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Investment Insights

Inflation

March 2017

Against a backdrop of tumbling sterling and anticipations of strong growth from the US – led by policy announcements from the new President – talk of a period of higher inflation has come to the forefront of investment discussions.

Whether we are entering a period of higher inflation is an important issue for pension schemes, for whom a significant proportion of their liabilities are linked to either the retail prices index (RPI) or the consumer prices index (CPI).

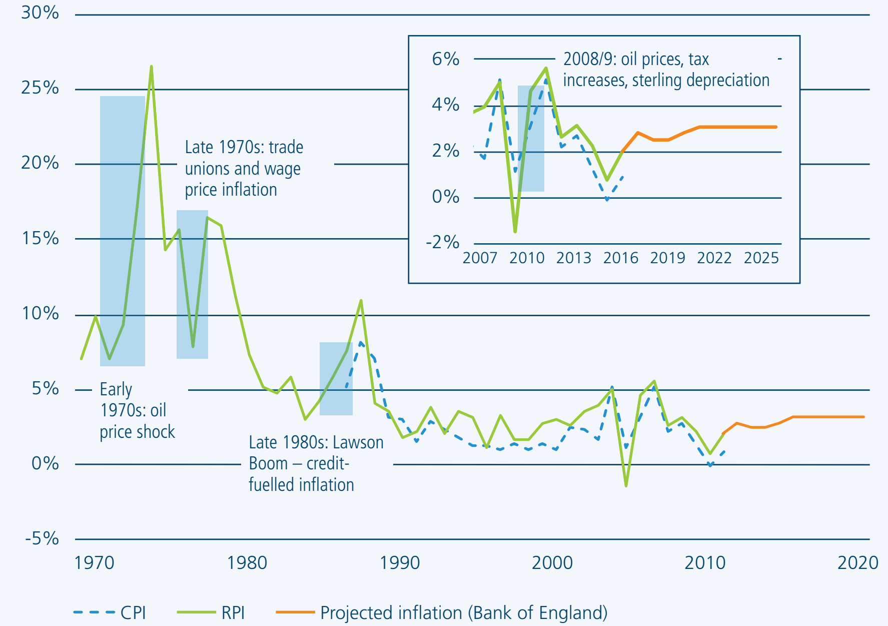
We last discussed inflation in our April 2014 Quarterly Insight, 'Inflation or deflation – which should we fear the most?' Our conclusion at the time was that deflationary forces were increasing but, whilst sounding contradictory, we still feared inflation due mainly to the temptation of policy-makers 'inflating away' their debts.

Three years on, has our view changed and are we now seeing inflation being driven upwards by economic drivers rather than by policy-makers? In this paper we investigate whether the recent heightened level of inflation is expected to stay and what the investment options are for pension schemes that wish to protect against such a scenario.

The chart to the right shows how inflation has moved over recent history, putting into context the recent rise. For each significant rise in inflation, we have identified the key determinants of that inflationary period.

We can see that the recent increase in inflation barely registers in a historical context; however, the question is whether this is the start of a sustained rise. Inflation returning to the 9% per annum levels seen at the end of the 1980s would have a significant impact on the funding and investment strategies of schemes.

Historical movements in price indices



Source: ONS, Bank of England. Change in index over 12 month period

What could lead to inflation?

So why do commentators expect inflation to rise? In this section we explore some of the economic events that could lead to sustained inflation in the UK at the present time.

Fall in sterling

One of the strongest arguments for a rise in inflation levels is the recent depreciation of sterling. Over the six months following the EU referendum in June 2016 sterling fell by 12% on a trade-weighted basis, having a significant knock-on effect on the price of imports. Numerous examples made the headlines - from the price of Marmite to the announcement that clothes retailer Next would increase prices by 5%.

The important question is whether these recent falls in sterling could start a period of sustained higher inflation or will just result in a one-off increase in prices.

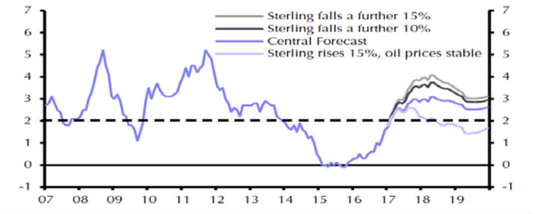
The former requires at least one of two things to happen:

1. A further fall in sterling over the next 12 months – at present, whether this will happen seems very heavily dependent upon the market's view on the conditions of the UK's exit from the EU. However, a further 10-20% fall seems unlikely at the moment.
2. Recent falls in sterling to improve the UK's export position and have a knock on positive impact on UK growth. We consider this further in the next section.

CONCLUSION

On balance, we believe that the falls in the value of sterling will lead to an increase in prices but this will come through as a temporary rise in inflation rather than a sustained period of high inflation.

CHART 8: CPI INFLATION GIVEN VARIOUS ASSUMPTIONS (%)



Sources – Thomson Datastream, Capital Economics

Rises in oil prices

Another argument being put forward for higher inflation is the 20% rise in oil prices that followed OPEC's (the Organisation of the Petroleum Exporting Countries) December 2016 agreement to limit supply. By itself, such a move could increase inflation by around 2%.

However, as with the fall in sterling, this will be a largely one-off effect unless oil prices continue to further increase, which is not anticipated by the market.

CONCLUSION

The recent rises in oil prices will lead to a one-off increase in prices. However, the expectation is that oil prices will not continue to rise at accelerated rates.

At this point, the rise in inflation appears to be a repeat of the situation in 2010/11 (as shown on the chart on the opening page), when the UK experienced two years of above target inflation principally because of oil price rises and a fall in sterling. The shock proved temporary and inflation fell back below target in the subsequent five years.

The key to whether we are entering a period of sustained higher inflation therefore lies with what the knock on impact on the UK economy of the price shock is and we consider this further below.

Reaction of UK economy

Over the last six months there has been a pick-up in global growth expectations and the UK is not isolated from this; so again the question is, could this result in sustained higher inflation?

The UK's gross domestic product grew by 0.6% in the fourth quarter of 2016, taking markets by surprise. However, the average forecast growth rate for the UK remains relatively modest at 1.4% for 2017, which is hardly consistent with soaring growth and inflation.

Furthermore, growth in employment in slowing down – in fact there is expected to be a small rise in unemployment over the next year – and productivity growth has reached long-term lows, with expectations that output will continue to slow in response to uncertainty over the terms of the UK's exit from the EU. Some of the key causes of the falls in productivity are around worsening demographics and slowing technological improvement, both of which are long term trends that that don't show signs of reversing.

CONCLUSION

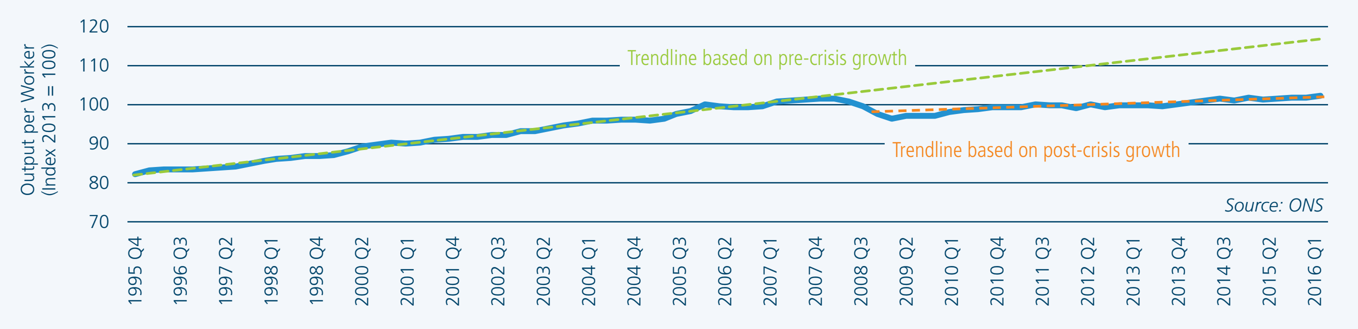
The flexibility in the labour supply and the generally lower levels of investment have two implications – firstly it is difficult to see wage inflation coming through and secondly it is difficult to see a significant increase in the rate of economic growth. We therefore do not see core inflation being driven up by either of these two factors.

What about policy-makers?

Our key view from above is that the economic backdrop does not suggest a significant increase in inflation over a prolonged period and we expect a repeat of the situation we saw in 2010/11. However, has our concern over policy-makers creating an inflationary outcome changed? After all, in many ways this is the present day concern of markets: that the Trump presidency will create inflation through the huge fiscal spending program that he has suggested he will undertake.

The key though is that it is a US phenomenon; the risk of US inflation rising has increased but that doesn't necessarily travel across the Atlantic. In the UK, the Bank of England shows little signs of changing its stance and so we look to fiscal policy. In the Autumn Statement, the new Chancellor indicated that he was targeting a 2% deficit in 2020 rather than the zero target under his predecessor. This is a few £10s of billions of additional activity compared to the $1trillion that is under consideration in the US.

Therefore, we do not see at this time a substantial shift in UK policy that would lead to an inflationary surge.



OVERALL CONCLUSION

Our "base case" is in line with the Bank of England's expectation that, whilst we will see higher inflation over the next few years, at this stage the UK will not see a sustained period of significant inflation.

The key risks to this view are:

Economic changes

- We are wrong about the labour market and large wage increases are set to come through on the back of rising productivity or shortage of workers
- A further precipitous fall in sterling – a further 15% fall in the value of sterling versus the dollar could result in CPI inflation rising to 4% (Capital Economics)

Policy changes

- A 'copy and paste' economic policy from US to UK – Philip Hammond has indicated that this isn't on the cards
- A change in the Bank of England's inflation target – whilst there is increasing talk of this we think it is unlikely in the near future

How would inflation impact pension schemes?

Despite our conclusion that we expect the current rise in inflation to be temporary, we still encourage trustees to understand the significant impact that higher inflation, or indeed a return to deflationary concerns, could have on their scheme.

Cashflow and cost

As mentioned above, our central expectation is for a temporary rise in inflation. However, even temporary rises in inflation can have a significant impact on the amount of cash schemes need to pay out to members.

Yields

Of particular interest to pension schemes will be how the Bank of England would respond if we were to see a rise in inflation.

Our view is that this is not the moment that many pension schemes have been waiting for – that is, we do not anticipate a significant rise in interest rates (and hence gilt yields) in response to the recent rises in inflation. Our view is that for the UK the rise in inflation is temporary and we therefore won't see rate rises of any significant level as a result of inflationary pressures in the short to medium-term.

Impact on covenant

As well as considering the possible implications of higher inflation for the scheme's liabilities and whether the asset portfolio should be adjusted in response, trustees should also consider the impact of higher inflation and sterling depreciation on the scheme's sponsor.

We are seeing a number of schemes and sponsors put in place Recovery Plans where deficit payments are linked to inflation; particularly where the Employer's revenue is heavily linked to inflation.

How can schemes invest to protect against inflation?

Whilst we are not unduly concerned by the current rise in inflation, we still believe that schemes' default positions should be to hedge out inflation risk – the factors considered in this paper illustrate how much uncertainty is attached to future inflation levels and the impact higher-than-expected inflation, even if only temporary, can have on a scheme.

The range of assets available to protect against inflation depends on whether you are concerned about matching cashflows, and/or a stable funding position and over what timeframe.

If you are concerned about the volatility of the funding position then the options for hedging are limited to using gilts (or gilt derivatives) or swaps. We have written previously about the structural imbalance that exists in these markets with:

- very high demand, including £1 trillion plus of unhedged UK DB pension scheme liabilities; and
- a reducing level of supply, notwithstanding the Autumn Statement, of inflation-linked assets.

> *Therefore, we continue to hold the view that the cost of hedging inflation is unlikely to cheapen significantly over the medium term. Given the strong demand for such assets, this view is almost regardless of the inflation outlook for the UK economy.*

However, there are other assets that have inflation-linked cashflows and therefore can help match benefit payments out of schemes where these are also linked to inflation if that is the key concern.

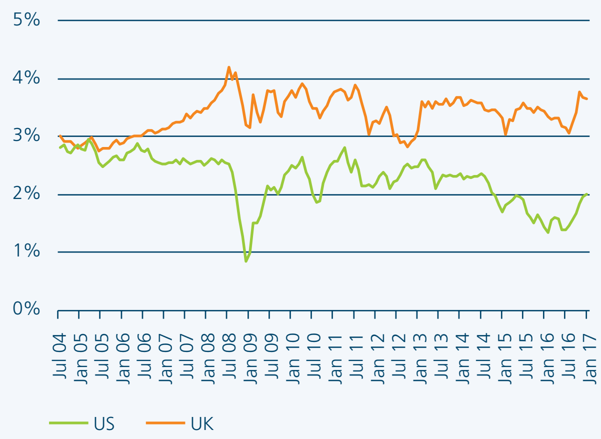
- **Long-lease property** – the rental-based income from this asset class typically has a high link to movements in the retail prices index and, although the yields have come down a little in recent years, they remain attractive against many of the alternatives.
- **Infrastructure assets** – similarly to long-lease property, the nature of most infrastructure assets is such that the income from these assets is linked to inflation. However, care needs to be taken as many infrastructure funds will invest globally and levels of inflation differ in different countries. In addition, volatility in currency will affect income.

Whilst it can be argued that both equities and loans (or other investments that are linked to floating interest rates) provide some protection against inflation, the link between inflation and these investments is indirect. We therefore take the view that, whilst there are strong reasons for holding these investments, we would not hold them as a cashflow matching or hedging asset – where they do provide some protection against inflation this is an added bonus.

It is often discussed whether to buy overseas inflation linked bonds to protect against UK inflation. Whilst UK and global inflation is fairly well correlated – when one rises the other tends to as well – this certainly does not happen uniformly and there will be significant differences in the outcome for UK and global inflation.

The chart below compares the outlook for UK RPI and US CPI over a 20 year period – this is vital for schemes looking to protect against long term inflation. The chart shows the considerable variations over the past 13 years and we conclude that US bonds are a poor hedge for long-term UK inflation (the same is true for other non-UK bonds).

Comparison of UK and US 20 year breakeven inflation



Summary

Whilst we think it is too early to announce that low inflation has been defeated and the UK is on the path towards higher inflation levels than the past 20 years, we do think it near inevitable that inflation will rise over the next couple of years. In the absence of a significant change to UK policy we see this as temporary and therefore are not expecting a continued rise in inflation.

That is not to say we feel schemes should ignore the risk of inflation and we continue to encourage schemes to build their asset strategy to protect against such a risk.

The challenges around protecting against inflation have changed little over the past three years and we expect these to remain for many years to come. There is significantly greater demand than there is supply of inflation-linked assets and so we expect the price of such assets to remain 'high'.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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www.barnett-waddingham.co.uk/investment-strategy

INVESTMENT CONFERENCE INSIGHTS

Our ninth annual Investment Conference brought influential industry leaders together to debate, discuss, and share their views on the most pressing investment problems.

We were delighted to welcome keynote speaker, **Alastair Campbell**, to our Investment Conference to discuss how the world of politics has affected our investment decisions.

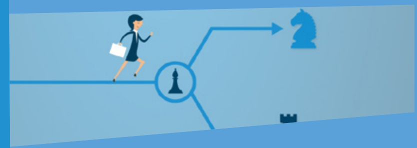
Matt Tickle shares his views on the economic outlook, understanding volatility and managing inflation risks at our Investment Conference.

Marcus Whitehead considers the impact that political decisions in 2016 will have on markets in 2017 and beyond, and how we can help our clients to think about strategic, long-term solutions.

With the introduction of social media, **Neil Davies** explains how socially responsible investment is becoming increasingly important.

Is self-sufficiency right for you? **Rod Goodyer** discusses the three key elements of self-sufficiency and any questions investors should be thinking about.

Don't be paralysed by political risk



Cash flow aware investment

The pros and cons of four alternative DC investment approaches

Interest rates to rise but no return to normal anytime soon