

Hymans Robertson Investment Services (HRIS)

Inflation in the UK

August 2022

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Latest inflation data showed UK inflation was 0.3% higher than the US, 0.8% higher than the euro zone and almost 7% higher than Japan. Inflation is expected to reach double figures by autumn once the energy price cap is reviewed. Why is it higher than other nations? Will the UK's high inflation persist or are there signs of relief?

Why is inflation in the UK higher than elsewhere?

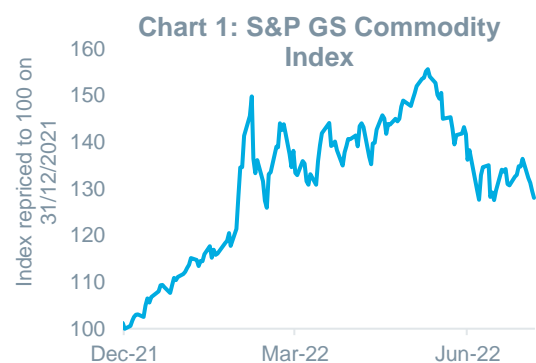
High inflation is by no means localised to the UK. Prices around the world started rising as a result of Covid-induced supply chain issues. A tight labour market in the US, where the number of vacancies is over double the number of unemployed, has led to strong wage growth, pushing up labour costs. In addition, the war in Ukraine has led to elevated commodity prices. This has been felt especially acutely in Europe where gas prices are nearly 10x higher than the average over the previous decade.

The US and Europe however are each experiencing one or two of these main causes. For example, the US has a very tight labour market but is not as reliant on gas imports. Conversely, Europe has been hugely impacted by high gas prices but has a cooler labour market. Unfortunately, the UK has both of these predicaments to contend with. Other drivers such as a weaker pound have also contributed.

Are there signs of peak inflation?

Looking at the three main inflationary drivers in turn:

- Several key input commodities have been falling in the past couple of months (see chart 1). Wheat is now back at levels seen before the invasion, copper is down c. 20% year-to-date and crude oil is c. 20% down from its peak in the early days of the war. Most of this is driven by concern for economic growth, as well as an end to the blockade of Ukrainian wheat by Russia. The exception to this is natural gas, where the threat of Russian supply being cut off keeps prices extremely elevated. The structure of the UK energy market regulation, which uses a biannual price cap review, means that any immediate fall in gas prices will take a long period of time for it to feed through to retail energy prices meaning a peak in inflation could be later than other regions.
- There are signs that the covid induced supply chain disruptions are abating. For starters, China has eased Covid restrictions, for now. In addition, the price of shipping goods across the world has fallen dramatically in the past few months.
- Labour tightness in certain sectors such as hospitality originally led to salaries going up in those sectors. However, workers are now asking and expecting their pay to keep pace with broader inflation which could lead to another, broader round of price rises if wage increases are passed on to consumers. There are signs that this is happening already.

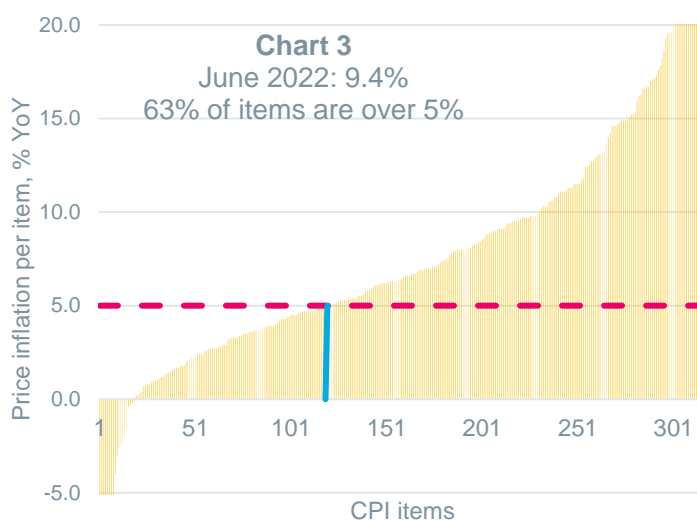
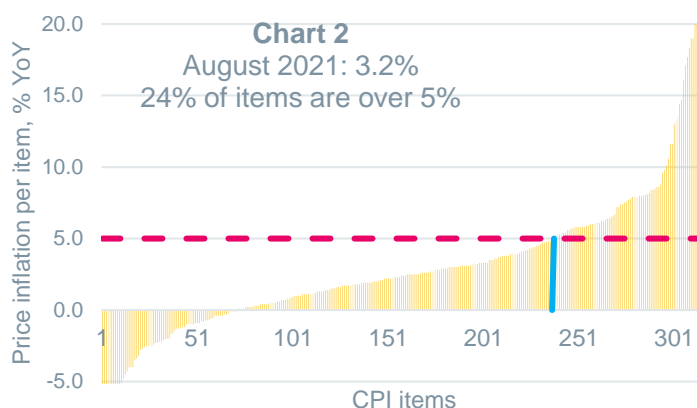


This is being borne out in the breadth of inflation which has increased significantly since prices first started creeping up last year. The first signs of inflation being meaningfully beyond the Bank of England's target were in August 2021 when CPI reached 3.2%. At this point the finger was pointed squarely at supply chain crunches caused by the global economy emerging from the pandemic. There were just a few items with huge price increases (used cars for example) skewing the overall index higher. In fact, only 24% of items in the CPI index had annual price increases of over 5% (see chart 2). This was the reason that most forecasters initially described the inflation spike as transitory. However, jumping forward to June 2022, where inflation had reached 9.0%, the percentage of items with an over 5% price increase had risen to 63% (see chart 3). This indicates inflation moving beyond just goods and into service sectors through wage increases.

Summary

Although there are signs that the initial causes of inflation such as supply chain problems and a commodity price boom are fading, there are arguably signs that a stickier and more self-perpetuating type is only just taking hold. Economic forecasters are constantly upgrading their inflation forecasts as data readings continue to surprise to the upside. At this point it looks like inflation will peak towards the end of 2022 but the pace of disinflation could well be slower than many anticipate. The Bank of England are hoping that the interest rate rises that they are bringing through cause a cooling in labour markets. However, they are also forecasting a recession will be necessary to finally get hold of inflation.

Jack Richards
Investment Manager



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