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Elston Insights

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UK inflation over 20%? Time to rethink investment risk

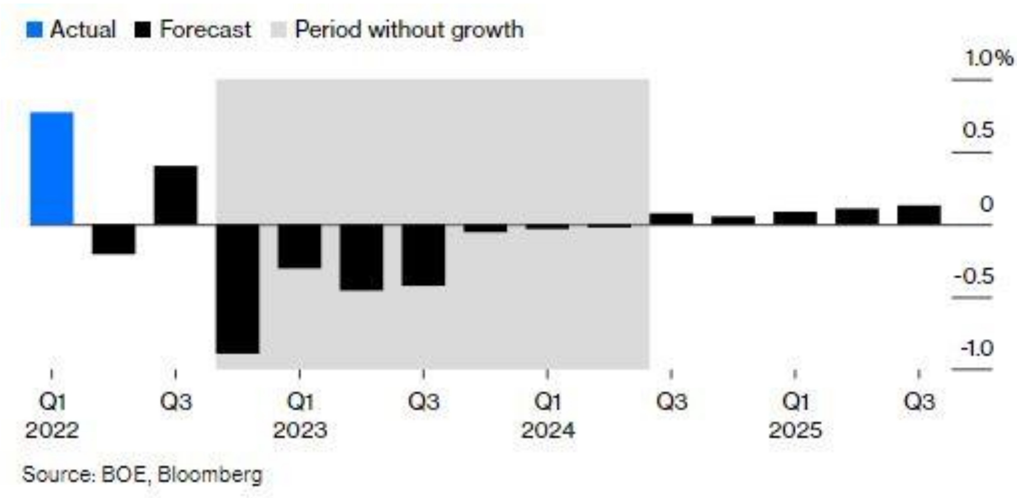
- UK could soar above 20% at current energy prices
- Triggered by sanctions blowback and policy errors
- Inflation inverts investment risks

With low growth, soaring inflation and spiking interest rates, advisers need to rethink the definition of risk. Focus on volatility is focus on the "wrong problem". Instead, advisers should focus on preserving purchasing power (mitigate inflation risk) to protect client outcomes. That requires a fundamental rethink around traditional definitions of risk, asset allocation and diversification.

Gloomy growth outlook

The combination of rising energy costs, slowing consumer spending and pressured corporate margins, means the Bank of England is expecting the UK to enter a recession in 4q22 and be in a two-year period of no growth.

Fig.1. UK GDP growth outlook

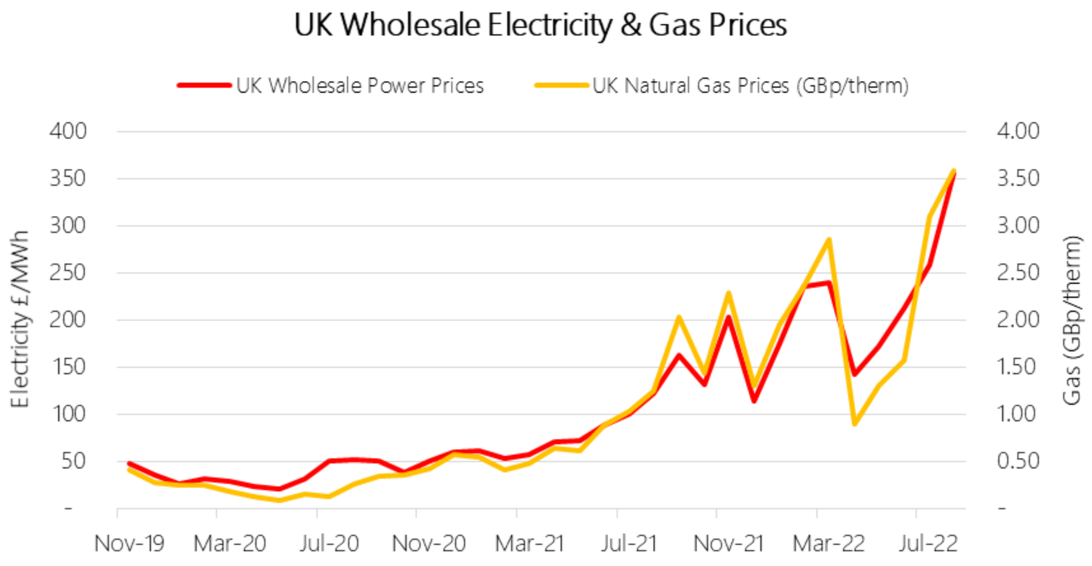


This chart shows that the Bank of England expects the UK economy to slide into recession in 4q22 and remain without growth until 2q24. Tough times are ahead for businesses and employees alike.

UK energy crisis

A string of policy errors mean that the UK, like Germany, and unlike the US, is highly exposed to the global energy crisis.

Fig.2. UK Wholesale Power Prices could crush economic growth



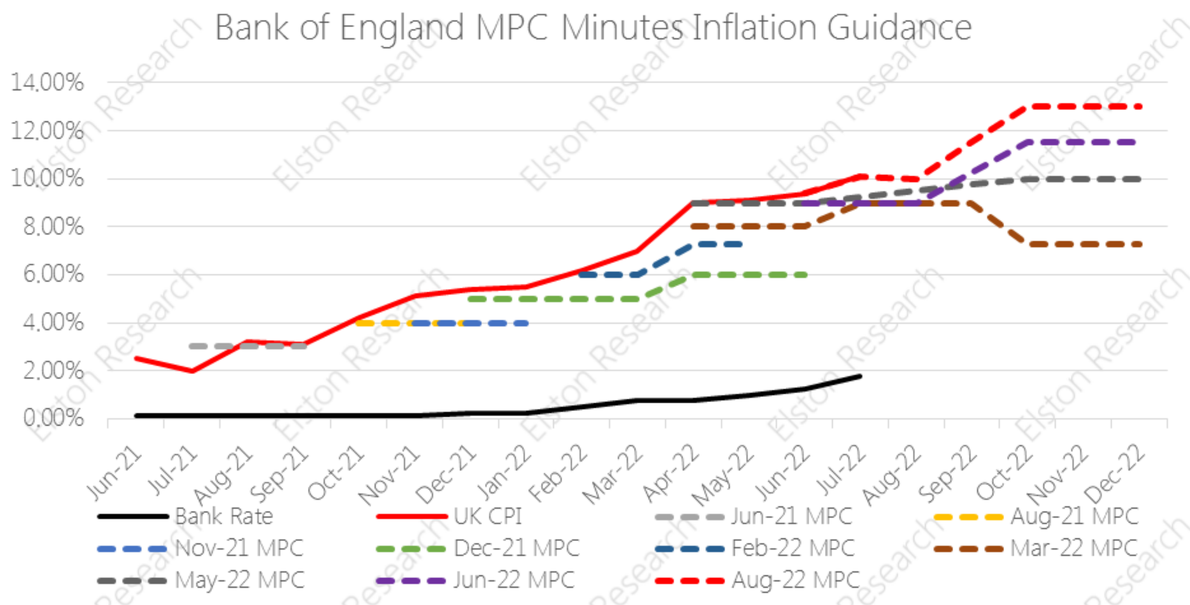
Source: Elston research, Bloomberg data

This chart shows the pressure on UK wholesale energy prices for both electricity and gas looking at the monthly average day-ahead prices. Whilst global LNG prices and European gas prices reflect broader energy market dynamics, UK wholesale power prices also capture the impact of 1) generation mix; 2) import constraints; and 3) currency effect. Monthly average wholesale electricity costs have increased +191%yy to £356/MWh. Recall that the 35-year contract price of Hinckley Point C Nuclear energy at £92.50/MWh (in 2012 prices, £106/MWh in 2021 terms) was seen as extortionately hjgh at the time: now it seems good value. The UK needs more nuclear energy if it wishes to decarbonise AND reduce (indirect) dependency on imported gas.

Based on current wholesale prices (see chart), without government intervention, the retail price cap could increase to £7,272 in April 2023, based on August wholesale gas prices. This compares to £1,143 pre-Covid and £1,277 pre-war. The increase represents a reduction of 12% of average disposable household income: the cost of living crisis is more than just a headline.

In the chart below we show how the Bank of England has been behind consistently behind the curve on inflation expectations. Part of their job is of course to keep inflation expectations "anchored." We continue to monitor wholesale energy prices – both as a direct and indirect driver of inflation. This underpins our thesis, that inflation remains a problem so long as the Russia/Ukraine war, and related sanctions remain in place. Whilst we hope the former comes to an end sooner (although tragically it shows no sign of doing so), the latter may not, and is consistent with the theme of de-globalisation discussed in our [recent Quarterly Investment Review.]

Fig.3. Bank of England MPC Minutes Inflation Guidance

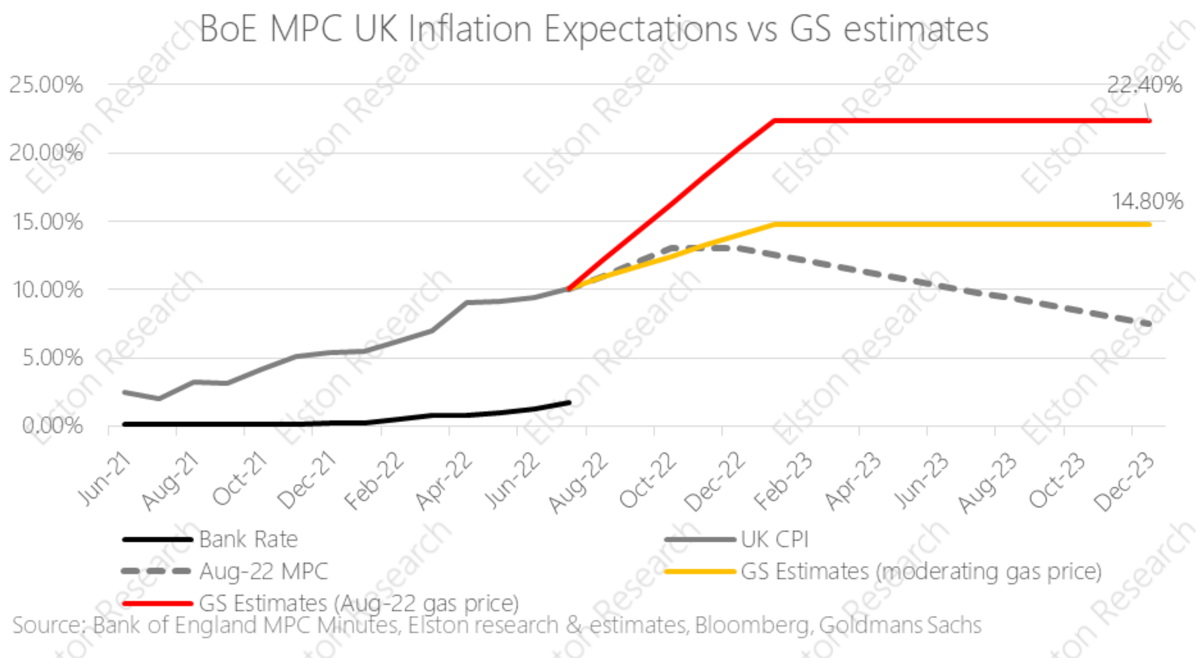


Source: Bank of England MPC Minutes, Elston research & estimates

This chart shows BoE MPC forecasts have been consistently behind the curve since the energy crisis started in 2021, exacerbated by the Russia/Ukraine war and related sanctions blowback.

If the Central Bank won't say it, the investment banks will. Estimates from Goldman Sachs, have highlighted how inflation could jump north of 20% at current energy prices. The chart below shows the inflation trajectory, the BoE forecast, the Goldman Sachs estimates assuming 1) gas prices moderate from current levels (+14.8% 2023 inflation), and 2) assuming gas prices remain elevated at current levels (+22.4% 2023 inflation). For those not fearing that the 2020s could be a re-run of the 1970s inflation shock – these estimates are sobering, and contributed to further GBP/USD weakness hitting multi-year lows, with the previously unthinkable threshold of sterling reaching parity with the dollar now a potential risk.

Fig.4. UK CPI estimates: back to the 1970s?



This chart shows BoE MPC forecast of inflation peaking at +13.0% in 4q22 (in grey). In amber, is Goldman Sachs' estimate for 2023 UK inflation at +14.8%, assuming wholesale gas prices moderate from current levels. In red, is Goldman Sachs' estimate for 2023 UK inflation at +22.4%, assuming wholesale gas prices remain at current (August) levels.

Focusing on volatility is focusing on the wrong risk

In our discussions with financial advisers, the inevitable question arises – how best to protect investors from risk?

Unfortunately, no matter how hard it is to accommodate into traditional risk profiling processes, the traditional approach on focusing on volatility alone is to focus on the wrong risk. Advisers must also consider inflation risk. In most risk profling tools and capital market assumptions, long run inflation is modelled at 2-2.5%, close to the Bank of England target rate. In the short- to medium-term this is problematic and unrealistic.

When considering risk, advisers should also consider risk to client outcomes in a high inflation regime, traditional asset-class designations as regards "riskiness" become inverted.

Lower risk assets, despite their stable appearances, mean capital is at risk in real terms if they can't keep pace with inflation.

Higher risk assets, despite their unstable appearance, mean capital is protected if it can keep pace with inflation.

The table below shows this inverted world of risk in an inflationary regime.

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Fig.5. The upside-down world of investment risk in low and high inflation regimes

	Low Inflation	Why	High Inflation	Why
Low Risk	▪ Cash ▪ Nominal Bonds ▪ Smoothed Funds ▪ Level Annuities	Investment risk (volatility) has higher adverse impact on client outcomes than (stable, low) inflation risk.	▪ Equities ▪ Commodities ▪ Gold & Precious Metals ▪ Real Assets ▪ Inflation-Linked Annuities	Equities (particularly with value/income bias) can keep pace with inflation. Investment risk (volatility) has lower adverse impact on client outcomes than (unstable, high) inflation risk.
High Risk	▪ Equities ▪ Commodities ▪ Gold & Precious Metals ▪ Real Assets	Investment risk (volatility) has higher adverse impact on client outcomes than (stable, low) inflation risk. Unstable appearance shows capital is at risk.	▪ Cash ▪ Nominal Bonds ▪ Smoothed Funds ▪ Level Annuities	(Unstable, high) inflation risk has higher adverse impact on client outcomes than investment risk (volatility). Despite "stable" appearances, capital is at risk in real terms. Loss of real value (purchasing power) in inflationary regime, as can't keep pace with inflation.

Source: Elston research and opinion

Summary

As we move into a "worst case scenario" for UK inflation outlook, a structural rethink how risk profiling relates to asset allocation, and how best to adapt asset allocations for inflation is necessary to protect client outcomes for the short- to medium-term.

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