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Outlook for inflation

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Thomas Wells
Sanlam Global Inflation-Linked Bond
Fund Manager

UK inflation figures were out last week and they do not make for pretty reading: CPI inflation climbed 6.2% year on year in February (vs 5.5% year on year in January) – the biggest print since 1992. The outcome was even worse than markets had feared as consensus was looking for a 5.9% rise.

At the moment, the price of just about everything is going up. Petrol and energy price rises are evident everywhere, and whilst it is easy to blame all of this on Russia's invasion of Ukraine, the inconvenient fact is that European energy markets (particularly natural gas) were dysfunctional long before Putin's tanks rolled into Ukraine. I have long felt that European governments have been disingenuous about the significant economic pain that would be felt as the world tries to transition from hydrocarbons to cleaner sources of energy – and that view assumed that the transition would be phased and managed in some way. The war in Ukraine has highlighted just how difficult any forced or rapid transition is likely to be, and the huge costs that consumers will face. The problem, of course, is that the long-term costs of doing nothing to mitigate climate change are likely to be even worse.

In the meantime, the UK consumer faces a cost of living crisis that is unprecedented in the 21st century. Customers of the 'big six' energy firms will have received in recent weeks notifications of huge price rises. To give some context here, EDF's cheapest available domestic electricity tariff – standard variable – goes up 54% from 1 April. We very much wish that this was a joke for April Fools' Day, but sadly it is isn't. More pain is coming later in the year when the price cap on domestic tariffs will be reset (upwardly) again. Spare a thought for big energy users – steel works, metal foundries, chemical plants, glass makers and the like – that don't benefit from any caps or protection at all on their energy costs if they don't have hedging contracts in place. Soaring electricity costs, and the difficulty of securing gas to generate electricity using gas turbines, will raise questions about just how clean and sustainable the future can be, particularly if countries drag their feet on ramping up nuclear capacity (UK) or choose to avoid it altogether (Germany).

Perhaps the more worrying issue is what businesses and companies do in response to soaring prices: in the agricultural sector, we are hearing that farmers are choosing not to plant crops because energy and fertilizer prices are unaffordable, and/or they are concerned that, come harvest time (when energy prices may have moderated) food prices may also have dropped back and they won't be able to recoup the huge outlays that need to be made now. Many companies will have made up their own mind on inflation and indeed the Institute of Directors confirmed as much this week when it said that inflation is now 'hardwired into routine business decisions'. Labour shortages have not gone away either, with the FT reporting that Britain is having to try and recruit unskilled labourers from as far away as Mongolia. There is also little evidence that global shipping costs are about to return to anything like pre-pandemic levels, which provides an ongoing headache for multinationals; paying a lot more for a standard shipping container does not mean you can fit more things in it, as retailers of bulky consumer durables are finding out. Our old friend 'shrinkflation' has also made an unwelcome return – anyone who has bought a Twix or Wispa recently will know that these once delightful confections are now slimmed-down and lower-quality versions of their former selves.

At times like these, consumers would perhaps look to the authorities for support, but we don't think they should expect too much help from central banks. Central banks have been raising rates despite the war in Ukraine and in the US Powell has already made it very clear that fighting inflation and stabilising prices will be prioritised, even if that means a hit to GDP growth. The front end of the nominal yield curve in the US has suffered an absolute rout. In Europe, the situation is a little more nuanced as Europe doesn't have the benefit of being self-sufficient in energy, but policymakers know that they have to do something to bring inflation down to more normal levels before it gets too embedded. Politically, governments will face growing pressure to mitigate the cost of living crisis, but it is worth remembering that governments have problems of their own; for example, looking at the UK, we reckon that there is around half a trillion pounds of debt that is linked to RPI inflation – this measure of inflation climbed 8.2% in February, a full 200bps ahead of CPI, and there are many in the market who think we will see higher RPI prints this year.

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Contact us

Bruce Simpson
Head of Distribution
and Marketing

+44 (0) 20 3316 4064
Bruce.Simpson@Sanlam.co.uk

Liz Adnitt
Head of UK Wholesale
Distribution

+44 (0) 20 3116 4071
Liz.Adnitt@Sanlam.co.uk

Andy Groves
Sales Manager

+44 07917580592
Andrew.Groves@Sanlam.co.uk

Tom Whitfield
Sales Manager

+44 (0) 20 3116 4016
Tom.Whitfield@Sanlam.co.uk

Sanlam Investments

Monument Place
24 Monument Street
London
EC3R 8AJ