

Inflation is getting stickier

- Inflation may be past the peak but not past the problem
- UK Core inflation has not softened
- Focus on where inflation rate will settle

We have left 2022 behind us – an *annus horribilis* for most investors – and in 2023, we are “Looking for Light”, with the worst of economic, geopolitical and inflation shock behind us. But the risk is that inflation whilst moving past the peak may be getting sticker. This is because of wage-price pressure, reconfigure supply chains and the energy sector (increase energy security/transition to Net Zero) and defence sector (prepare for deglobalisation and a less stable world security).

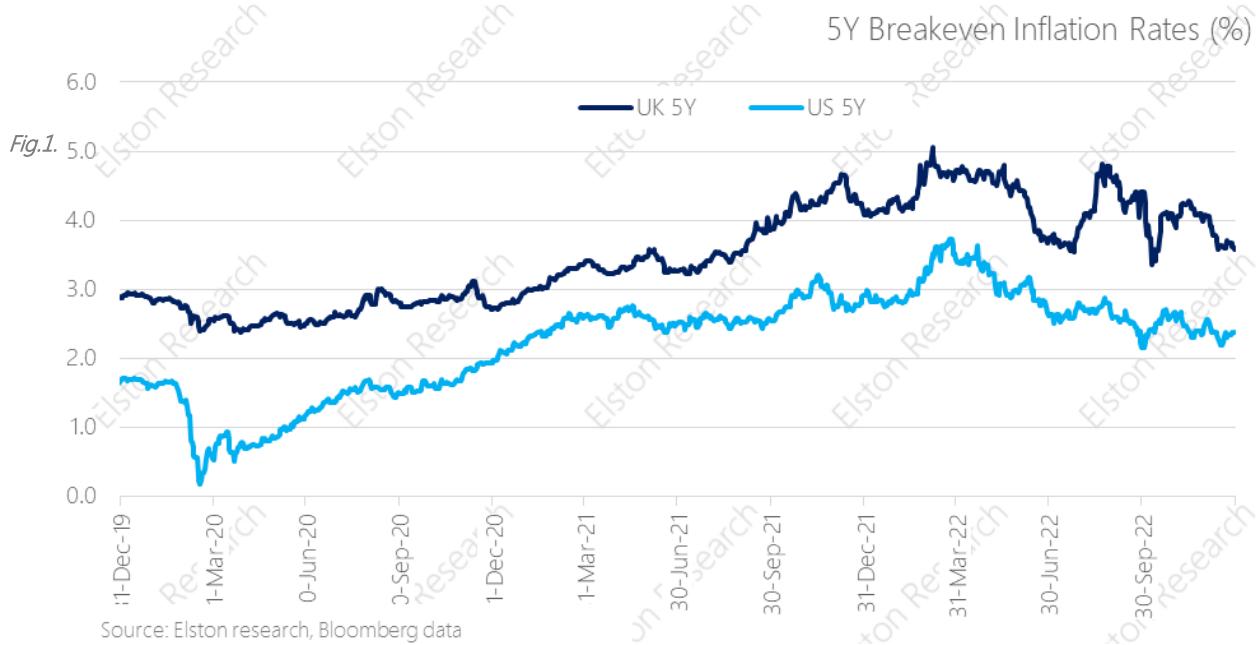
UK inflation

While the most recent UK inflation print of 10.5% year on year for December 2022 means there have now been two straight months of declines (following an October high of 11.1%), we are nonetheless still looking at a double digit figure. Furthermore, core inflation, which excludes some of the more volatile sectors such as food and energy, has not shifted at all, digging its heels in at 6.3%.

Comparative impact of a recession

Although the US labour market remains surprisingly tight in spite of a series of significant rate hikes, there are signs at the edges that things may be on the turn. A recent survey based on data from employers diverged significantly from a similar survey based on data from individuals with regards to their work status which showed things flat-lining.

However, should the US enter a recession, in our view it is likely to come out faster, and pass peak inflation quicker, than its European counterparts. This can largely be ascribed to two factors: the relatively strong dollar and internal energy security.



By the same token, should the UK and Europe enter a recession, their relative lack of energy security and the weakness in their respective currencies will likely see a much more prolonged downturn.

In the case of the UK, even when it is well past peak inflation and comfortably back into single digits, the current 5-year break-even rate stands at 4% and UK rolling 5-year inflation could peak closer to 5.6% in 2026, a full three years from now. In other words, this is structural inflation.

Fig.2. UK inflation shock will take time to wash through the system

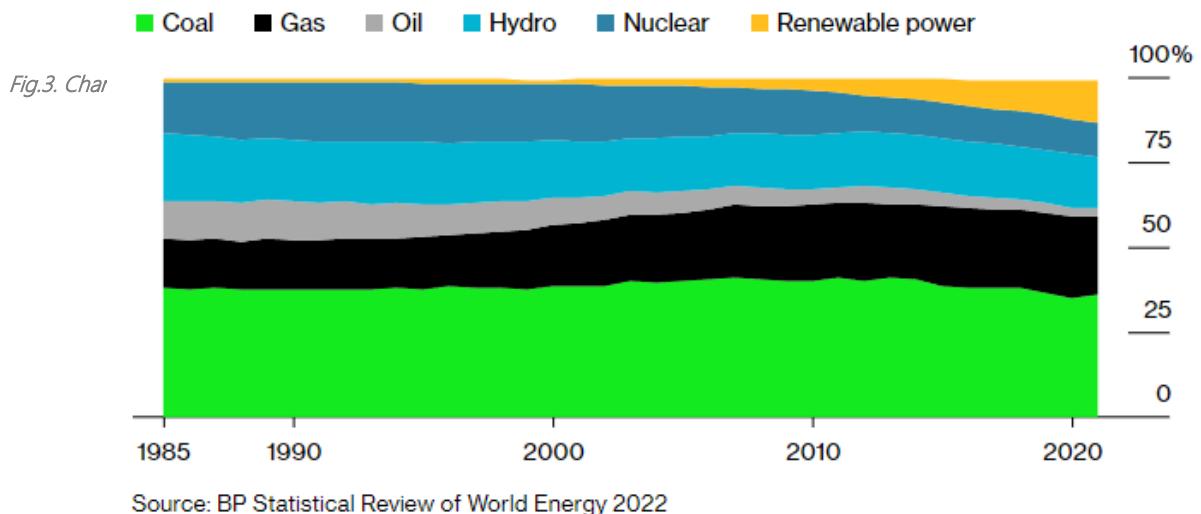


What is making inflation stickier?

Beyond the base effect, there are three main issues that are likely to keep upwards pressure on inflation:

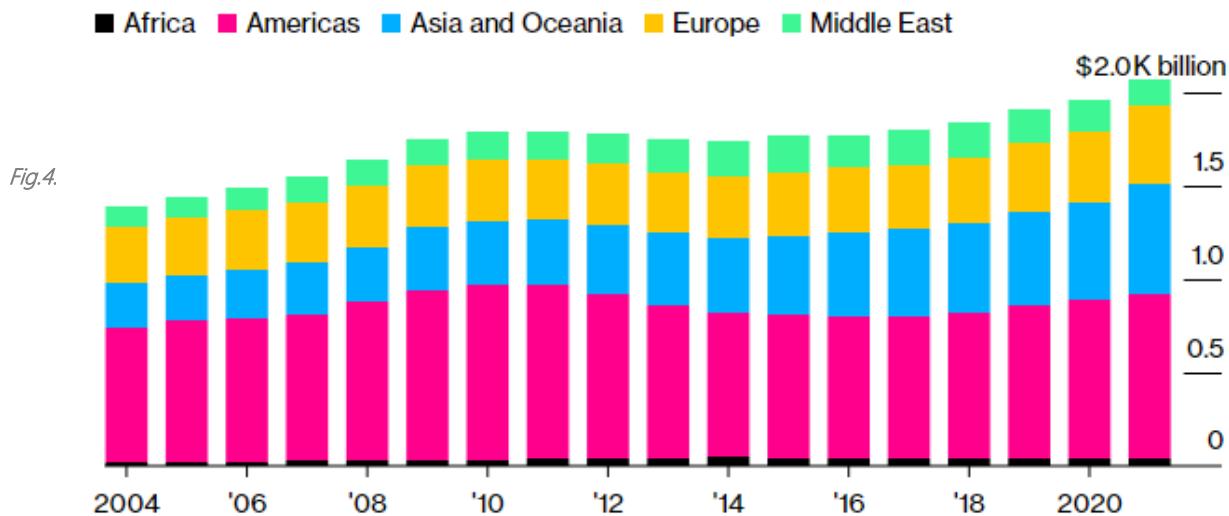
Firstly, wage-price pressure shows that the inflation base is broadening as evidenced by the core inflation figures.

Secondly, the remapping of supply chains, particularly energy supply in Europe, both logically and from a security perspective, will take time and money. This combined with the transition to Net Zero means transforming the energy mix is a capital-intensive business.



Finally, there is an urgent need to reinvest in defence in the context of increased geopolitical risk and a return to a warm cold war. UK and Europe are having to rebuild defence supplies, increasing expenditure and expanding production.

¹ Chart Source: <https://www.bloomberg.com/news/articles/2022-06-30/these-4-charts-show-how-much-global-energy-has-changed-since-2000>



Source: SIPRI

So whilst the move past inflation peak is welcome, inflationary pressure may not subside as quickly as it arose. Investment decision-making should take that into account for the near- to medium-term.

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² Chart Source: <https://www.bloomberg.com/news/articles/2022-04-24/military-spending-passes-2-trillion-as-europe-boasts-defenses>



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