For professional investors only – not for retail use or distribution

INVESTMENT INSIGHTS

December 2011

The price of inflation

Paul Sweeting
European Head, Strategy Group
J.P. Morgan Asset Management

Dan Morris
Global Strategist
J.P. Morgan Asset Management

Introduction

Even as the UK economy struggles under the weight of the government's austerity programme and weak global growth, inflation has remained stubbornly high. Despite numerous predictions from the Bank of England (BOE) that rates would soon fall back towards the target rate of 2%, headline inflation is currently closer to 5% and most economists do not forecast it reaching the BOE's target again until 2013.

The normal reaction of a central bank to high inflation is to raise policy rates. To understand why the Bank of England has not, and to evaluate how large a threat inflation (or even deflation) is to the UK economy, we must look at how inflation is calculated, what it represents, and where it comes from.

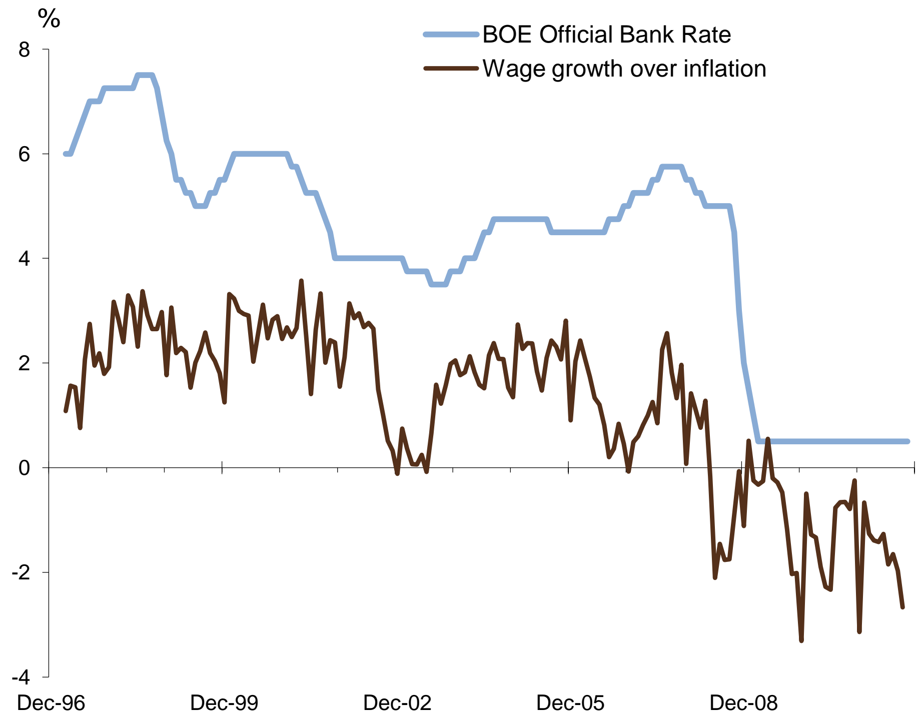
What is inflation?

Inflation is the term given to the increase in a price index over time. A price index represents the standardised cost of some notional basket of goods. The two basic price indices in the UK are the Retail Prices Index (RPI) and the Consumer Price Index (CPI). Both the RPI and the CPI are calculated by assuming that you buy the same basket of goods one month apart and look at the amount by which the value of the basket has increased, though there are differences in the way that the price for each item is calculated.

Types of inflation

It is important to recognise that inflation can come from more than one source. There are several ways of thinking about the different causes of inflation, but a helpful approach is to distinguish between controllable and uncontrollable inflation (from a central bank's point of view at least). A central bank's ability to influence inflation determines their response to it, that is, whether or not to raise interest rates.

Exhibit 1 – UK wages and bank rates



Note: inflation based on the Retail Price Index (RPI). Source: Bank of England, UK Office for National Statistics (ONS), J.P. Morgan Asset Management. Data as of 6 December 2011.

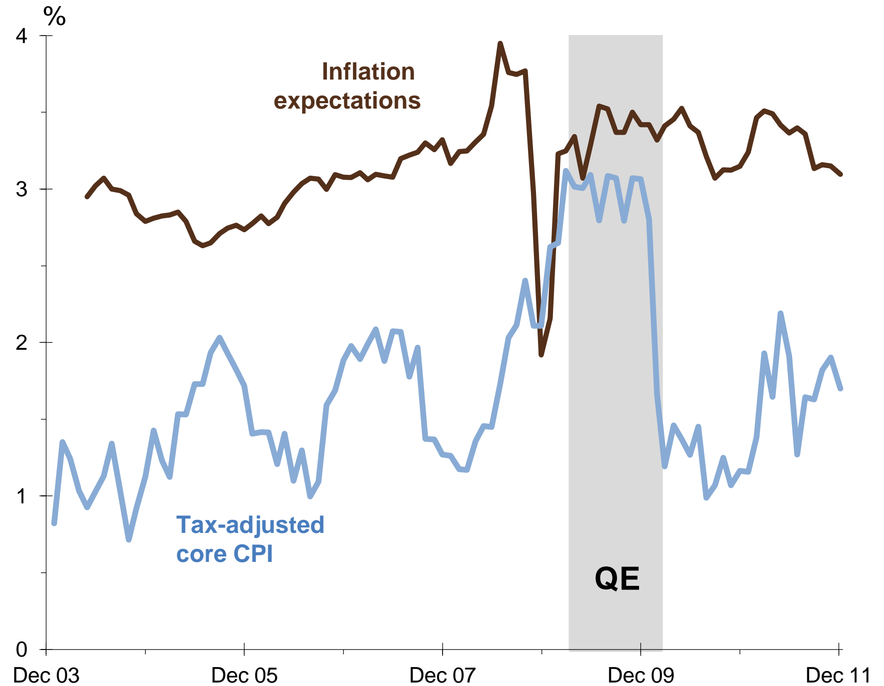
Controllable inflation

The type of inflation that a central bank can control is inflation stemming from an economy that is growing too strongly, pushing up prices for labour and other inputs. The risk of a "wage-price spiral", where rising prices lead workers to demand higher wages, which in turn leads to higher prices, is most pronounced in an economy where either the unemployment rate is very low or the level of unionisation very high. Neither is the case for the UK: the unemployment rate is forecasted to remain above 8% for two more years, and the percent of the UK labour force in trade unions has fallen by half over the last 30 years. In fact, real wages have been falling since 2007, allowing the BOE to cut its policy rates to support the economy despite high inflation (see **Exhibit 1**).

Another type of inflation the central bank can affect is inflation stemming from rising import prices due to a weak currency. The bank could raise rates to strengthen the currency, but the decision to do so depends on several factors, including GDP growth. If growth is already strong, raising rates helps to slow growth and to make imports cheaper, as rising interest rates generally lead to a stronger currency. But in the current environment where domestic production is weak, the BOE is unlikely to raise rates and will let import prices increase. The economy could not support the higher rates and in any event costlier imports help reorient demand towards local producers.

J.P.Morgan
Asset Management

Exhibit 2 – UK inflation measures



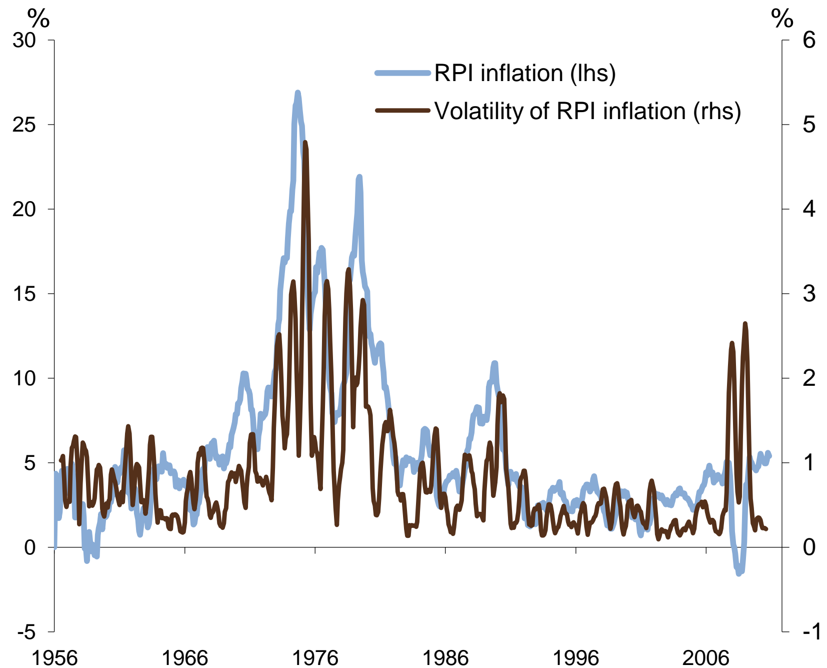
Note: Inflation expectations based on zero coupon inflation swaps. Source: Bloomberg, ONS, J.P. Morgan Asset Management. Data as of 6 December 2011.

Uncontrollable inflation

Sometimes, however, inflation is outside of a central bank's control. If inflation stems from rising energy or food prices, often because of demand or supply problems outside the country, higher interest rates will have no impact. Moreover, the pricier goods act as a tax on consumers and companies, so higher interest rates are probably not needed to moderate economic growth. If inflation jumps because of a tax hike, this is normally just a one-time increase that should not lead to continually rising prices.

Most of the inflation that the UK has experienced over the last few years has been of the non-controllable or transitory type, though it is often difficult to gauge. As the name suggests, the Retail Price Index measures the prices that consumers face, but it is less relevant for a central bank which is interested in core inflation. The CPI excluding energy, food, alcohol and tobacco is a better measure of underlying inflation, but it has been distorted recently by the numerous changes in VAT. There are several indices published by the Office for National Statistics which remove these tax effects, but unfortunately they are only for the broader index, not the core index. We have consequently constructed our own core, tax-adjusted, CPI in order to see more clearly how much inflation is rising in the UK (see **Exhibit 2**). Perhaps surprisingly given headlines about high inflation, underlying inflation is only 1.7% by this measure, equal to the average rate over the last eight years. Just as important, market expectations for inflation are also at comparatively low levels.

Exhibit 3 – Inflation volatility



Source: ONS, J.P. Morgan Asset Management. Data as of 6 December 2011.

It is also worth noting that inflation that is uncontrollable for one economy is frequently controllable for another. For example, if inflation is being driven by commodity price rises, then the country whose demand is causing these rises might be able – and inclined – to control this inflation. Indeed, this is what we are seeing with China, which is attempting to slow down its own economy, the net effect of which should be to reduce the pressure on commodity prices.

The economic consequences of inflation...

Mild inflation is generally beneficial for an economy as it allows relative prices to adjust more easily and has little impact on the real economy. A 5% decline in the price of one good relative to another can happen in two ways. The price of one good can stay constant and the price of the other fall by 5%. Or the price of both goods can increase, but one increase is by 10% and the other is by 4.5% so the second good is now 5% cheaper. Prices are considered to be "sticky" downwards, that is, they rise more easily than they fall. So the second option, where both prices rise but at different rates, can happen more smoothly.

At higher levels, inflation may begin hurting economic growth. One reason for this is that higher inflation is also generally more volatile, as shown in **Exhibit 3**. Volatile prices make it more difficult for firms to plan and may reduce the returns on investment. Higher inflation in any one country also makes exchange rates more volatile, complicating the import and export of goods and services.

J.P.Morgan
Asset Management

...and deflation

Even with prices increasing around the world, the threat of deflation is still a worry for some policymakers. If there is any doubt as to how seriously the threat is taken, consider the comments of US Federal Reserve chairman Ben Bernanke in his June press conference. Here, he was quick to highlight the benefits that the second round of quantitative easing (QE) had in relation to avoiding deflation. Similarly, the June Monetary Policy Committee minutes raised the possibility of using the same approach again in the UK if the risk of deflation increased.

The commonly-held view of deflation risk is that if prices are falling then people will stop spending while they wait to get more for their money in the future. This perception is flawed, however. First, even if prices are falling, some things are necessities that people still need to buy to survive, such as food. Second, demand can only be put off for so long. If you want to buy a new car, you are not going to put off the purchase forever just because it might be cheaper next month. Even with deflation, price declines are not uniform so relative prices will still be changing, and the demand for the now cheaper goods should increase. Finally, prices may also fall because of technological improvements and better productivity, in which case deflation is in fact a benefit.

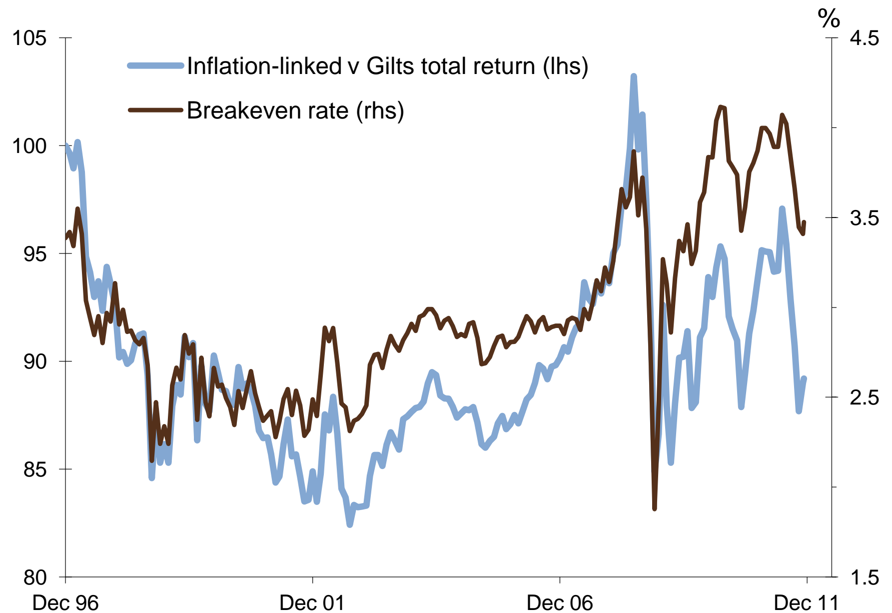
The main concern with deflation is that it works more easily on prices than on wages. This was famously – and disastrously – seen in the United Kingdom in 1925, when the decision was taken to return sterling to the gold standard at pre-First World War levels. This pushed prices downwards, but wages failed to follow as people were reluctant to take pay cuts.

So should we worry about deflation? Perhaps – but the issue is not as clear cut as it might appear at first. Falling prices do not necessarily cause economic collapse. Whether they *reflect* other problems in the economy – such as a lack of consumer confidence – is a different issue.

Quantitative easing

The benign outlook for inflation in the UK and excess capacity in the economy suggests that the recent decision by the BOE to pursue another round of QE poses little immediate danger of stirring inflation. The theoretical risk is that the increase in money supply will push up prices if money supply grows much more rapidly than GDP (more money chasing the same amount of goods). This is probably a greater risk for the US than it is for the UK as two rounds of Fed quantitative easing have resulted in a much greater increase in the money supply. Another problem with QE is that by intervening in the publically traded market for government debt, as opposed to simply setting benchmark interest rates as central banks traditionally do, they distort prices and so muddy the signals markets may be giving to investors. But compared to the hoped for boost to the economy from QE these costs are probably reasonable.

Exhibit 4 – Gilt and linker relative returns



Source: Bank of America Merrill Lynch, J.P. Morgan Asset Management. Data as of 6 December 2011.

Investment outlook

As breakeven inflation rates have fallen over the last six months, from over 4% in June to just 3.5% today, inflation-linked bonds (linkers) have underperformed Gilts (see **Exhibit 4**). With the poor outlook for growth in the UK, and the inevitable spillover of the eurozone crisis to UK exports, inflation expectations are likely to continue falling. This suggests Gilts are the better investment choice, but neither asset class offers particularly attractive returns. Ten-year Gilt yields are at their lowest level since they were first introduced in the 1950s, while yields on linkers are negative. Investors may feel confident that the UK government is a credible counterparty, but they are paying for that assurance in the form of low returns. We expect Gilt yields to rise over the next year as risk aversion due to the eurozone crisis falls, UK GDP growth slowly improves, and the latest round of QE ends. Similarly, yields on linkers are unsustainably low and should return towards more normal levels. Investors will need to look elsewhere for real gains for their portfolios.

Conclusion

Inflation, both its measurement and its effects, is complex. The appropriate response from central bankers and investors depends on a clear understanding of the sources of inflation. For central bankers, the biggest risk stems from wage or GDP growth leading to ever rising price levels, ultimately damaging the economy. Fortunately for investors, who worry about falls in the real value of their portfolios, the current risk of inflation is perhaps less than is widely perceived. The bigger challenge is to find yield.

Paul Sweeting, *managing director,* is European head of J.P. Morgan Asset Management's Strategy Group, based in London. An employee since 2011, he is responsible for providing institutional clients with tailored advice, analysis and education about various aspects of asset allocation, risk management and investment strategies. Paul published a book called "Financial Enterprise Risk Management" in 2011. Before joining the firm, he held a full time post at the University of Kent as professor of Actuarial Science, a role he continues to hold on a part-time basis. Prior to this, he worked at Munich Reinsurance and at Fidelity Investments, where he was director of Research at their Retirement Institute. Paul holds a Bachelor's degree in Economics from the University of Bristol, a Master's degree in Actuarial Science from Cass Business School and a Doctoral degree in Finance, also from the University of Bristol. He is a fellow of the Institute of Actuaries, of the Royal Statistical Society and of the Chartered Institute for Securities and Investment, and a CFA charterholder.

Dan Morris, *vice president,* is a strategist responsible for delivering market analysis and insight to clients in Europe and Latin America. Prior to joining J.P. Morgan Asset Management, Dan was the Senior Equity Strategist at Lombard Street Research and before that part of the Institutional Investor-ranked portfolio strategy team at Banc of America Securities in New York. Dan began his career covering Latin American equity markets at BT Alex. Brown and Dresdner Kleinwort Benson. He holds an MBA from the Wharton School and a Masters in International Relations from John Hopkins' School of Advanced International Studies. His undergraduate degree is in Mathematics from Pomona College and he is a CFA charterholder

Follow **@JPMAM_UKAdviser** on

Visit **jpmorganassetmanagement.co.uk**

For professional investors only. Not for retail use or distribution.

Any forecasts, figures, opinions or investment techniques and strategies set out, unless otherwise stated, are J.P. Morgan Asset Management's own as at the date of the document. They are considered to be accurate at the time of writing. They may be subject to change without reference or notification to you. The views contained herein are not to be taken as an advice or recommendation to buy or sell any investment and the material should not be relied upon as containing sufficient information to support an investment decision. It should be noted that the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yield may not be a reliable guide to future performance. Changes in exchange rate may have an adverse effect on the value price or income of the product. Investments in smaller companies may involve a higher degree of risk as they are usually more sensitive to market movements. Investments in emerging markets may be more volatile and therefore the risk to your capital could be greater. Further, the economic and political situations in emerging markets may be more volatile than in established economies and these may adversely influence the value of investments made. You should also note that if you contact J.P. Morgan Asset Management by telephone those lines could be recorded and may be monitored for security and training purposes. J.P. Morgan Asset Management is the brand name for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. Products may not be authorised or its offering may be restricted in your jurisdiction.

Issued by JPMorgan Asset Management (Europe) Société à responsabilité limitée, European Bank & Business Centre, 6 route de Trèves, L-2633 Senningerberg, Grand Duchy of Luxembourg, R.C.S. Luxembourg B27900, corporate capital EUR 10.000.000. Material issued in the United Kingdom are approved for use by JPMorgan Asset Management (UK) Limited, 125 London Wall, London EC2Y 5AJ, England. JPMorgan Asset Management (UK) Limited is authorised and regulated by the Financial Services Authority. Registered in England No. 01161446. Registered address: 125 London Wall, London EC2Y 5AJ.