The emergence of inflation

UK
In the year to September, UK inflation, as measured by the Consumer Prices Index (CPI), rose to 1%, from 0.6% in the year to August. This is the highest level of inflation since November 2014. The main changes in the rate were rising prices for clothing, overnight hotel stays and motor fuels. Prices for gas, which were unchanged, having fallen a year ago, also affected the rate. The Office of National Statistics has suggested that the impact of the weakness in Sterling has yet to be felt. The expectations for inflation have naturally increased. Expectations for inflation in 2017 range from 3% to 5%. It must be pointed out that currently, inflation remains at low levels, although there should be a pick up in the upcoming months.

The decline in Sterling has led to British exports growth being at its highest level since 2014. The referendum vote to leave the EU has resulted in the Pound falling from $1.50 to $1.22 against the Dollar, which has made UK products and assets more attractive to overseas buyers. Analysts from Capital Economics have commented that, “The fall in the pound appears to be acting as a shock absorber by improving competitiveness”.

In a CBI Industrial Trends Survey, an economist stated, “Manufacturers are optimistic about export prospects and export orders are growing following the fall in Sterling”. The survey also stated that the weaker Pound was also feeding into costs, which are rising briskly and may well spill over into higher consumer prices in the months ahead.

A report from insolvency experts, Begbies Traynor, reported that the level of financial distress for UK businesses fell in the 3 months after the Brexit vote. The report found levels of ‘significant’ business distress was down 6% over the previous quarter. Begbies Executive Chairman, Ric Traynor, said, “While we want to see whether the government opts for a hard or soft Brexit strategy, businesses at least appear to be better placed to tackle any challenges on the horizon. The stronger the UK becomes pre-Brexit, the better it will be able to withstand any post-Brexit shocks.” The 3rd quarter saw a marked improvement in the building sector, where the number of distressed companies fell 11%. Professional services were also buoyant, with distressed companies down 10%.

In the 3 months after the referendum, the UK economy grew faster than expected at 0.5%, helped by strong service sector growth. Although this is slower than the 0.7% growth rate in the previous quarter, it was stronger than analysts’ estimates of about 0.3%.

US
The US economy continues to make positive progress with non-farm payroll employment increasing by 156,000 in September. The unemployment rate remains at 5%. There were job gains in the professional and services sector and the healthcare sector, however, the US Consumer Sentiment Index fell to 87.9 in October, which is well below the market expectations of 91.9, and compares to 91.2 in September. It is the lowest figure since September last year.

On a seasonally adjusted basis, inflation, as measured by CPI for All Urban Consumers, increased 0.3% in September, after rising 0.2% in August.

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Europe
Inflation is also picking up in the Eurozone, although admittedly from an extremely low base. Inflation, as measured by CPI rose 0.6% in September, up from 0.21% in August.

The European Central Bank (ECB) Lending Survey revealed that Eurozone banks are set to tighten corporate credit for the first time in two and half years, as they become wary of risk, with negative interest rates eating into their profits. The ECB’s ultra-easy monetary policy includes bond purchases (Quantitative Easing), loans to banks and a charge on deposits, which has fuelled a recovery in Eurozone lending, but banks’ margins have started to suffer. The survey also revealed the banks’ discomfort with the ECB’s negative deposit rate, which is effectively a charge on banks’ excess deposits with the central bank. In Spain and Italy there has been a fall in companies’ demand for credit.

There are serious question marks about Eurozone banks. One of the largest banks in Europe, Deutsche Bank, is in serious danger of requiring a bailout. Deutsche Bank, like Lehman Brothers is too big to fail.

Italy’s banks are also a serious concern in that they hold around €270billion of so-called “non-performing loans” - a third of the Eurozone’s total. The International Monetary Fund (IMF) has highlighted the Italian loan crisis as one of the biggest risks to Europe’s economy. One of Italy’s oldest lenders, Monte dei Paschi di Siena’s share price has collapsed due to fears over its future. Monte dei Paschi di Siena has a market value of less than £1billion - but has around £40bn of secured loans on its books.

Although there remains serious question marks regarding the Eurozone’s banks, economic activity, in October, has picked up sharply across the Eurozone and is expanding at its fastest rate so far this year. The Eurozone’s Purchasing Managers Index (PMI) rose to 53.7 in October, up from 52.6 in September. This is the highest level since December last year. Anything above 50 signals growth.

The PMI survey is showing signs that inflationary pressures are picking up, with the survey recording the largest increase in prices for more than 5 years. Growth and rising prices may fuel possible tapering of asset purchases (Quantitative Easing) by the ECB. Germany was the biggest engine of growth behind the PMI numbers. France also saw manufacturing hitting a 10-month high.

Japan
There has been positive news on the Japanese economy. The Flash Markit/Nikkei Japan Manufacturing PMI rose to a seasonally adjusted 51.7 in October, from 50.4 in the previous month. The economic activity expanded at the fastest rate since January. Japan’s manufacturers have benefited from new orders from overseas. Government data on exports and household spending suggests Japan’s economic growth was subdued in the 3rd quarter (July to September, so the PMI survey could point to acceleration in growth in the 4th quarter (October to December). The improving manufacturing conditions have led good producers to increase staffing levels, with the rate of job hiring up to a two and a half year high. Manufacturers have also benefited from lower cost burdens, as input prices declined in October.

China
Inflation in China has also risen. Inflation, as measured by CPI, rose 1.9% in September, up from 1.3% in August. Historically, this remains a low level of inflation. Between 1986 and 2016, CPI has averaged 5.44% per annum.

Oil Price
Oil prices have recovered, with the WTI crude oil currently priced at around $50 per barrel, having reached a low of $26 in February 2016. OPEC has announced a preliminary deal to cut oil production, which should naturally support global inflation.

Infrastructure
One other trend in the global economy is infrastructure spending. The demand for infrastructure spending in Asia and the developing markets is huge, whilst many of the developed economies, including the UK have exhausted monetary policy and are looking to increase infrastructure spending to boost their flagging economies. Infrastructure spending could push up global inflation.

Conclusion
Since the financial crisis, the global economy has been characterised by both low growth and low inflation, with many economists fearing actual deflation.

On the positive, the global economy does appear to be picking up, particularly in the UK, Europe and Japan. However, there are also clear signs that inflation is creeping back into the global economy, although inflation is starting at historically low levels and at this stage, it has a long way to go before it becomes a problem.

The situation within the UK is unique, in that weakness in the currency, in the short-term at least, is going to be the main driver for higher inflation. At this stage it appears it will be just a short-term spike, but it could become a more serious long-term problem.

Although global inflation is increasing, it is too early to say whether there has been a change in direction in the long-term trend for global inflation.

If expectations for inflation change, it could have an impact on the investment environment and the various asset and sector classes. Inflation, which has been dormant for so long, may resurface as an investment risk.

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