



News

The Way Past Peak Inflation

Signs of an easing in inflation, and a peak in interest rates, should support a recovery in equities, with UK value sectors looking attractive



James Lowen



Clive Beagles

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Something unusual has happened. In 30 years, the only thing that has shaken the bond market has been central bank activity. Big real-world events – systemic risk, geopolitical conflict, pandemic – do indeed move bond yields, but by far the most important event is a move on interest rates by the central bank.

But then, in mid-November, the Federal Reserve did nothing and said nothing, but the yield on the 10-year Treasury fell 35 basis points. For context, that's more than the fall following the 9/11 attack on the Twin Towers.

The trigger was a decline in the US CPI, which rose 0.4% in October, the same monthly increase as September and 20 bps below the consensus expectation of 0.6%. The 12-month number was down 50bps, coming in at 7.7% for October, compared to 8.2% in September, the first time it came in below 8% since February and down from a high of 9.1% in June.

Associated data were encouraging. There were falls in prices for gas utilities and goods ex food and fuel. Among key US trading partners, inflation is strong in Europe, the crucible of the energy crisis, but in Asia, in China and Japan, inflation is still low single digits, suggesting the potential to import disinflation as China re-opens.

Are we past peak inflation? The data is still mixed. In contrast to the US, consumer price inflation in the UK and across Europe, in many ways the crucible of global inflation, remains strong and may climb higher.

Investors seem ready to hope. The fall in yields flowed immediately into the foreign exchange market. The dollar weakened, pushing sterling materially higher, from a trough of \$1.07 on 27 September to where it is now, scraping \$1.20, as high as it has been since August and well above \$1.13, where it was on the night prior to the Mini Budget.

The UK stock market closed a little lower on the day of the inflation report but rose through the following days. The upward drift in fact goes back to September and the replacement of Liz Truss with Rishi Sunak. More striking, and more important, is the material shift in the underlying mix of what is driving performance.

Inflation changes everything. When interest rates are at or near zero, or even negative, investors become less interested in immediate cash returns and more concerned for long duration capital growth. But if prices are rising and interest rates are meaningfully positive, short duration cashflow becomes important.

This was the logic of the move from growth to defensives as inflation emerged and rose through the winter of 2021/22. The switch was rapid, with Russia's invasion of Ukraine adding to the mood of panic and uncertainty. Making matters worse, few market participants – or any at all? – have direct experience of running money in an inflationary environment, never mind how to respond to war in Europe.

The shift was rapid, and extreme. At its peak, a quarter of the value of the UK stock market lay in just seven stocks, all mega-caps in ultra-defensive food, alcohol, drugs and tobacco. The panic may have come off the boil but it is certainly still simmering. In-favour Astra Zeneca has a price/earnings ratio above 95x. Out-of-favour Barclays, hardly a candidate for imminent collapse, has a PE under five. UK banks altogether are on a PE of 8.2x, compared to pharma and biotech on an average of 34.5x. Mining stocks are on 6.47x, beverages on 25x.

The question now is whether inflation is likely to subside or to worsen. And in the meantime, if we fall into recession, how severe it will be.

We are already seeing a softening of the underlying drivers. There is no meaningful shortage of fossil fuels and as logistical issues have started to resolve themselves, for example, in Europe, sourcing liquified natural gas (LNG) from the US rather than in pipes from Russia, energy prices have fallen. OPEC+ is likely to continue to suppress production but there are other supply options and price manipulation has rarely if ever lasted for long in the past. Prices are still above their long-term mean but they are well below where they were prior to the Russian invasion and drifting down toward the upper edge of their five-year variance. A point to watch will be the EU's attempt to impose a price cap on Russian seaborne crude.

The other driver has been broken supply chains. The pandemic and ongoing stringent zero-Covid policy in China have created delays and scarcity in goods that were plentiful until recently. This too is easing, and goods are starting to flow again, if not yet normally at least more promptly than at the worst of the global lockdowns.

As supply of energy and goods recovers, inflation should ease. Producer prices are already falling and according to Moody's Analytics global inflation is on its way down. November inflation in Germany was 11.3% annualised vs 11.6% in October, and in Spain it was 6.6% annualised vs 7.3% in October. The Bank of England, somewhat surprisingly, is forecasting inflation back below 2% by 2024.

Despite the Bank's apparent confidence, or over-confidence, in our view we are unlikely to go back to the world as it was in 2019, prior to the pandemic. China's more assertive geopolitical stance, including its support for Russia, has chilled relations with key developed markets, including Japan, Germany, the UK and, of course, the US. And while energy prices are likely to continue to decline, Russia, accounting for 10% of world supply, is expected to be out of the market for many years to come, suggesting the days of limitless cheap energy are behind us.

A recession in real terms is almost certain, but equally unlikely in nominal terms. This matters. Many

companies are likely to have the pricing power to maintain or even to increase their nominal revenues, protecting their operating margins and even growing profits. This will be a very different experience to historic recessions, when nominal and real growth both contracted.

Our view is that inflation may worsen in the short term but in the medium to longer term it will moderate, settling somewhere in low to middling single digits. Investors will start to take a calmer view, winding down expensive ultra-defensive positions in favour of a stance biased more toward cyclicals and stocks and sectors that benefit from higher interest rates, such as financials, or that can push through price rises or benefit from recovery. The UK equity market, with its concentration of world-leading stocks in value sectors such as consumer staples and healthcare, may turn out to be a key beneficiary.

(1) <https://www.ft.com/content/85498afc-43d3-4525-bee0-7ea7c6c05b34>

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