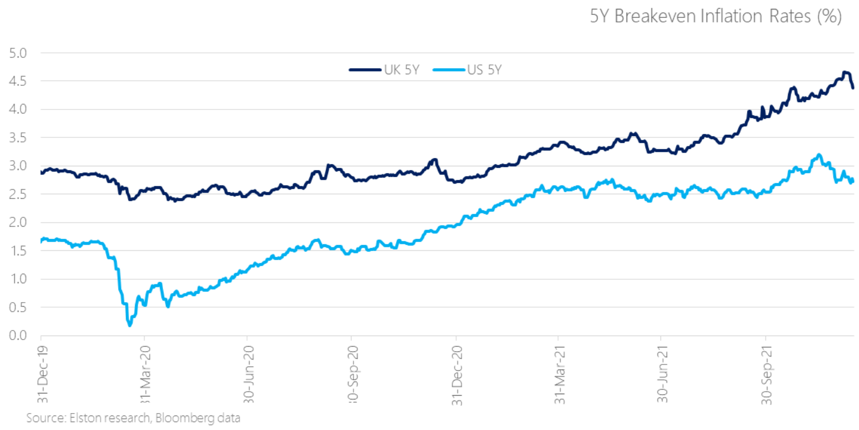
The Bank of England today announced a +0.15% increase in the Bank Rate from 0.10% to 0.25% citing "more persistent" inflation, and following the Fed's lead in a greater level of tightening.

Furthermore, the Bank of England minutes suggest that inflation could remain at elevated levels and *"expect inflation to remain around 5% through the majority of the winter period, and to peak at around 6% in April 2022"*.

Markets are pricing a 80% chance of a further +0.25% to 0.50% in February 2022. In October, BoE Governor, Andrew Bailey guided that rates would need to rise to address inflation.

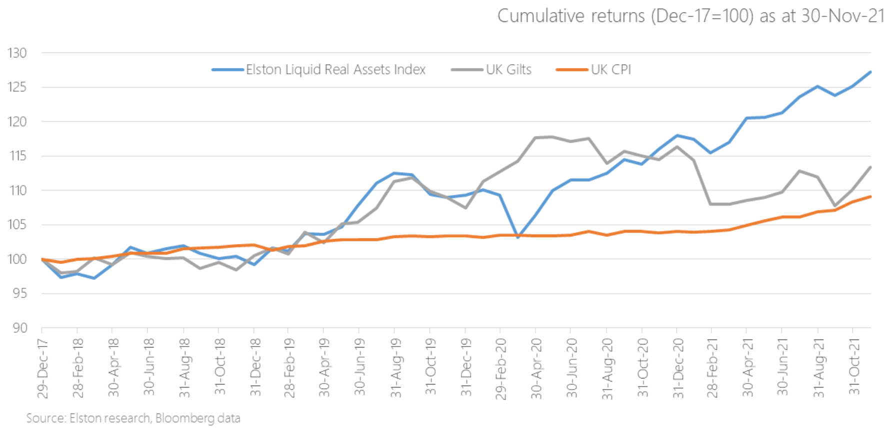
Where are breakeven rates?

The UK 5 year breakeven rate is at 4.38%, following the announcement, compared to 4.66% at the end of last week. The US 5 year breakeven rate is at 2.73% today from 2.80% at the end of last week.



Liquid Real Assets performance

Our Liquid Real Assets Index combines exposure to higher risk-return real assets for inflation protection and lower risk-return rate-sensitive assets for interest rate hike protection for an overall volatility that is comparable to UK bonds. By incorporating allocations to exposures that are driving inflation, such as Commodities, or can pass-through inflation, such as Property and Infrastructure, the real assets index can provide a return premium in excess of inflation and in excess of nominal bonds.



Summary

Inflation is proving persistent, policy makers are catching up to keep it in check. Nominal bonds will remain under pressure, particularly longer-duration in a rising inflation, rising interest rate environment.

We advocate pairing equity allocations with diversified real asset exposure that can respond to inflation and floating rate notes that can respond to interest rate hikes.

Henry Cobbe

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