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FIRST FOR INVESTMENT STRATEGIES

JUST A TAD DEFLATED

COMMITTEE CHAIRMAN

Laura Suter

EDITOR FUND STRATEGY

May saw the announcement of official deflation in the UK, based on the Consumer Prices Index measure, which showed prices had fallen by 0.1 per cent over the past year.

It marked the first time deflation was recorded since March 1960, when the drop was more dramatic, at 0.6 per cent.

The drop in inflation in April was put down to three factors: oil, food and travel. The oil price lowering means petrol prices have dropped and pushed prices down, while it's a similar story with food costs. Air and sea travel were up on the previous month, but the rise was not as much as last year, which is being largely pegged to Easter falling on a different month last year – a time when prices typically rise.

However, many see this period of deflation as temporary, rather than something that needs to be banked on in the longer term. When oil prices rebound, they say, inflation will stabilise.

Another factor that points to deflation being temporary is that core CPI, which excludes volatile items such as energy and food, was positive for April. It was 0.8 per cent, a new low since March 2011, but still in the black.

One knock-on effect of the deflation data is that the Bank of England could stall further on any interest rate rise. Predictions are for a rate rise in 2016, but if inflation data continues to disappoint, this may be pushed further out.

But is the UK actually in deflation? The Office for National Statistics termed the 0.1 per cent drop as deflation, but many would label it just as negative inflation. Full deflation is defined as a sustained period of falling prices across more than a couple of sectors – which this is not.

This means all eyes will be on next month's figures to see which way the index swings.

Jonathan Davis

MANAGING DIRECTOR, JONATHAN DAVIS WEALTH MANAGEMENT

We are in an era of disinflation – falling inflation – and possibly even deflation – falling prices. The small negative of CPI in May does not confirm deflation but it provides evidence to the thesis. Are we 'turning Japanese'? It remains to be seen. And yet, central banks and policymakers have been firing 'nuclear weapons' (QE, zero interest rate policy, etc) to create inflation and avoid deflation. However, as Jeff Wayne said in the War of the Worlds album, 'Yet still they come'. Deflation is here whatever they throw at it – because of technology and globalisation. In light of this we have been banging the desk about government bonds. It is our way of investing in a disinflationary or deflationary economy. At the date of writing this the markets expect UK and US rate rises next year; in euroland it's 2017. Thus, after the recent correction, government bond prices are attractive again. We like US Treasuries as the US dollar appears to be in a multi-year bull market. For long-dated bonds we prefer iShares 20+ Year Treasury Bond ETF.

James Calder

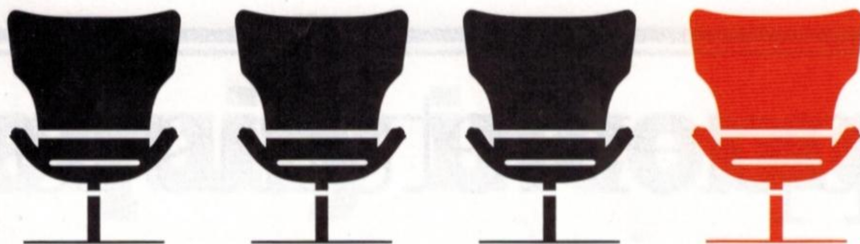
HEAD OF RESEARCH, CITY ASSET MANAGEMENT

The announcement that UK inflation has fallen to -0.1 per cent over the year to April was hardly unexpected as it has followed the recent trend. The reasons given for the fall include an early Easter and the collapse of the oil price. The rate will likely stay low for the rest of the year, but 2016 will be a different story. As inflation is rebased each year we would expect some oil price/energy inflation as the price normalises, although it will take some time to get back to previous peaks. Therefore inflation will trend up through 2016, although the timing of UK rate rises is still a cause for debate. Focusing purely on the oil price, it should be noted that the negative impact of this fall tends to be immediate from a market perspective. One only has to look at the share price movements of those companies that the market perceives, rightly or wrongly, to be related to the oil price. However, the positive impact of this fall will take time to filter through to companies that have energy as part of their input costs. Therefore it may take the market some months to notice the beneficiaries.

Lee Robertson

CHIEF INVESTMENT OFFICER, INVESTMENT QUORUM

Deflation is is more serious than inflation as it is more difficult to control. While you would think that if prices were falling people should be happier, this is not the case because it means companies will need to sell products more cheaply, which could lead to cuts in production, reduced wages or even job losses. Deflation can be bad for equities as investors worry about growth and recovery and reduce their allocations. Bond investors are likely to add to positions temporarily, given their attractiveness and defensive qualities, making them the most obvious choice for investors in a deflationary environment. However, government bond yields have fallen all over the world to levels not seen for decades, making this asset class unattractive versus equities over the longer term. The Bank of England may hold off raising interest rates for the foreseeable future because of the current news on inflation, but in the short term the UK market is likely to react more to international matters than a blip in UK inflation.



The UK has entered deflation for the first time since 1960. But is it *really* deflation? And what does it mean for the economy?

Deflation in the UK economy was flagged up well ahead of it happening and it has been easy to see this forecast was unlikely to be wrong. Of course, it makes for a good headline to say this is the first time since 1960 that the economy has seen negative inflation, but from the markets' point of view it is part of a trend that has been going since 2011 when CPI touched 5 per cent. The fall in the oil price has simply accelerated this trend and it is widely accepted that its impact will start dropping from the numbers next month. So CPI should be ticking higher by autumn at the latest, but not dramatically. Low inflation can reflect either a lack of demand in an economy or an excess of supply. We have both, so it's hard to see inflation really picking up. This is what has been forecast and it fits with the 'slow growth' scenario. The only factor that could really change the outlook is sharply higher wage growth, and at present the growth is not rapid. Meanwhile, it is hard to see the supply side contracting. Consequently, the negative inflation number is not material to markets.

Tim Cockerill
INVESTMENT DIRECTOR, ROWAN DARTINGTON

The main reason we are seeing negative inflation is the oil price. Last June a barrel of Brent Crude cost $115. It now costs $65, having been only $45 in January. Inflation figures always compare prices with those a year earlier. If the oil price stabilises, then by simple maths the impact will reduce and after January we will actually see oil price inflation. No one can forecast the oil price but there are good reasons why it might be lower in future. Scientists estimate that perhaps 60 per cent of fossil fuels will need to remain 'unburned' if we are not to do irreparable damage to the climate. It is also worth noting that core inflation, which strips out oil and food prices, is very low at 0.8 per cent. The hangover effect from the 2008 financial crisis is still causing lower economic growth and inflation and will do so for some time. Interest rates will therefore only be increased gradually, meaning bond yields should also increase slowly. Lower economic growth should also mean lower earnings growth for companies, so do not expect stellar equity returns in the coming months.

Mike Deverell
PARTNER AND INVESTMENT MANAGER, EQUILIBRIUM

It cannot be much of a surprise to have seen negative inflation after witnessing a crash in the oil price. While commentators continue to speculate on the cause, the effect of a halving of the oil price in a matter of months is obvious for UK households, who have enjoyed a noticeable private tax cut with lower fuel and energy bills. This should provide the consumer with increased spending power with extra pennies to spend elsewhere and, in economic theory, create demand leading to a rise in inflation. Although in the near term I accept that with a weaker euro we will probably import further deflation, this will eventually be offset as an annual oil price fall becomes an annual price rise. So I am not too concerned about low inflation, believing much is already priced into the markets, unlike the surprise election result that causes concern over our EU membership. However, the challenge here really lies with the Bank of England and its interest rate conundrum of when to hike with a benign inflationary environment against a stronger jobs market.

John Husselbee
HEAD OF MULTI-ASSET, LIONTRUST

Deflation is a pronounced, pervasive and persistent fall in prices. The UK isn't in deflation. The Consumer Prices Index was marginally below its year-earlier level in April but other price measures – including the core CPI (excluding food and energy), the Retail Prices Index and the GDP deflator – are still rising.

Price pressures are not the weakest for 50 years. An average of the annual rates of change of alternative price measures is above its level in 2009. This makes sense: deflationary risk was surely greater in the wake of the financial crisis than in the present environment of solid growth and near-full employment.

Deflation is a monetary phenomenon and requires sustained weakness in money and credit. Broad money is growing by 4 per cent year-on-year, with the narrower M1 measure of money supply up 7 per cent. Bank lending is reviving, expanding at a 4 per cent annualised rate in the past three months.

Low inflation, as opposed to deflation, is good for the economy and markets. Central banks have confused the issue by loosening monetary policy further or deferring normalisation. Additional liquidity has boosted markets temporarily but is bad for the medium term.

One risk is that markets have become so detached from 'fundamentals' that a small change in the outlook will result in a large decline in prices that feeds back into a weaker economy. Another is that 'excess' liquidity will drive a strong pick-up in global growth and a faster-than-expected inflation rebound.

Global monetary trends signal robust second-half growth. Inflation is likely to pick up as the impact of commodity price weakness fades and tight labour markets lift wage growth. Liquidity-fuelled markets face rising challenges.

THE INDEPENDENT VIEW

Simon Ward
CHIEF ECONOMIST, HENDERSON GLOBAL INVESTORS