

The Old Enemy: UK Inflation is Back

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The beleaguered Office for National Statistics released the latest inflation figures this week and they did not make happy reading for those hoping to see further cuts in interest rates this year.

The headline rate for the Consumer Price Index (CPI) came in at 3.8% yoy, whilst the “core” rate, known as CPIH came in at 4.2%. CPIH excludes volatile items like energy and food; it is the Bank of England’s preferred measure of inflation.

It is worth remembering just what inflation is.

At bottom, inflation is the erosion of purchasing power and the corrosion of real wealth. If current CPIH rates of 4.2% were to be sustained, let’s say for five years, it would mean that in 2030, £1 would be worth some 20% less it is today at just 81.4p. That is to say, individuals on fixed incomes would endure a 20% “pay cut.”

There is a great deal riding on the future path of inflation. Indeed, there are those who argue that the only route out of very elevated public debt, (the UK national debt is very close to 100% of GDP), is to inflate it away. That is a debtor’s charter and would destroy the credibility of the British Government in international financial markets.

Interestingly, in a demonstration of the impact of decisions made even decades ago, the UK’s experience of hyper-inflation in the 1970s led to the development of the “Index-linked market” to underpin government borrowing requirements.

Today, 25% of UK debt is linked to the path of inflation; if inflation rises, the government has to pay more. In effect, decisions made forty or more years ago have removed the capacity of UK governments to “inflate away” the debt. On balance, that is a “good thing” for financial stability.

The introduction of the index-linked market helped anchor politically motivated economic decisions and that framework was given a boost when the Bank of England was made operationally independent back in the 1990s. The conduct of monetary policy was taken out of the hands of politicians.

Correlation is famously not causation but nonetheless that policy framework has delivered successful outcomes and UK inflation has oscillated around the 2% target since the early 1990s: that is, until now.

The Covid pandemic badly damaged international supply chains. As a result, global inflation rates spiked sharply. However, as the pandemic abated and supply-chains recovered, price inflation subsided; the market was prepared to “look-through” an obvious short-term hiccup and remained largely unfazed.

Today, in a period of geo-political stress and US induced tariff wars, inflation rates, particularly in the UK, which is very exposed to international markets, are rising again.

Stable inflation is very important: it allows businesses and individuals to plan ahead with confidence; it keeps borrowing costs low; it supports consumption and growth.

There are two major constraints on British economic policy with respect to inflation: firstly, as noted is the volume of outstanding index-linked debt and secondly, the triple-lock with respect to state pensions. UK state pensions are effectively index-linked. The UK has a big incentive to keep inflation low.

Yet, even low rates of inflation are corrosive to wealth. Fixed income streams are very exposed, but “variable” income streams are a hedge.

Companies don't like inflation any more than anybody else but unlike other economic actors they can raise output prices in response to higher input prices. Dividends tend to rise over time even as inflation rises.

In the end the cost of high inflation is borne by consumers and taxpayers. Owners of real assets have a natural hedge which is why we recommend that even the most risk-averse investor maintains a minimum exposure to “growth” assets such as equities. This feels very uncomfortable as it feels risky in a volatile world, but the alternative is a permanent erosion of your purchasing power which we feel is even more risky for our clients.

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