J O Hambro
Capital Management Group

News

Confounding Inflation

Are we overly pessimistic on the underlying resilience of the UK economy? Are we reading too much into headline inflation and over-discounting more positive data?

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Markets would have us think high inflation is here to stay. Commentators conjure an image of an insidious disease, specific to the UK and resistant to the Monetary Policy Committee's (MPC) increasingly aggressive interventions. But we think the only disease that pervades our markets is economic pessimism, the very British response to uncertainty and a defence against disappointment: if you always expect the worst, you'll never feel let down.

Contrary to this downbeat consensus, we think inflation has peaked and that halving it down to about 5% should be achievable by roughly the end of this year. Halving that again will admittedly be more difficult.

Inflation in the UK

One of the reasons why UK inflation has been disproportionally higher than in other economies is simply because we're more dependent on external energy sources. That means we imported a lot of inflation through energy, but we're about to see a big step down there as the latest price cap comes into force. A reduction in energy prices should lead to a fall in food prices, which will support lower inflation too.

The MPC has an important role to play, but there's a potential for policy errors if it focuses entirely on the rearview mirror. Markets are discounting four or five more rate rises but we think that's overblown. Two more rises of 0.25% seems realistic to us. Inflation is falling already and will fall further, even if

the MPC does nothing. There's also a delay in the transmission to consider as the proportion of five-year-fixed-rate mortgages has risen from 20% to 50% in the past decade. The media clambering for short-term action is not helpful.

The future seems to be bright-ish

The UK economy is not as bleak as is made out. Let's look at the recent labour report. It showed that unemployment has fallen and that workforce participation has risen. It turns out those that took early retirements during Covid have realised their bank balances weren't up to it, and the huge influx into higher education we saw at the same time is now lessening as those that started retraining in 2019 have qualified in their new fields. This means the supply-side issues aren't as bad as some analysts would have you think.

We've also got £280 billion unspent savings which have accumulated since Covid, so we've got full employment and a healthy safety net of savings, which explains why companies like Next have recently published sensational results.

Currency is a pretty good reflection of global sentiment, and we're at a one-year high against both the US dollar and the euro, with sterling at $1.28 and €1.17. Inflation is coming down significantly in Continental Europe and the US, which will help to reduce our imported inflation. This isn't the same situation as last autumn, when bond yields were at the same levels, but sterling was threatening parity against the dollar. It's still early days, but there's plenty about the UK economy which is moving in the right direction and that will help at the margins.

Equity income works well in this environment

For years we'd had a low inflation, low interest rate environment, and that served growth stocks very well as they rely on very low discount rates. Now the tables have turned, and value stocks are having their time in the spotlight. Although inflation is coming down, it won't be 2% anytime soon so investors need balance in their portfolios, and our equity income fund has value as a natural bias.

Financials clearly do better in a higher interest rate environment. We're also anticipating a rise in corporate derisking and a doubling in the bond purchase annuity market over the next couple of years. Plus, corporate pension schemes are no longer in deficit because interest rates have gone up and we think that will lead to structural growth. It's for these reasons we have significant exposure to financials.

Finally, you may ask, with bond yields at 4.5%, why should I buy equity income over a bond fund? Equities provide a natural hedge against inflation which the nominal bond simply cannot provide. That's because a company's revenues and profits grow with inflation – which is why corporate earnings have held up as strongly as they have. Companies pass on price increases, which doesn't necessarily expand their margins, but it does mean their revenues have some protection. And importantly, it supports the capital value of your investment.

The yield on the JOHCM UK equity income fund for calendar year 2023 is roughly 5.7%. Since we launched the fund 20 years ago, we've grown the dividend stream by 9% per annum on average. It's fair to say a starting yield of 5.7%, growing at the rate of high single digits, ought to provide better protection against inflation than a bond fund with a coupon which doesn't grow at all.

Sources: JOHCM/FTSE International/Bloomberg (unless otherwise stated)

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