Memo to Cormorant Clients

Regarding: Inflation and Interest Rates

From: Steve Williams

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Inflation and Interest Rates

Introduction

Before I explore the most recent inflation data and what it might mean for the outlook for interest rates, I thought it interesting to look at the Bank of England's track record in dealing with inflation.

Before I do, it will help to note that the inflation numbers I am referencing are 'year-on-year' rates, which are published 'monthly'. That means that the December 2023 inflation rate, for example, is the rate observed from December 2022 to December 2023.

The Bank's Record

The Bank of England (the Bank) is formally tasked with keeping inflation 'low and stable'. To that end, the government has set an inflation target of 2.0%, as measured by the year-on-year increase in the Consumer Price Index (CPI). Additionally, in circumstances where inflation has moved more than 1.0% away from the target, there is a requirement for the Governor of the Bank to send an open letter to the Chancellor of the Exchequer explaining why this has happened and what remedial action the Bank is taking. The effect is to imply a 'comfort zone' for inflation in the UK between a lower bound of 1.0% and an upper bound of 3.0%.

The current framework was first adopted in December 2003. Since then, the average monthly year-on-year increase in CPI amounts to 2.8%. That's on the high side but within the Bank's comfort zone. There is, though, a clear distinction dividing the record into pre-pandemic and post-pandemic periods. The pre-pandemic rate (between December 2003 and March 2020) averages 2.2%, and the post-pandemic rate (between April 2020 and December 2023) averages 5.2%.

Prior to the pandemic, inflation fell outside the 1.0 to 3.0% comfort zone on 59 occasions from a total of 196, equivalent to 30% of the time. Higher rates (over 3.0%) occurred in 2008 and again in 2010-2012 coinciding with considerable oil price increases. Lower rates (under 1.0%) occurred in 2015 and 2016, this time overlapping with a considerable decline in the price of oil.

The post-pandemic record sees inflation initially fall short of the 1.0% bound for 11 months and then overshoot the 3.0% bound for 29 consecutive months, beginning in August 2021.

The occasions we have identified when inflation falls outside the comfort zone are associated with 'exogenous shocks' to the economy. The Bank has no control whatsoever over the price of oil and just as little influence over the presence of a novel virus and the reaction to that virus from those in Westminster. Some would advocate setting aside the inflationary and disinflationary effects associated with these shocks and conclude that the Bank of England has a good track record, in which inflation has been low and stable.

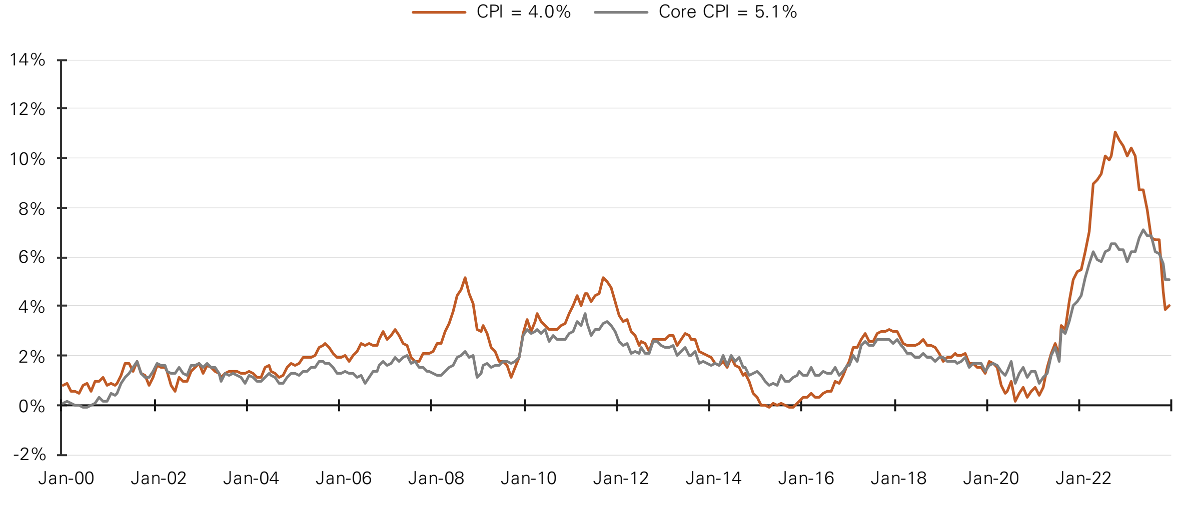


Chart notes: Underlying data from ONS. Chart format, further assumptions, and any associated transformational calculations by Barras Capital Management Ltd.

In my view, it is unreasonable to exclude these periods; an inflation-targeting framework is expensive and invasive, and it ought to be judged across all conditions, not just those that are most favorable. That being the case, I'd say that the Bank's record is mixed. And the extent to which the Bank's record suffers further deterioration depends on how quickly inflation settles back into the comfort zone.

The Most Recent Rate

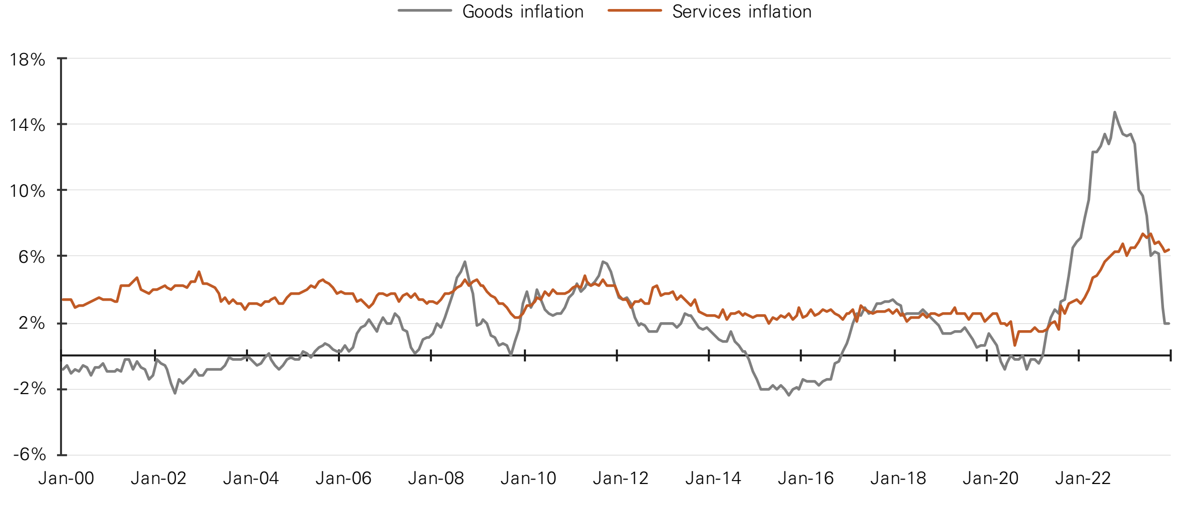
The Office for National Statistics (ONS) calculates that the headline CPI increased by 4.0% in the 12 months to December, up from the 3.9% rate in November. The equivalent rate for 'core' CPI, which excludes the more volatile items in the consumer basket, was unchanged at 5.1%, and the older Retail Price Index fell from 5.3% to 5.2%.

December's increase contrasted with a broader expectation for a further, albeit slight, decline in the headline rate. The consensus called for a rate of 3.8%, and our model marked our expectations at 3.9%. In the event, it was the higher costs associated with duty increases in the tobacco and alcohol categories that tipped the rate higher when compared with the prior month. That is not necessarily an indication that inflation is reaccelerating.

More broadly, cost increases in 'food and non-alcoholic beverages' (up 8.0% year-on-year), 'recreation and culture' (up 5.7%), and 'restaurants and hotels' (up 7.0%) account for a little over two-thirds of the full 4.0% increase in inflation. Those are partially offset by lower costs in 'housing, water, electricity, gas and other fuels' (down 3.4% year-on-year) and 'transport' (down 1.1%).

Headline inflation can be split into 'goods' inflation and 'services' inflation, and doing so helps to identify some of the underlying trends. Goods inflation, the more volatile of the two, quickly peaked at 14.8% in October 2022 following the pandemic and has fallen rapidly to 1.9% in December. Meanwhile, 'services' inflation has increased more slowly, peaking at 7.4% in July 2023, and decreased similarly slowly to 6.3% in November before nudging higher to 6.4% in December. Goods inflation is running at a rate close to its long-term average (1.9% compared with an average of 1.8%), while services inflation is almost double its long-term average (6.4% compared with 3.4%).

Wage pressures have likely contributed to elevated services inflation. An 8.5% near-term peak in wage growth coincided with the July 2023 peak in services inflation. Since then, 'average weekly earnings' (total pay) have slowed to 6.5%, which is still high, but the trend is heading in the right direction. Additionally, the Bank's most recent 'Decision Makers Panel' survey suggests that the proportion of employers reporting 'hard' recruitment conditions remains less than 50%. With luck,



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the uptick in services inflation is just a blip.

The Near Term Outlook

The consensus calls for inflation to climb slightly in January to reach 4.2% before resuming a downward trajectory in February. That is broadly consistent with our expectations. Our model sees inflation at 4.0% to 4.1% in January, with a sizable shift down in February before finally dipping under the 3.0% threshold and into the comfort zone during March or April.

Looking further ahead, we see inflation close to the 2.0% target by the middle of this year, in line with the consensus. We don't have a tremendous amount of conviction in that outlook – there is plenty of potential for inflation to deviate significantly one way or the other (trade disruptions, trade disputes, war, energy volatility, etc.) – but we do consider it to be a reasonable base case.

The Implications For Monetary Policy

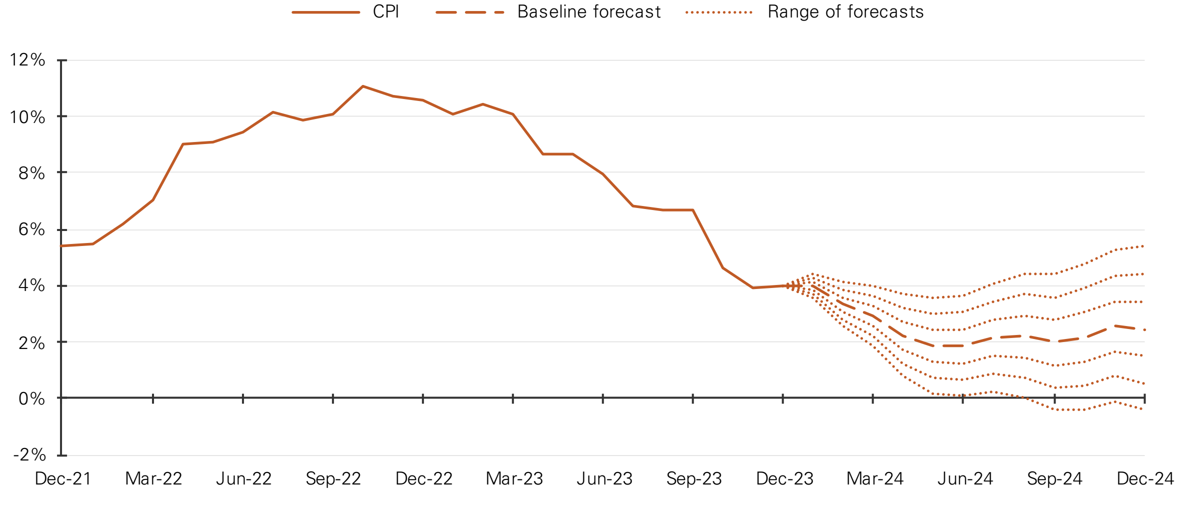
If the path for inflation implied by our model and the consensus among economists does come to pass – and the headline inflation rate does approach the 2.0% target by the middle of the year – the Bank will have ample scope to reduce Bank Rate from the current cycle high of 5.25%. Indeed, that is the pattern we see priced across the bond market. Prices in the market for 'overnight index' swaps, in particular, reflect a 100 basis point shift by the end of the year. It's not easy to tell, but it looks like the market is pricing the first rate cut at either the 9 May meeting of the Monetary Policy Committee or during the 20 June meeting. We are not wedded to a particular date, but it seems that the 9 May meeting may be a little early and the 1 August may be a little late, so the 20 June looks reasonable, though much will depend on the April inflation print. (To add to the uncertainty, April is a tricky month for inflation forecasts; the historical variability in April's data is twice that of some other months).

So, although there is a significant degree of uncertainty in the outlook, the consensus among economists, the output from our model, and prices inferred in the bond market all point in the same direction.

If only it were that simple. The Bank's most recent projections, as contained in the Monetary Policy Report (November 2023), are for inflation in the region of 3.5% by the middle of the year, as much as 1.5% higher than the outlook outlined above. This alternative outlook renders a mid-year rate cut unlikely and calls into question the market's inferred 100 basis points of cuts.

One of the reasons the Bank's projections are so much higher is that they assume that 'services' inflation will fall much more slowly, so much so that overall inflation doesn't meet the 2.0% target until the middle of next year. That is certainly a risk.

And so we have at least two competing outlooks. Our tendency



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is toward the first (the consensus view, which sees inflation at 2.0% by June 2024), but we are conscious of the likely slow pace of decline in services inflation contained in the second (the Bank's view, which sees inflation at 2.0% by June 2025).

A resolution of those outlooks, seeing either the consensus drift toward the Bank's assessment or the Bank's assessment drifting toward the consensus, will likely hinge on developments in the labour market. A weaker labour market (increased joblessness, lower wage growth) will favour the first outlook, and a more robust labour market (decreased joblessness, higher wage growth) will favour the second.

The Implications For Asset Prices

As we move through the next few months, one of those outlooks will prove to be more accurate. But both outlooks incorporate a downward trajectory for inflation and increased scope for interest rate cuts. All other things being equal, both offer a tailwind for asset prices.

Important Information

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