

**UK Inflation spike – how worried should investors be?**

City forecasters have been consistently surprised by the strength of UK inflation in recent months, and risks are for more of the same in the short term. The jump in inflation in December leaves it a whisker away from the level where Bank of England Governor, Mervyn King, will have to write an open letter to the Chancellor explaining why it has increased and what he plans to do about it.

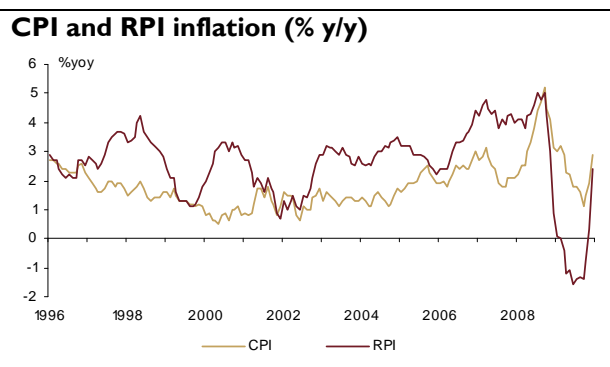
Over the next few months there are further upside risks to inflation - because of the pass-through from a weaker currency and the possibility of further increases in administrative taxes - that could lead investors to continue to seek inflation protection via index linked bonds. However, looking further ahead deflationary/low inflation forces could still re-emerge. Much will depend on the pace of growth in the UK economy over the next few quarters. If the outturn for Q4 GDP is anything to go by, we could still see lower inflation in the medium-term.

UK inflation leapt a full percentage point in December to 2.9% y/y, the biggest one-month increase ever recorded for CPI inflation, and well above expectations. The jump in RPI inflation (which includes housing costs such as mortgage interest) was even sharper, from 0.3% y/y in November to 2.4% y/y in December.

The Office for National Statistics highlighted a number of exceptional factors in December 2008, which led to a sharp fall in prices then. This “base effect” boosted the y/y comparison with December 2009. These factors were a sharp fall in the oil price at the end of last year, reduction in VAT to 15%, and pre-Christmas discounting as a result of the economic downturn.

RPI inflation - the relevant measure for pricing index-linked bonds - was also boosted by higher

mortgage interest costs compared to a year ago, when lenders passed on Bank of England rate cuts.



**What is catching the City out?**

Since June last year headline CPI inflation has been higher than forecast 15 out of 19 months, suggesting that there may be other factors at work too. This is not just because of difficulty forecasting the more volatile components such as oil prices. Core inflation (which excludes food, energy, alcohol and tobacco) has also exceeded City forecasts.

The roughly 20% fall in the value of sterling over the past two years may also be having an impact by raising import prices. As well as the direct impact of higher import prices on the consumer basket, such as higher energy and imported consumer good prices, they can also feed through into domestic manufacturers’ raw material and component costs and eventually into output prices. Given the time lags involved, these effects may continue into 2010.

**Mervyn King will use his writing paper**

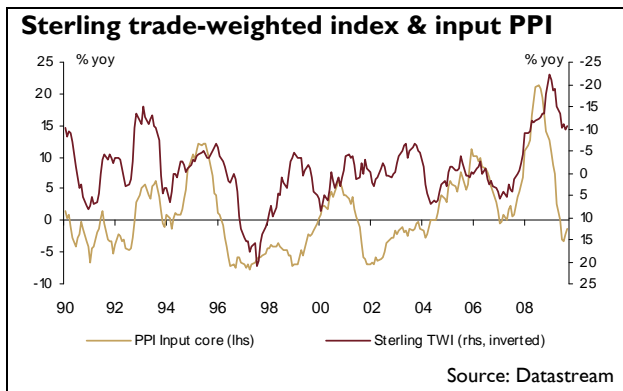
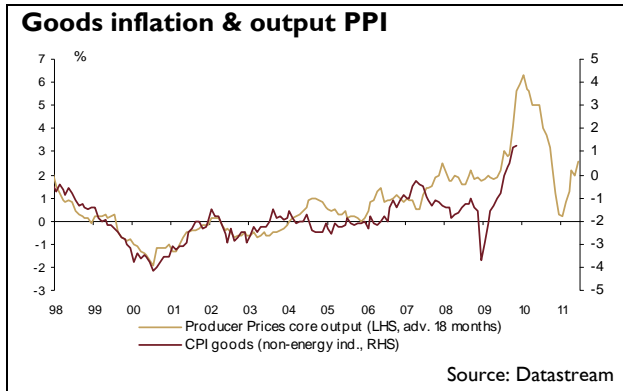
There are good reasons to expect that CPI inflation will climb above 3% early in 2010, forcing Governor King to pen an open letter to the Chancellor.

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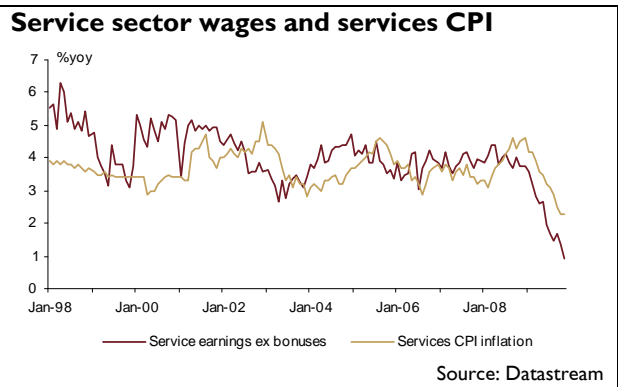
For one, the full impact of the VAT changes is yet to be felt. The standard rate of VAT was temporarily reduced to 15% on 1<sup>st</sup> December 2008 and returned to 17.5% on 1<sup>st</sup> January 2010. Therefore, inflation will jump higher again in January, simply as prices readjust to the higher level of VAT. There is also a possibility that VAT will be raised again after the general election (likely to take place in May), with a 20% VAT rate being discussed by some politicians.

In addition, anecdotal evidence suggests retailers were less aggressive in their discounting over the Christmas and New Year period than they were last year.

The Governor is likely to argue that many of the factors causing the increase are one-off/temporary factors. The Bank of England will 'look through' these as long as they don't feed through into significantly higher wage demands,

## Deflation - down but not out

Indeed, deflationary or at least low-inflation forces still exist in the UK economy, especially in the labour market. Many sectors are seeing a second year of pay freezes and as a result wage growth is extremely weak. Wage growth is a good leading indicator of service sector inflation, suggesting that this will continue to fall in 2010.



In the medium term, this deflation/inflation tug-of-war is likely to be settled by the pace of growth in the UK. A strong recovery would imply that labour-market conditions will improve and wage growth resume. Conversely, a weak recovery would allow some of these deflationary forces to become more entrenched. This would then allow inflation to fall towards the end of the year, and especially in 2011 once factors such as higher mortgage costs and administrative tax increases drop out of the y/y comparison.

## Conclusion

In the short-term, there are further upside risks to UK inflation that are likely to support strong investor demand for inflation protection, such as index-linked bonds. However, in the medium to long term inflation and inflation expectations should fall back, especially if growth remains weak and labour market slack persists. For now we expect inflation concerns to trump deflation concerns.

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