Heartwood
Investment Management

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Investment Insight

Weekly Insight

Fears of deflation deflate

Headline inflation rates saw a marked rise in September in both the US (1.5% year-on-year) and the UK (1% year-on-year). Ten- and thirty-year government bond yields in the US and UK have traded back to their pre-UK referendum levels, reflecting the stronger inflation picture, stable commodity prices and questions around the effectiveness of central bank stimulus policies.

Higher yields are welcome news to many investors, including ourselves, who for some time have viewed developed sovereign bond markets as unsustainably expensive. We were not subscribers to the 'deflation' view of the world, which has dominated investors' concerns over the past year, and we expect the base effect of higher energy prices to feed into prices over coming months. It is worth noting that in September 2015 oil prices had fallen by nearly 50% from the previous year. In contrast, the year-over-year comparison today is broadly stable. If oil prices remain around current price levels in the next few months, year-on-year comparisons from the lows in January and February 2016 have to exert upward momentum on headline rates in early 2017. The base effect would be clearly seen in the US, where energy comprises 7% of the CPI basket.

The Fed now has flexibility to increase interest rates

Food and energy prices tend to be volatile and that is why markets ascribe attention to the core inflation rate, which excludes those items. US core inflation has remained consistently above 2% year-on-year since November 2015, primarily due to two factors: 1) higher medical costs – a part consequence of the Affordable Care Act – and 2) higher housing costs. Housing is the largest individual component, comprising around one-third of the US CPI basket, and has experienced rising costs for some time compared with other goods and services. Increasing rental growth has been mainly due to falling rental vacancy rates, which have declined from a high of 10.6% in 2010 to 6.7% as at the end of the second quarter in 2016 [Source: US Census Bureau].

While we expect US inflation to drift moderately higher towards the Federal Reserve's target of 2%, price pressures are unlikely to accelerate meaningfully. US economic growth remains low relative to history, and this is containing wage pressures amid sluggish corporate profitability. However, the latest US inflation data does provide the Federal Reserve with flexibility to increase interest rates by year end and continue to tighten monetary policy in 2017. Furthermore, despite a surprise fall in consumer inflation expectations in September due to US presidential election uncertainty, market-based measures of US inflation have been trending higher.

Sterling's devaluation complicates the Bank of England's job

The UK inflation outlook, meanwhile, is being distorted by sterling's devaluation. It is too early to attribute September's inflation rise to sterling's depreciation; it has largely been explained by less discounting among retailers. Looking ahead, a weaker sterling will lead to higher inflation over the next few months, though to some extent mitigated by falling demand as the impact of Brexit weighs on spending decisions. Nonetheless, market-based measures of inflation have moved more than 50 basis points from the recent low at the end of July and are now above 3.5% (UK five-year, five-year UK inflation swap rate). Higher inflation expectations will no doubt present challenges for Bank of England policymakers who are looking to ease policy to support the economy and, at the same time, maintain price stability. Recent comments have suggested policymakers' willingness to overlook a modest overshoot of the Bank's inflation target of 2%.

Clear Thinking

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As UK gilt yields rise, we may take advantage of these moves depending on their magnitude, and consider rolling up the curve as some of our shorter-dated bonds mature. Developed sovereign bond markets remain expensive on a historical basis and we expect US and UK yields to drift moderately higher. However, the current environment is atypical. Relatively low interest rates and low rates of growth are likely to persist unless we see a significant policy change, such as huge fiscal stimulus; and that seems a small probability at this point.

David Absolon
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