

# weekly digest

Week ending 16 October 2016

global investment management

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## **Marmite this be the start of inflation in the UK?**

Consumer goods producer Unilever and retailer Tesco had a very public spat last week over the suggestion that the former's prices needed to go up to reflect the impact of a weakened sterling on input costs. Since the surprise Brexit vote sterling has fallen 16% on a trade weighted basis implying that the UK's imports have become more expensive. This, coupled with an increase in dollar terms of 35% in oil year to date (which translates to over 60% in sterling terms), suggests that the UK should expect to see growing inflationary pressures such as these in coming months.

Should inflation pick up it allows the Monetary Policy Committee of the Bank of England (BoE) far less wiggle room than it has become used to in recent years: the BoE has been able to keep its foot hard on the accelerator with ever looser monetary policy because inflationary fears have been modest of late. Were inflation to pick up it would put the committee in something of a quandary, especially if economic growth remains relatively meagre and fragile as strictly speaking the BoE should start to raise rates to stop the inflation rate exceeding the 2% target. Over the recovery period post financial crisis central banks globally have been relatively relaxed with respect to inflation overshoots because growth has been poor and inflationary pressures have been transitory in nature. The BoE Governor, Mark Carney, suggested last week that he would remain sanguine for now, noting the committee would 'tolerate a bit of overshoot in inflation over the course of the next few years' in order to cushion the blow of an anticipated increase in unemployment. The UK's inflationary impulses, founded as they are on increased import prices and increasing energy costs, may also be transient because once the 'base effect' comes out in the wash then the force from price moves may dissipate. The risk in the UK, however, is that employment is reasonably solid and the squeezed consumer, who has had to put up with small (if any) real wage rises over the past few years, may simply demand greater wage increases which employers will struggle to push back on. In this case the inflationary forces become entrenched and self-fulfilling as inflationary expectations become embedded in wage inflation which again pushes up prices and so on.

More worrying for the UK is the spectre of stagflation, an environment where the economy stagnates but there is reasonable inflation. This is a painful period for consumers and while it does not have the ultimate consumption killer of deflation which encourages consumers to defer purchases which can be made at a lower nominal amount in the future, it will still be a knock to consumer confidence and squeeze either companies or consumers depending on which part of the consumption chain is forced to absorb any price increases.

We are also starting to see asset prices adjust to a higher inflation environment in the UK. Government interest rates are starting to drift up, causing falls in capital values of fixed income securities. Also other assets that have been used as an 'income play' as gilts were bid up are also starting to come under pressure as yields rise. Furthermore, the breakeven inflation levels, a gauge of inflation expectations, have reached their highest levels since 2014 this month and it is this combination of rising yields, falling sterling and rising inflation expectations that will likely cause the BoE to tread carefully when considering their next move.

If the BoE's Forbes is correct in his statement that we should expect inflation to overshoot its target 'sharply' over the next couple of years and that the days of 'inflation bouncing around zero are gone', this poses a significant risk for savers because even modest levels of inflation can significantly impact the real value of savings over the long term if nothing is done to protect against the ravages of inflation.

## The Marketplace

- Dollar strengthens as market prepares for Fed rate hike
- Inflation expectations rise in the UK
- Bond yields rise amid tapering rumours
- Chinese trade data disappoints, whilst inflation rises
- Eurozone industrial production beats expectations

## Market Focus

### US

- The minutes from the Federal Reserve's latest monetary policy meeting indicated that the committee is nearing readiness to raise rates. Indeed, FOMC member Rosengren stated that the market is pricing in an 'appropriately' high 66% probability of a rate hike in December.
- Monthly economic data supported expectations of a December hike, as retail sales printed in line with forecasts (+0.6% month-on-month), whilst headline producer price inflation was slightly higher than expected (+0.3% month-on-month against +0.2% forecasted).
- The dollar index rose 1.4% over the week whilst 10-year treasury yields rose by 7.9 basis points to 1.8%.

### UK

- Sterling continued its downward trend, falling 2.0% against the dollar to USD 1.22, bringing its month-to-date depreciation to 6.1%.
- Expectations of inflation seem to be rising: last Tuesday the five-year five-year forward breakeven rate reached 3.57%, its highest level since 2014. And comments on Friday from Bank of England governor Mark Carney that the bank "will tolerate a bit of overshoot in inflation over the course of the next few years" will undoubtedly continue to fuel such expectations.
- UK gilts and investment grade debt prices fell 1.3% and 1.0%, respectively.

### Europe

- On top of contagion effects from rising yields in the US and UK, European bonds continued to react to speculation over the potential tapering of the European Central Bank's bond purchasing programme ahead of its March 2017 end date. Euro government bond prices fell 0.2%, including 0.7% and 0.8% falls for German 20 and 30-year bunds, respectively.
- Meanwhile continental European equities bucked the trend by gaining 0.6%, while global equities stumbled. This was due in part to Eurozone industrial production data rising by 1.6% in August and rebounding strongly from a 0.7% contraction in July.

### China

- Chinese trade data, released on Thursday, showed exports falling 10.0% year-on-year in September, with imports only increasing by 2.2% after increasing by 10.8% in August.
- Inflation data was more positive, however, with consumer and producer price inflation for September both beating expectations: rising by 1.9% and 0.1% respectively year-on-year.
- The trade figures sent the Australian dollar, which is often viewed as a proxy for the outlook of the Chinese economy, lower by 0.6%. Equities were relatively unaffected, however, with the Shanghai Composite index rising 2.0% for the week.

Source: Bloomberg. Returns in US dollars unless otherwise stated.

James Klempster (CFA) & Oliver Bickley



Asset class/region	Currency	Currency returns			
		Week ending 14 October	Month to date	YTD 2016	12 months
<b>Developed markets equities</b>					
United States	USD	-1.0%	-1.6%	5.6%	8.6%
United Kingdom	GBP	-0.5%	1.7%	16.3%	16.1%
Continental Europe	EUR	0.6%	0.1%	-3.6%	-0.2%
Japan	JPY	-0.3%	1.8%	-11.1%	-6.3%
Asia Pacific (ex Japan)	USD	-1.9%	-1.0%	11.1%	9.0%
Australia	AUD	-0.6%	0.0%	6.3%	9.3%
Global	USD	-1.1%	-1.8%	3.6%	4.6%
<b>Emerging markets equities</b>					
Emerging Europe	USD	-1.9%	0.0%	14.7%	-0.4%
Emerging Asia	USD	-2.4%	-1.2%	11.6%	7.8%
Emerging Latin America	USD	1.7%	5.0%	38.8%	26.8%
BRICs	USD	-1.7%	0.8%	17.4%	11.1%
MENA countries	USD	0.2%	0.2%	-3.4%	-12.4%
South Africa	USD	-4.8%	-6.2%	15.3%	-6.1%
India	USD	-1.4%	-0.4%	8.6%	4.4%
Global emerging markets	USD	-1.9%	-0.7%	15.2%	8.1%
<b>Bonds</b>					
US Treasuries	USD	-0.3%	-1.2%	4.2%	2.7%
US Treasuries (inflation protected)	USD	-0.2%	-0.8%	6.8%	4.9%
US Corporate (investment grade)	USD	-0.1%	-0.6%	8.6%	6.9%
US High Yield	USD	0.1%	0.5%	15.7%	11.2%
UK Gilts	GBP	-1.3%	-2.9%	11.4%	10.2%
UK Corporate (investment grade)	GBP	-1.0%	-2.8%	10.5%	10.6%
Euro Government Bonds	EUR	-0.2%	-1.2%	5.1%	5.2%
Euro Corporate (investment grade)	EUR	-0.1%	-0.5%	5.5%	6.0%
Euro High Yield	EUR	0.3%	0.5%	7.6%	7.5%
Japanese Government	JPY	0.0%	-0.3%	5.1%	5.9%
Australian Government	AUD	-0.5%	-1.7%	5.2%	4.4%
Global Government Bonds	USD	-1.1%	-2.8%	7.7%	4.9%
Global Bonds	USD	-0.9%	-2.1%	6.9%	4.2%
Global Convertible Bonds	USD	-1.0%	-1.5%	1.5%	0.6%
Emerging Market Bonds	USD	-0.8%	-1.2%	14.4%	13.2%

Source: Bloomberg



Asset class/region	Currency	Currency returns			
		Week ending 14 October	Month to date	YTD 2016	12 months
<b>Property</b>					
US Property Securities	USD	1.1%	-4.3%	6.1%	9.2%
Australian Property Securities	AUD	0.5%	-3.7%	6.4%	11.8%
Asia Property Securities	USD	-2.3%	-4.5%	4.8%	2.9%
Global Property Securities	USD	-0.4%	-4.6%	5.8%	6.6%
<b>Currencies</b>					
Euro	USD	-2.1%	-2.4%	1.1%	-4.4%
UK Pound Sterling	USD	-2.0%	-6.1%	-17.3%	-21.3%
Japanese Yen	USD	-1.2%	-2.7%	15.5%	14.1%
Australian Dollar	USD	0.4%	-0.5%	4.5%	4.3%
South African Rand	USD	-3.0%	-4.2%	8.0%	-7.7%
Swiss Franc	USD	-1.3%	-1.9%	1.2%	-4.1%
Chinese Yuan	USD	-0.5%	-1.0%	-3.5%	-5.7%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	0.8%	1.4%	10.8%	-4.5%
Agricultural Commodities	USD	2.2%	2.1%	1.9%	-2.7%
Oil	USD	0.0%	5.9%	39.4%	5.7%
Gold	USD	-0.4%	-4.9%	17.9%	5.7%
Hedge funds	USD	-0.4%	-0.3%	0.8%	-0.2%

Source: Bloomberg

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