Weekly Digest

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The weekly insight into world stock markets

Investec
Wealth & Investment

Inflation Returns

Last week I promised to write about inflation, at least as long as nothing came along to make a stronger claim on this publication's space. The last few days in financial markets have turned out to be relatively quiet, so I can stick with Plan A. First, a quick recap on why I need to cover this subject. Fears of higher inflation are generally considered to have been the catalyst for rising bond yields and falling equity prices at the beginning of this month (I have attempted to explain the detail behind these moves in the last couple of weeks). The killer release was the US wage growth figure in January's employment statistics published on 2nd February, with annual growth jumping from an original 2.5% in December to 2.9%. The thought process from there was that higher wages, in the continued absence of productivity improvements, would force companies to raise prices to counter the pressure on margins. Those higher prices would themselves spur even higher wage demands, and before you know it we are back in a classic wage/price inflation spiral. This would force the Federal Reserve (Fed) to raise interest rates to choke off inflation pressures, but not before bond investors demand higher yields to compensate for the higher inflation risk. Higher interest rates and a slower economy could put a big dent in corporate profits, and those profits would be valued more cheaply thanks to a rising discount rate. Cue panic!

As you can see, it's very easy to create a simple linear narrative that takes us very quickly from all-time highs on the stock market to a bear market or worse. But, as is almost always the case, the reality is much more open to interpretation. I have been scouring all the available reports I can find and there is no consensus about this inflation threat. There are certainly signs that wage inflation is creeping up in the US, but the gains appear to be distributed more towards higher paid, more skilled workers who tend to be the most productive. Lower paid workers, who also tend to be those with a greater propensity to spend their higher incomes than save, are not yet seeing the same increases. There is also the effect of automation to be taken into account, where less skilled (and increasingly even more skilled) jobs can be taken over by machines – or I could use the word "robots" to be more emotive. Taken together, those pieces of data might suggest a more limited impact on corporate margins and less chance of boom demand conditions developing.

The emphasis here is very much on the US, which is leading the developed world in terms of its position in the economic cycle. It was first to take the medicine after the financial crisis, and the first to be wheeled out of intensive care. It ended Quantitative Easing in 2014 and started to raise interest rates in 2015. It is beating a path for others to follow. To add to the drama, US interest rates have a huge influence on setting the cost of capital for investors globally. The good news for equity investors is that the Fed itself, in a report to Congress last week, appears to be relatively relaxed, finding it "difficult to see much evidence of emerging supply constraints". Remember that the world's central banks have spent most of the period since the financial crisis trying to create higher inflation because deflation remains a much more serious threat in a world where high levels of debt persist. Are they really going to blink at the first sign of what is still a relatively subdued inflation threat relative to past experiences?

The jury remains out on the threat of potential wage inflation leading to higher consumer prices. Technology is the main factor here, too, with on-line retail innovation and greater pricing transparency keeping prices in check. These trends have even reached the previously price-insensitive funeral industry, with funeral director Dignity's share price languishing at one third of its level of only last November as it has had to cut prices aggressively in response to an on-line campaign drawing attention to its high charges relative to the competition. When a company has a debt-fuelled acquisition strategy based on the relative ease of raising prices every year, it's amazing how wrong things can go when the music stops.

Adding to the debate is uncertainty over whether or not inflation indices are being calculated correctly, given that the world is changing so fast. The UK's Office for National Statistics (sometimes cruelly referred to as the Office for Notional Statistics owing to regular miscalculations) recently owned up to having massively overestimated mobile phone package prices from 2010 to 2015. Whereas they recorded prices as flat, improved bundles – more data and texts, more voice minutes – effectively delivered 35% price deflation over the period. That would mean that inflation has been somewhat lower than published, and therefore real growth and productivity commensurately higher. Great news for anyone with index-linked income or investments, but aggravating for those with index-linked liabilities (think student debtors or rail commuters). There seems little chance of a revision to the indices currently, although it has been calculated that it would knock anywhere between 9 and 23 basis points off recorded inflation in each of those years – and that adds up.

Interestingly, US statisticians spotted the same problem last year and adjusted accordingly, which is one reason why headline inflation was so benign last year. That effect will wash out in 2018, which, along with higher oil prices and a weaker dollar almost guarantees rising headline inflation. It will be important to judge what is cyclical and what is secular. More on this debate next week. Finally The Belgrade Theatre is in Coventry. This week who wrote the opera Isabeau, based on the story of Lady Godiva?

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Head of Investment Strategy

FTSE 100 Weekly Winners

Centria	12.5%
Evraz	9.5%
BT Group	6.9%
Barclays	4.9%
RSA Insurance Group	4.8%
Mediclinic International	4.4%
SSE	4.3%

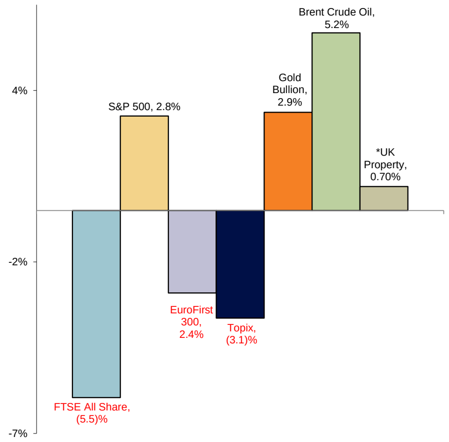
Source: FactSet

FTSE 100 Weekly Losers

Reckitt Benckiser Group	-9.9%
WPP	-7.9%
Fresnillo	-6.4%
Shire	-5.6%
BAE Systems	-5.5%
HSBC Holdings	-4.9%
Randgold Resources Limited	-4.6%

Source: FactSet

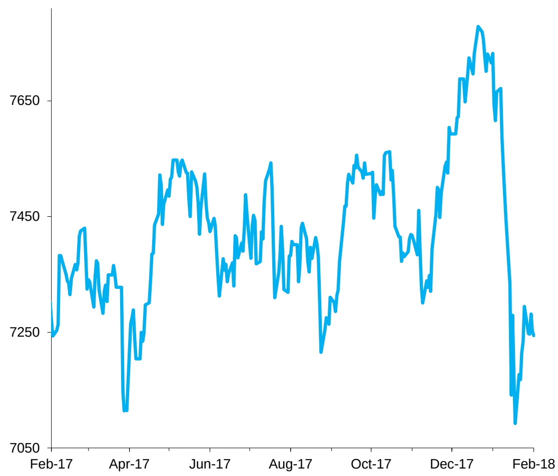
Year to Date Market Performance



*Lagged to latest UK IPD Total Return All Property Index (Jan 2018)

Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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