18th May 2022

Elston Insights

UK inflation and sterling pressure

- UK inflation hits 40 year high
- Bank of England has been behind the curve
- Sterling under pressure – how to protect against inflation

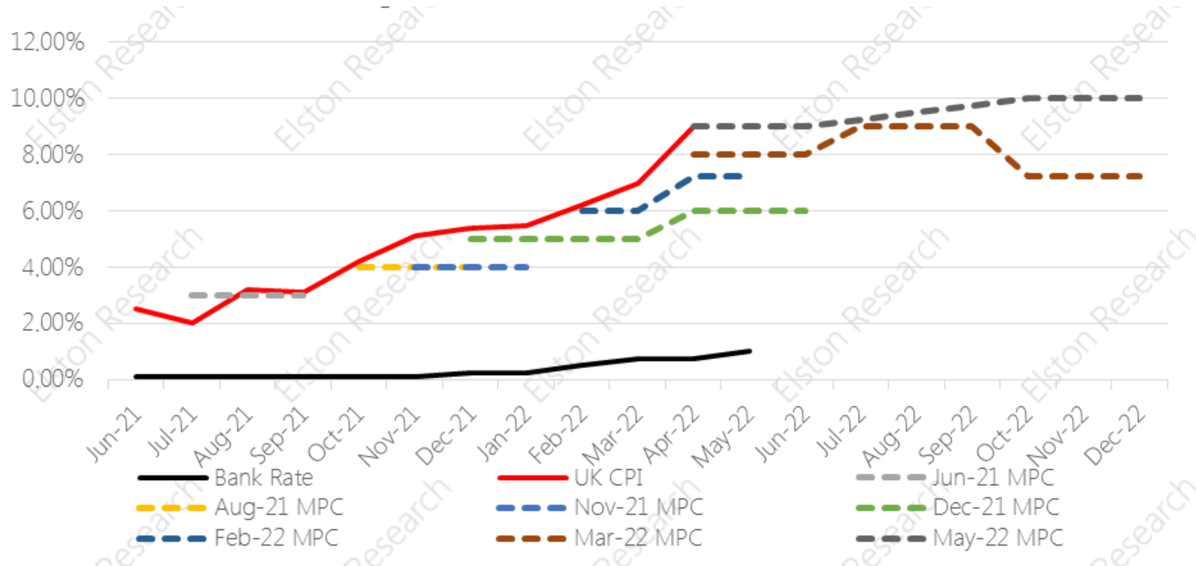
Inflation hits 40 year high

UK inflation figures came out today with a print of +9.0%yy (April), from +7.0% (March) and slightly below +9.1%yy consensus estimate.

This is the highest level in 40 years, putting renewed focus on the "cost of living crisis". Rising energy and food costs are the primary drivers, linked to the sanctions regime and the Russia/Ukraine war.

The Bank of England has been "behind the curve" as regards to inflation risk. A look at inflation guidance contained in recent Monetary Policy Committee (MPC) minutes shows. Near-term inflation guidance has consistently under-estimated inflation since August 2021 – rising from "above 2%", to 4%, 6%, 8%,, 9% and now 10%.

Fig.1. Bank of England MPC Minutes Inflation Guidance

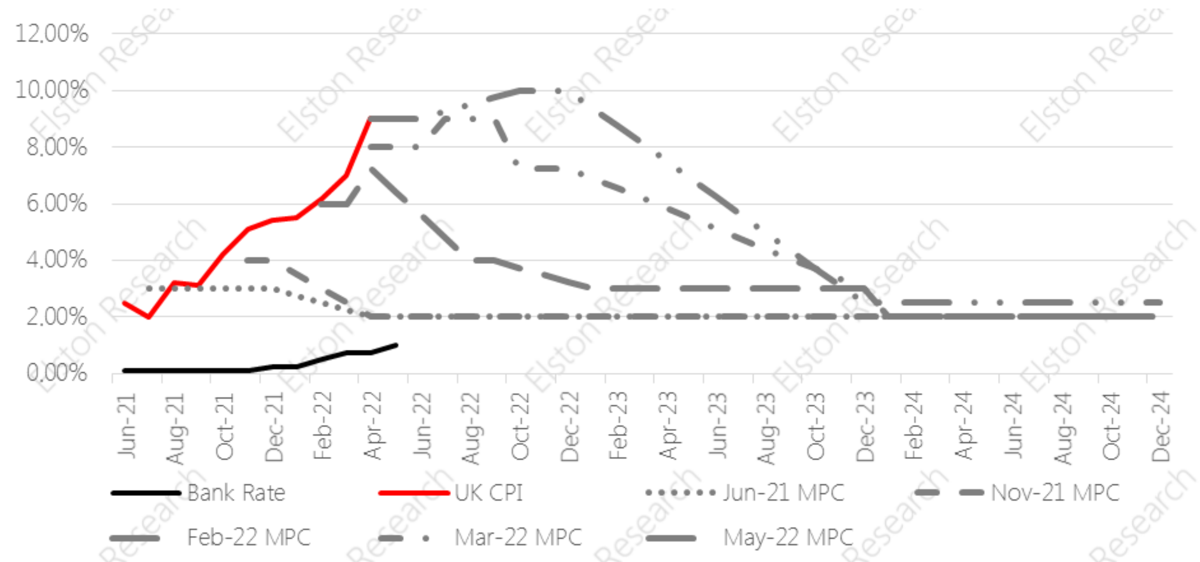


Source: Bank of England MPC Minutes, Elston research & estimates

In addition to being behind the curve, Bank of England forecasts have been over-reliant on "mean reversion": the idea that long-run inflation rates will revert to the target rate of 2% (or now, "slightly above" target rates). This can be "wishful thinking" and is a result of their methodology of assuming energy prices remain flat during the forecasting period.

We have converted the wording around near- and medium-term inflation estimates from the MPC minutes into a visual chart, outlining those expectations.

Fig.2. Bank of England MPC Minutes Inflation expectations over time



Source: Bank of England MPC Minutes, Elston research & estimates

Our view is that the Bank of England has not only consistently under-estimated inflation, but also been over-optimistic on how and when inflation normalises.

This is why we prefer to look at [market-implied Break Even Inflation Rates (BEIR)]() as a more representative view of inflation expectations.

What does this mean for sterling?

The market sentiment for sterling is bearish with the risk that the pound could weaken further. According to the latest MLIV Pulse Survey from Bloomberg the pound could go as low as $1.15 owing to sluggish economic growth and inflation risk. Sterling has declined 7% YTD, new expected lows would imply an additional 6% decline.

Fig.3. GBP Weakness relative to USD, year to date

Source: Bloomberg as at 17th May 2022

Focus on liquidity

For those wanting to maintain a near-nil volatility liquidity buffer with a yield pick up over cash in a rising rate environment, Floating Rate Notes and ultrashort duration bond ETFs offer a convenient, liquid and low-cost alternative.

However currency hedging policy is key.

- For lower risk-return investors GBP ultrashort bonds, and USD Floating Rate Notes hedged into GBP would be more appropriate. This approach makes sense for investors who don't want currency risk in the lower-risk part of their portfolio, and/or expect sterling to strengthen relative to the dollar.
- For higher risk-return investors USD ultrashort bonds, and USD Floating Rate Notes (unhedged) would be more appropriate. This approach makes sense for investors who are comfortable introducing currency risk into the lower-risk part of their portfolio, and/or expect sterling to weaken relative to the dollar.

The chart bellow shows the performance of iShares $ Floating Rate Bond UCITS ETF USD (Dist) vs iShares $ Floating Rate Bond UCITS ETF GBP Hedged (Dist) and iShares $ Ultrashort Bond UCITS ETF USD (Dist) vs iShares £ Ultrashort Bond UCITS ETF GBP (Dist) year-to-date.

Fig.4. USD Floating and Ultrashort bonds Unhedged vs GBP Hedged YTD

Source: Bloomberg as at 17th May 2022

What about risk assets?

In face of rising inflation, we have considered a number of ways to [adapt portfolios for inflation](#).

Rising interest rates and rising inflation provide good reason to reduce exposure to nominal bonds, which are adversely impacted by higher interest rates, and cannot keep pace with inflation.

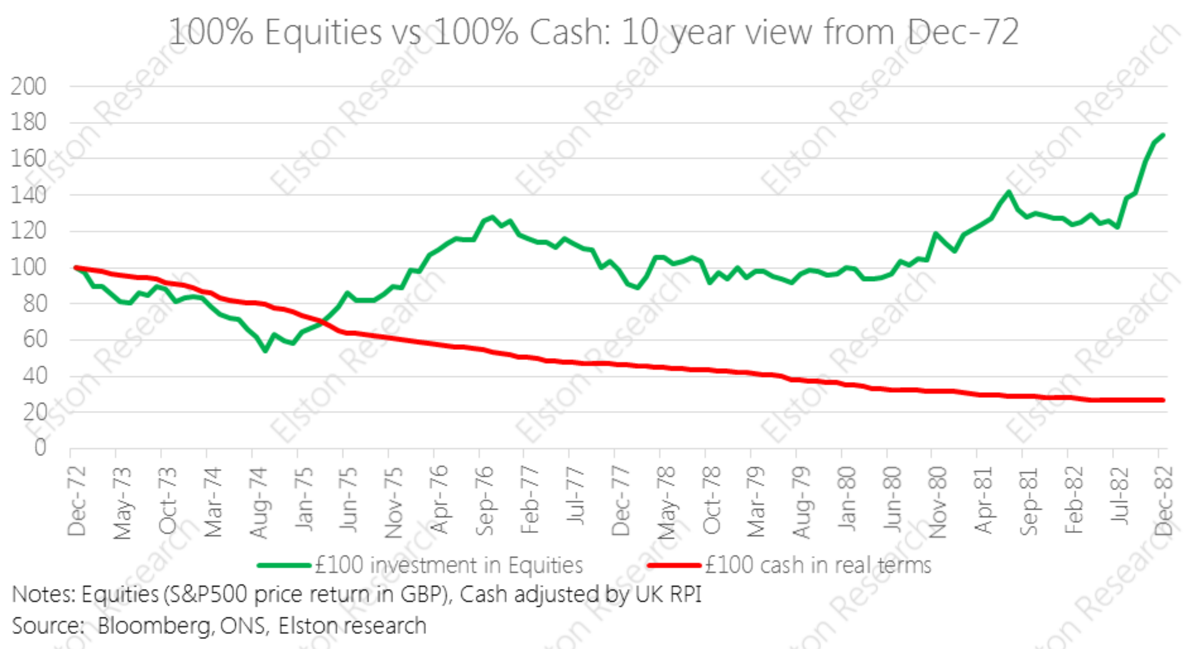
Low real yields are supportive of risk assets. However the ongoing inflation pressure, and the knock-on effects of the Russia/Ukraine war are creating a risk to European and UK economic growth. This would be negative for equities in the short-term.

Real assets are a useful hedge against inflation in the medium-term and equities are the ultimate long-term inflation hedge. Within equities, ([funds with a value/income bias](#) help ensure valuations are grounded in the ability of a business to pass on inflationary costs and generate stable or growing earnings in excess of inflation.

To understand the performance of asset classes during a high inflation regime, we can draw on [lessons from the 1970s](#). By way of illustration, equity was goods a medium- to long-term inflation hedge in the 1970s. To illustrate this, we show the performance of US equities (in GBP terms), relative to cash, during the 10 years from December 1972 during a peak inflationary regime.

On a 10 year view from December 1972, an allocation to equities delivered a price return of +72.9% (+5.6% annualised), ensuring capital growth in a high-inflation regime. Cash meanwhile lost -73% of its purchasing power (12.4% average annualised inflation).

Fig.5. Performance of 100% equities vs 100% cash in GBP terms, 10 years from Dec-72



Summary

UK inflation risk remains skewed to the upside, and will run so long for at least as long as the Russia/Ukraine war will run: and that requires political, not economic resolution.

The greater risk is the risk to growth, and the combination of these factors will keep sterling under pressure. For higher risk-return investors willing to accept, or even seek, currency risk within their portfolio, dollar based ultrashort bonds and unhedged floating rate notes could have a role to play.

In the medium-term, real assets provide a useful inflation hedge by "owning the inflation problem".

In the long-term, despite anxiety as regards short-term apparent volatility, equities offer better inflation protection than cash, in a high inflationary regime.

Find out more

For more insights and information on research, portfolios and indices, visit:

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