

**Blog November 9<sup>th</sup> 2016**

**This blog is in two parts. Part 1 discusses the possible consequences of a return to higher levels of inflation. Part 2 'Brexit Broth' will look at what we have learned since June 23rd on how the negotiations might develop.**

### **Part 1 - Inflation Creeps In**

Inflation was the curse of the UK economy during the 1970s. During the early 80s, it fell back to single figures, and has remained low ever since.

Now, inflation may be about to return. Our attention is being pulled this way and that, between Brexit and the US election, but inflation may end up influencing our economy and markets more than either of these terrible twins.

Consumer price inflation rose sharply in September – to just 1.0%, but it is likely to go up a lot further in the coming months.

We are experiencing inflation from two different sources at the same time. The **first** is global, caused mainly by rising commodity prices. A five-year slump in the prices of 'hard' commodities such as iron ore, copper and coal, appears to have ended earlier this year. Prices are rising partly because, when prices fall, producers mothball mines that aren't profitable at lower prices, and the market tightens as falling supply catches up with falling demand.

Demand is rising again because China is trying to stimulate its economy through large infrastructure projects such as 'One belt, one road', which aims to improve communication links between China and its neighbours to the west. Governments everywhere are coming round to the view that they can stimulate their economies better through promoting infrastructure schemes – much-needed in most areas – than by relying on central bank interest rate policies and QE. Roads, railways, bridges, sewers, power plants - all these schemes will use commodities.

Inflation numbers always compare today's prices with those of a year ago. Hard commodity prices hit bottom early this year, and the same time as the oil price, so inevitably, inflation will be higher in around three months' time than it is now.

The **second**, unrelated cause of higher inflation is the direct result of Brexit. Sterling has fallen by around 20% since the vote, so anything we import costs 20% more than it did before June 23rd. Someone has to pay the higher price, either the manufacturer, the importer, the retailer, or the customer, and possibly all four. The 'Marmite war' that broke out recently between Unilever, producers of Marmite, and Tesco, who stock it, is an example of the struggle to decide who bears the brunt of the price increases. Retail price inflation is bound to rise unless the manufacturer, the importer and the retailer absorb the entire price increase between them. That won't happen, and we are already seeing prices rising in the shops and at the pumps.

Will inflationary pressures continue? Commodity prices will probably go on rising, because they are cyclical and the cycle has turned up. This current cycle is likely to be on a smaller scale than the previous 'super-cycle', but is underpinned by the fact that the world's population is still growing quickly, living standards across the world, in aggregate, are rising, and there is a global need for infrastructure building and repair. In the US, new President Clinton would introduce an infrastructure package at an early stage. New President Trump would increase infrastructure spending 'by at least twice as much' as new President Clinton. Whoever wins, their plans will include the purchase of oil, copper and steel.

UK domestic inflation is a one-off, caused by the fall in Sterling, which may already be almost complete, but the effects will take months to work through fully into retail prices. If the shock of Brexit causes a recession, as some economists predict, then the upward inflationary pressure could be offset by lower demand in due course, but the price rises will come first.

Taking all the above into account, economists expect inflation to rise next year. The Bank of England predicts 2.7% by the end of 2017, while the NIESR (the National Institute of Economic & Social Research) is looking for a punchy 4.0%. Economists expect that inflation will then drop back to lower levels, near or below the Bank of England's target 2.0%.

Economists are, on the whole, not very good at predicting inflation, and central banks are, on the whole, not very good at controlling it. For most of the 1970s inflation stayed stubbornly in double figures, despite strenuous efforts to bring it down, and more recently, inflation has stayed stubbornly at almost zero, despite strenuous efforts to push it up. What we are seeing could be a blip, or it could possibly turn into something more significant.

### **Interest rates**

The classic remedy for rising inflation is to raise interest rates.

We know that there will be no interest rate rise next year whatever happens to inflation. Classically, inflation is caused by excessive demand within the economy, and higher interest rates are a way of containing it. Neither of the two present drivers of inflation is caused by excessive demand within the UK economy, so neither can be controlled by raising interest rates. Commodity price rises are a worldwide phenomenon, while the pound's fall reflects the uncertainty triggered by the referendum result.

Besides, Mark Carney, the Governor of the Bank of England has said he won't raise interest rates. He is much more worried about the fragile state of the UK economy (though the economy has, till now, been a good deal less fragile than he expected) than a bit of imported inflation. He has cut interest rates since the referendum, and has said he is prepared to cut them again.

### **What happens if inflation rises to 4.0%?**

If inflation rises to 4.0%, and the cost of borrowing doesn't rise, life becomes easier for borrowers. The biggest borrower of all, the UK government, benefits hugely. If you have £1.5 trillion of debt, 4% inflation reduces the real value of your debt by £60bn a year, roughly the amount of the current budget deficit. Over ten years, the real value of your debt drops by a third.

The best time to borrow money is when the cost of borrowing is lower than the rate of inflation, as it will be next year.

Central banks have been using QE (Quantitative Easing) for the last eight years to keep interest rates low and encourage borrowing. The policy has failed, because for most people the experience of the Crisis was so traumatic that they don't want to borrow money, however cheap it may be. It is possible that higher inflation may succeed in encouraging borrowing, where the central banks have failed. This change would be unlikely to happen overnight, and possibly not at all if inflation falls back below 2% as predicted.

### **Investing in a higher inflation environment**

Under QE, central banks buy up huge quantities of government stock, thus boosting its price to extreme levels. A few weeks ago, the lucky owners of UK government stock due to mature in ten years' time (the 'ten-year gilt') could look forward to annual returns at a princely 0.75% per annum. When inflation is 0%, such a rate of return is just about tolerable, particularly if you are a risk-averse institution such as a pension fund. At 4% inflation, you are making guaranteed returns of minus 3.25% a year. Gilts pay you a fixed rate of interest, and return your original capital at maturity. They give you no protection whatever against inflation. A logical response to rising inflation is to sell gilts, and that's just what has begun to happen over the last few weeks.

The situation is no better for investors with money on deposit. Interest rates on deposit accounts won't rise to compensate you for higher inflation. You will continue to receive zero interest, and your capital will be losing spending power too. A logical response to rising inflation is to reduce cash holdings.

### **How to protect savings against inflation**

Shares and commercial property can protect you against inflation, because most rental agreements have inflation-linked rent rises built in, and companies can raise their dividends as profits increase.

In 1979, I was working for a trading company. During the year, the cost of all our bought-in stock rose by 10%, so we just put all our prices up by 10%, which restored our profit margins, and gave us extra profits on all the stock we'd bought at the lower prices. Amazingly, hardly anyone complained.

What's to stop companies putting up their prices now? If inflation pushes up the cost of the goods they are selling to you, they need to pass those increases on. In practice, price rises are easier to achieve for some companies than for others. The most ideally placed companies are those who sell products that you need to have, can easily afford, can't defer buying, and can't replace with cheaper alternatives. Those companies are said to have 'pricing power' – they can pass price rises on without losing sales. Less fortunately placed companies must bite the bullet of lower margins, worried that if they raise prices, they will lose sales, and end up even worse off.

Life appears to be easier for service companies, who aren't relying on buying goods from abroad, but they will come under pressure too. Their highly-trained staff will begin to complain that the buying power of their salaries is being eroded in these conditions of higher inflation, and will threaten to leave if they don't receive inflation-beating pay rises. The

companies will be left with higher wage bills, and the same decision over how much they can get away with passing on.

Investors have responded to the referendum by rewarding exporters, who benefit from the lower pound with sales that are higher in sterling terms, while punishing companies who sell their wares into the UK market. However, the situation could be more complex and nuanced than this. For example, shares in most retailers and in leisure sector companies like Marston's have been weak. Next year, because of weak Sterling, is likely to be a record year for inward tourism into the UK. You might wonder what all these tourists will do. Might they not visit the shops, and possibly stop off at a pub? Commercial property company shares have been weak in anticipation of the recession that we may be going to have. However, UK property has become much better value for overseas investors, and business is brisk. Since June 23rd, the property markets, in both commercial and residential property, have been notably resilient.

### **Pension deficits**

In the 1990s, nearly all UK companies used to offer a final salary pension scheme to their employees. Today, all private sector schemes have closed. Final-salary schemes have become too expensive to run. The main culprit is an accounting anomaly which links the amount companies must pay into their schemes to the yield on UK gilts. QE has pushed gilt yields down to all-time low levels, and in doing so has killed off the final salary pension schemes, leaving closed, legacy funds behind. However, falling gilt prices, which we have begun to see, mean higher yields, and higher gilt yields make pension deficits disappear, reduce the payments companies are compelled to make, and free up capital for more productive investment.

Companies with big pension deficits benefit from higher gilt yields.

### **Where next for the stock market?**

Most expert commentators on the investment markets are firmly of the opinion that we are late in the economic and market cycles, and that a downturn is imminent. It's true - if you date the current bull market from March 9th, 2009, this has been a very long up-cycle, and, judging by the length of previous bull markets, should end soon. However, market gains during this period have been glacially slow. On Friday November 4th, the FTSE-100 index closed around 2% lower than where it was three-and-a-half years earlier, in May 2013. In other words, the market has spent the second half of this 'bull market' going down.

Furthermore, the current market doesn't behave or feel like a bull market top. It is said that bear markets ignore good news, while bull markets ignore bad news. Today's investors appear mesmerised by the sheer volume of bad news – low levels of growth, the increasingly fraught nature of public debate, a Trump presidency, rising interest rates, a Chinese banking collapse, Brexit, the increasing instability of the Euro zone, and global warming. A sure sign of the top of a bull market is when most investors expect the market to rise further. How many people do you know who've enjoyed the gains of this year, and are confidently expecting more? When was the last time someone gave you a share tip over the dinner table?

Sooner or later, the FTSE-100 index will break decisively upwards through the 7,000 level which has contained it since 1999. The last seventeen years look like a huge consolidation pattern, following the astonishing gains of the 1980s and 90s. The FTSE-100 reached 7,000

at the end of 1999, then halved. In 2007, it almost reached 7,000, then halved again during the Crisis. Since then it has almost reached 7,000 on several occasions, and actually breached it twice, most recently last month. Each time the stock market fails to reach 7,000, the fall is shallower (last winter's sell-off being an exception) and the subsequent recovery faster than the previous time.

The next significant move may therefore be upwards.

The bull market of the last fifteen years has been in gilts. The gilt and investment-grade corporate bond markets look and feel like a market top. Prices are grossly inflated, but no one seems to mind because prices can only go up, and are expected to be supported if they don't.

### **But surely, if gilt prices fall, then shares must fall too?**

This is a valid argument, and in a normal cycle, that's exactly what would happen. The cycle ends with elevated levels of economic activity, leading to shortages. Prices rise. The authorities raise interest rates, making gilts, whose interest rates are fixed, less attractive, so their prices fall to restore the yield relationship with cash deposits. This in turn makes shares look over-valued, and they fall too, anticipating more difficult recessionary times ahead.

But this isn't a normal cycle, because the yield relationship between gilts and shares has broken down. Gilt yields could double without dividend yields looking unattractive. In the last few weeks, ten-year gilt prices have fallen by around 5%. They need to fall by a further 15-20% to become investable again on their merits, without central bank support. This readjustment would not happen without turbulence in the stock market, but afterwards, I would expect share prices to recover quickly.

### **Conclusion on inflation**

I was a student during the high inflation years of the 1970s. One day, a couple of weeks before my finals in 1974, I decided to fortify myself with a Mars bar from the newsagent's shop downstairs. The Mars bar was remarkable for the fact that its original price sticker, four and a half p, had been partially covered over with another sticker, saying 5p, and then another saying five-and-a-half p, which was what I paid. Inflation at the time was running at around 20%.

I'm not suggesting that we will return to the inflationary conditions of the 1970s any time soon, if at all, but it is worth bearing in mind the possibility that the coming inflation could turn out to be more significant than is implied by forecasts of a modest rise to 2.7%, returning quickly to almost zero.

Inflation changes the game for investors. We need to be aware that the conditions we have become used to in financial markets since the crisis, may be about to change.

### **Brexit Broth**

**The soup – are we all in it together?**

**Is the whole continent in the consommé?**

As part of the Government's new initiative to revive the economy through infrastructure spending, a railway has been commissioned – the Brexit Line. The Brexpress will run at ultra-high speed along this railway, calling at all stations along the way - 'Nobrexit', 'Softbrexit', and 'Hardbrexit', before crashing into the buffers at 'Brexit Terminal'.

In real life, it is remarkable how quickly we have moved along the Brexit line. Before June 23rd, most of us looked no further than Nobrexit, believing that common sense would prevail. After a brief halcyon period of Softbrexit, we reached Hardbrexit at the Tory conference, when it became clear that our new leaders intend to prioritise the control of our borders over trading relationships with the EU.

One might have thought that the best approach to the negotiations from the British side would be a low key one. Theresa May could have been rather apologetic in a very British way, explaining to our European partners that Leave only won by the narrowest of margins, that David Cameron would never have called the referendum if he had thought Leave had the least chance of winning, and that now we would have to go ahead with it, but would do our best for all parties including most of all them. Mrs. May could have explained that she fully understood how crowded the EU agenda already is with contentious matters such as the refugee crisis, and said how sorry we all are to have to add another item which could have been avoided altogether if only...etc. Furthermore, the UK, to her deep regret, is not even ready to begin negotiations, but we'll rustle up a team just as soon as we can, full of good-hearted chaps who will of course respect the expertise of the professionals on the EU side. This approach might possibly have had a faint chance of evoking a positive response.

With regard to Brexit, Mrs May's approach has been rather more strident. We all know that the free movement of people is one of the four basic freedoms enshrined in the EU constitution, and that the option of controlling our borders while at the same time being members of the Single Market has been clearly ruled out, but Mrs. May appears sure that she can have both. She irritatingly insists that Brexit should be at the very top of the EU's agenda. She talks as if the decision to leave the EU was unanimous, which it wasn't. Her oft-repeated statement that 'Brexit means Brexit' is meaningless. There are an almost infinite number of possibilities for the final shape of Brexit, and perhaps every Leave voter had a slightly different version in mind. Already the farmers, who voted Leave, have said that without an influx of non-EU migrant workers, they will have to leave crops to rot in the fields, for the lack of anyone to gather them in. EU nationals have been leaving the UK following the vote.

Already, long before negotiations are due to begin, attitudes are hardening. Senior EU officials have made a number of strongly anti-British comments. The UK 'must be made to suffer' for its decision, says M. Hollande. The Government may be able to overturn the ruling that Parliament must be allowed to vote on the terms of the negotiations, but if the ruling stands, the – overwhelmingly pro-EU – House of Commons will be able to slow the process down still further. It has taken almost ten years for the EU to negotiate a treaty with Canada, which was in the end almost blocked by the tiny Walloon parliament.

Perhaps Mrs. May's attitude reflects a concern for the more challenged sectors of society, as she said in her opening speech as Prime Minister. As a true One Nation Tory, she aims to address the concerns that the Leave vote expressed. Her speeches reflect a desire to let the Leave side know that she is committed to delivering what they've voted for, while letting the

EU know that she means to negotiate the best possible terms for the UK. But her main achievement so far has been to create resentment among Remain voters and in the EU.

The events of the last four months suggest that the process of negotiating Brexit is likely to be a prolonged and difficult one. I am not sure that our Government's approach is going to make it any easier.

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**Please note – this blog contains the personal opinions of Tony Yarrow. It is not intended as financial or investment advice, and does not contain recommendations to buy or sell financial assets.**