For professional investors only

Five reasons to think inflation will fall

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Christopher Mahon
Head of Dynamic Real Return,
Multi-asset

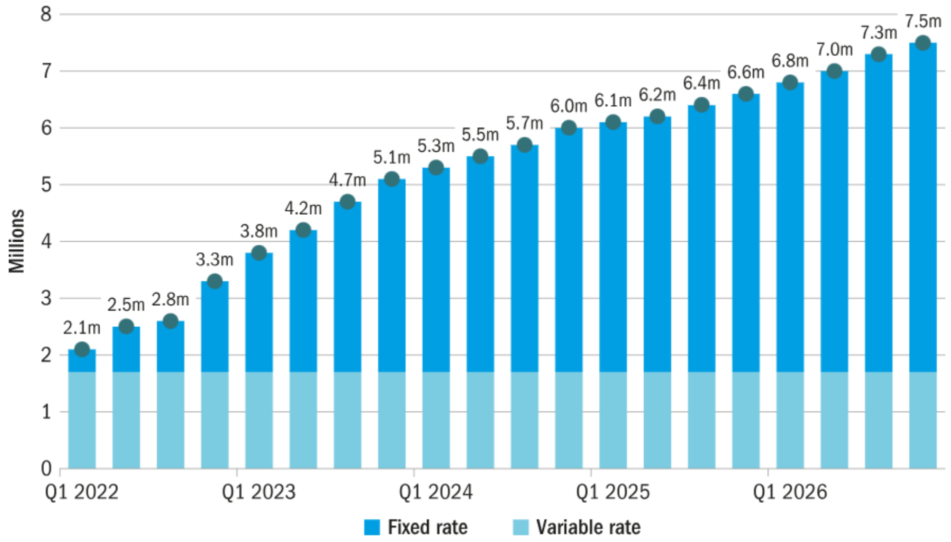
Inflation and interest rate expectations are once again dominating news bulletins. UK government borrowing costs are now above that of Greece and Italy. Headlines are warning of the impact on mortgage holders.

Investors will know the cause: despite recent falls in the Consumer Price Index (CPI) – 8.7% in April down from 10.1% in March – expectations were that inflation would fall even faster. Markets are worried about it becoming entrenched and bond yields have risen in response. But while markets are focused on the recent misses in inflation, we think there are several overlooked reasons why it will in fact come down meaningfully in the next 12 months.

1) As time passes, the long and variable lags of central bank policy will start biting harder

Monetary policy operates through numerous channels. One of the most high profile is mortgages. So far only a small number of refinancings have taken place, but the pace will pick up over summer (Figure 1) and as time passes the interest rate rises we have seen – from 0.25% at the end of 2021 to 4.5% in May 2023 with more hikes expected – will begin to have a noticeable impact on household finances, dampening demand and cooling inflation. Additionally, media coverage around rising mortgage rates will serve to alert more households to the changes in their cost of capital.

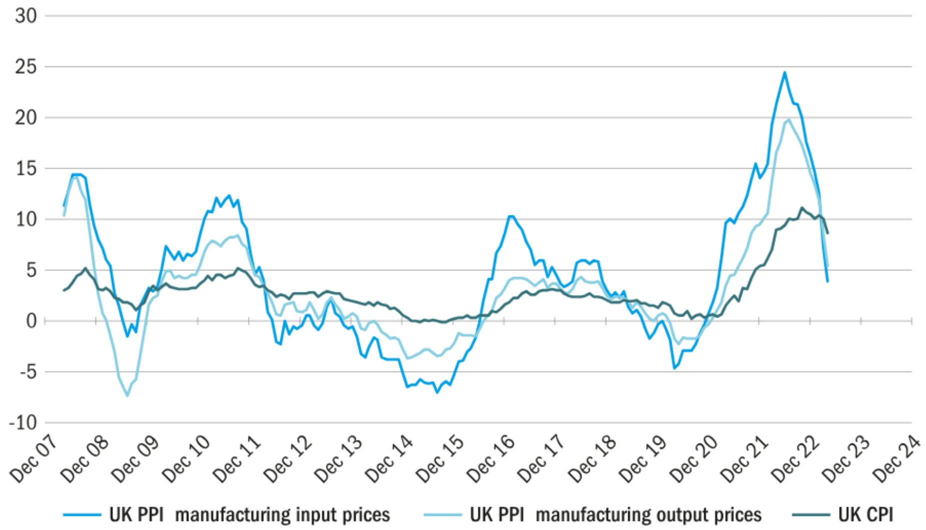
Figure 1: Estimated cumulative number of UK households facing a change in mortgage rate



Source: Resolution Foundation/ONS/Bank of England/Bankstats, 2023

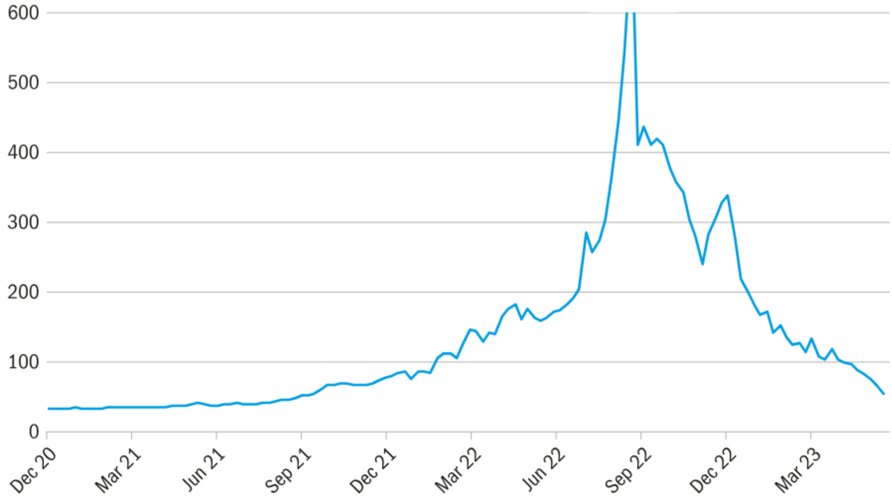
2) **Declining commodity prices mean input prices are already softening** The huge increase in factory gate prices seen post-Covid has already eased substantially (Figure 2). This is likely to continue with the Bloomberg commodity index around 25% lower than its Covid peak and the oil price down from a peak of around $120 in May 2022 to around $70 now. Additionally, the stabilisation and recovery of sterling since autumn 2022 will help reduce the price of imported goods.

Figure 2: Factory gate prices typically lead CPI … and are well below it (index levels, YoY change %)



3) **Tumbling gas prices will see the energy price cap continue to fall** The surge in natural gas prices last summer has reversed rapidly. The UK energy price cap has been reduced from £2,500 to £2,074, with expectations of continued falls across the rest of 2023. Of interest is also the higher additional weight of "electricity, gas and other fuels" in the UK CPI basket – this was 3% in the 2022 basket, growing to 5% in the 2023 basket – which will help magnify the impact of these falls from July onwards when lower bills start coming through. It is worth noting that the pace of these falls continues. From the end of Q1 until the end of May the price of natural gas has fallen from £117 per 1,000 therms to £57 (Figure 3). This bodes well for the direction of the energy price cap in future quarters.

Figure 3: Falling prices – UK natural gas, benchmark £ per 1,000 therms



4) **Lead by the US, global inflation is already easing** The UK inflation story does not exist in isolation. But the good news is that globally the inflation picture is improving, with the Covid-era supply chain bottlenecks unwinding and more balanced supply and demand (Figures 4a/b/c).

Figure 4a: An ebbing inflationary impulse …(US CPI, YOY %)

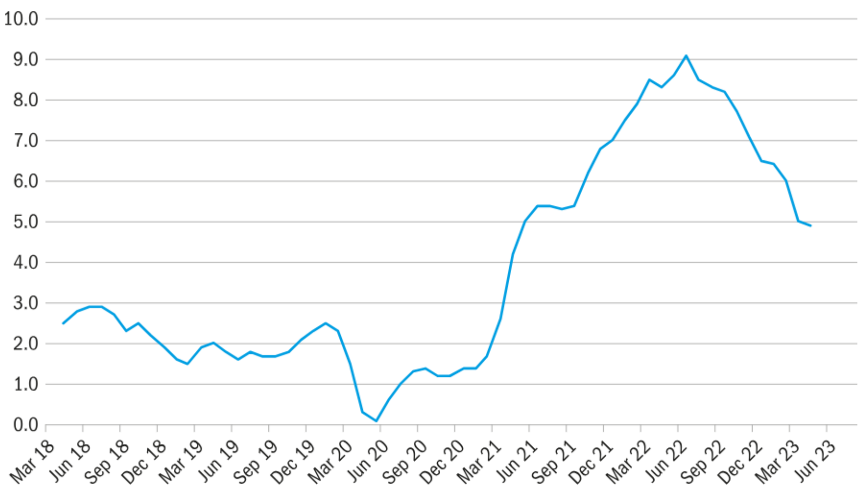


Figure 4b: … as logistical bottlenecks unwind (shipping cost index, $per 40ft box) …

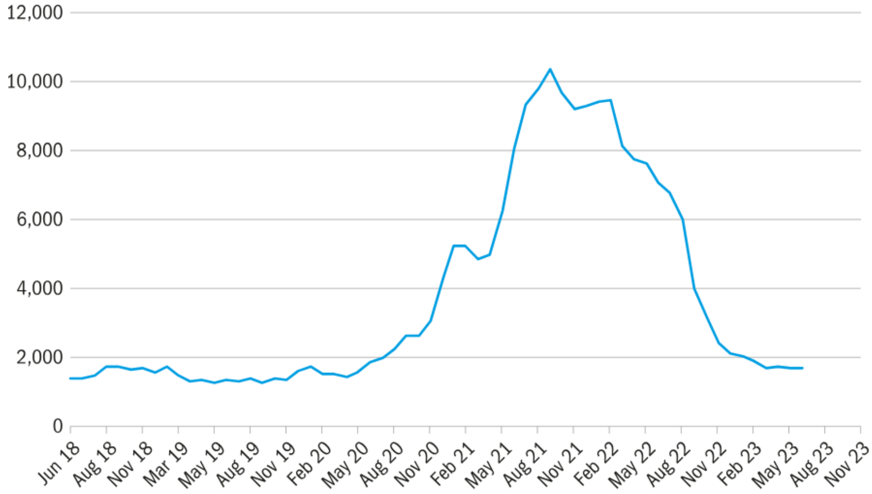
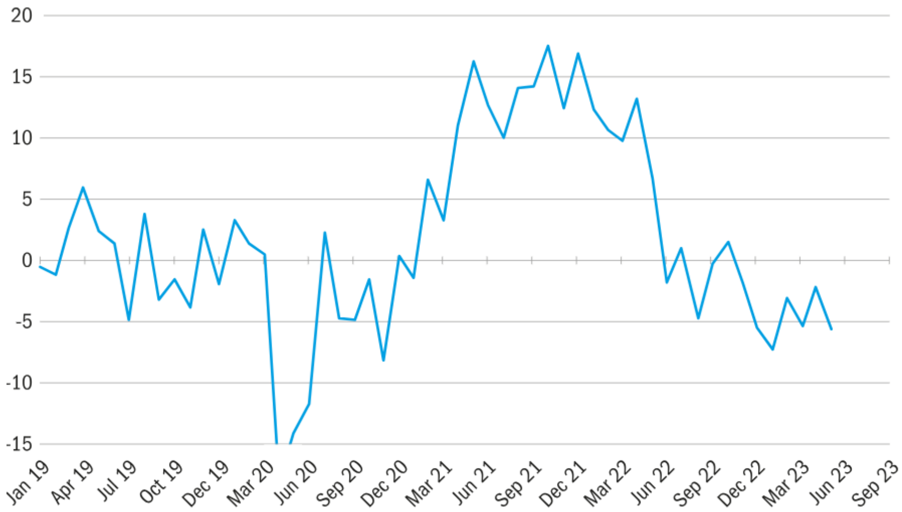


Figure 4c: … and supply/demand come back into balance (US unfilled orders)*

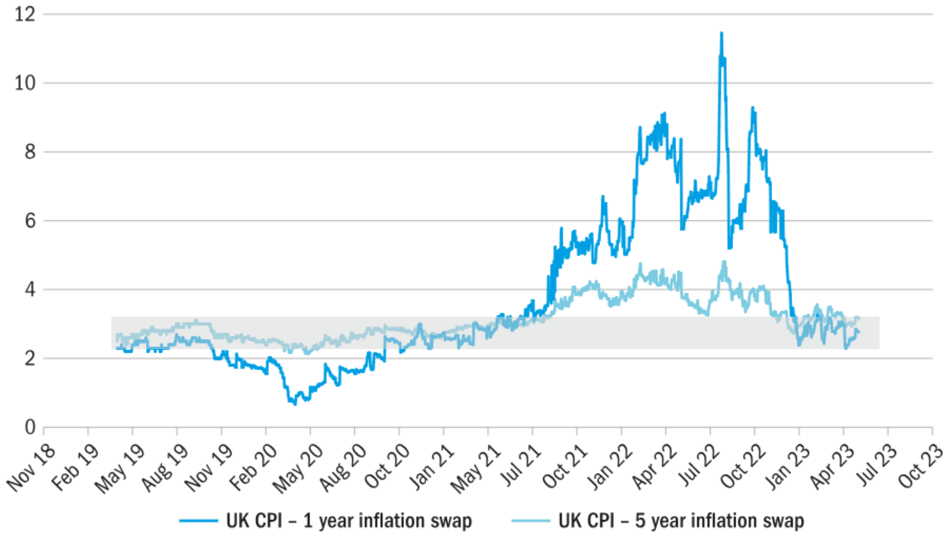


*Above zero, demand is greater than supply; below zero, demand is less than supply

5) Forward inflation expectations remain anchored

Despite everything the Bank of England (BoE) has done (or rather not done) – including its mixed track record over the past few years, the inflation misses this year, and poor communications – its inflation fighting credentials are still respected. UK inflation expectations – both in the short and medium term – remain well anchored (Figure 5) and are back to long term norms.

Figure 5: Inflation expectations are back to pre-Covid norms (expected CPI % per annum)



What could challenge our views? In terms of inflation, wage growth remains too high and continues to be a risk highlighted by the Bank of England. And for markets it is the pace of sales of bonds from the BoE balance sheet that were bought under quantitative easing. The market has the BoE overnight rate around 4% even in five to 10 years' time – we believe this is overly hawkish and fails to account for the likely falls in inflation we should see in the next 12 months and beyond. As such, we think much of the risk of these factors is overstated, and by early 2024 the market will be focusing on easing inflation – both globally and here in the UK.

Note: all market data within the article is sourced from Bloomberg unless stated otherwise, data as at 8 June 2023

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