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## EUROPEAN MARKET COMMENT

# BENIGN INFLATIONARY PRESSURES IN THE UNITED KINGDOM: WHAT SHOULD INVESTORS DO ABOUT IT?

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## Benign Inflationary Pressures in the United Kingdom What Should Investors Do About It?

Inflationary pressures in the United Kingdom seem under control at the moment. The Consumer Prices Index (CPI) ticked up a mere 1.3% in 2003 (see Table A), well below the Bank of England's (BOE) 2.0% inflation target and the historical 1.6% average since 1994, and is among the lowest rates in the European Union since 2000. However, inflation as measured by the Retail Price Index excluding mortgage payments (RPIX) expanded at the brisker pace of 2.6% for the year, slightly above the BOE's 2.5% annual target. The current 1.3 percentage-point disparity between the two measures is primarily due to higher housing costs, which are not included in the CPI measure (see Various Ways to Measure Inflation on the following page for more details).

Despite benign pricing pressures, the BOE is widely expected to raise policy interest rates at its upcoming February 5 meeting; this follows November's 25-basis point (bp) hike to 3.75%. The consensus also believes the Bank will gradually raise rates over 2004 in order to cool an economy that appears to be gaining momentum while running close to full capacity. In 2003, GDP rose 2.5% (in the fourth quarter alone increasing 3.8% compared to the third quarter). Housing price growth, while decelerating, is still quite high, rising 17.3% in 2003, after a 23.1% increase in 2002 (see Table B). Although industrial production is flat, unemployment is only 3%, a 28-year low, and real household spending has risen at a slightly higher-than-expected pace in recent months.

### Investment Implications

Although inflationary pressures seem quite tame, institutional interest in the United Kingdom in inflation-hedging products has grown noticeably in recent months. Last year, inflation-linked bonds posted strong results, with the FTSE British Government Index-Linked All Stocks Index returning 6.5%. The break-even point (the spread between nominal gilts and linkers) increased 52 bps for the year for the ten-year segment, pointing to simmering concerns about the prospects for rising pricing pressures (see Table C). Ten-year linkers currently yield 2.0% while ten-year gilts yield 4.8%. Investors will therefore be better off with linkers if annual inflation averages more than 2.8% over the next decade. While current inflation measures are around this level, this degree of inflation is low by historical standards. Over rolling ten-year periods since 1957, ten-year inflation has exceeded 2.8% in every period but three, or 92% of the time.

Other inflation hedging investments include hard assets—such as equity real estate, energy reserves, timber, commodity indices, gold, and agriculture—and asset-based stocks, such as REITs, energy, and mining stocks.<sup>1</sup> Each has its pros and cons. First, supply/demand dynamics will determine how well each asset hedges against an inflationary shock; for instance, real estate investments would not provide an effective hedge if commercial real estate vacancy rates were high at the time. Second, since these assets are likely to perform well only during periods of inflation, they carry a significant opportunity cost over the long term. Third, since most inflation hedges are relatively illiquid, it may be difficult to realize gains to meet spending requirements or to rebalance the total fund's asset allocation.

Although inflationary pressures appear quite tame at the moment, the surge in global liquidity, increased strains on government budgets, and the momentum of the U.K. economy have prompted investors to search for assets that could hedge against an inflationary shock. While the need for such assets may not seem urgent at the moment, history has consistently demonstrated that the optimal time to invest in them is when they are out of favor and relatively inexpensive.

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<sup>1</sup> Please see our upcoming paper on global inflation-hedging investments that will discuss these investment opportunities in more detail.

## Various Ways to Measure Inflation

In December, the Bank of England changed its official inflation measure from the Retail Price Index excluding mortgage interest payments (RPIX) to the Harmonised Index of Consumer Prices (HICP, also formally known as CPI). There are two main differences between the gauges: how prices are averaged and how owner-occupied housing costs are treated. RPIX uses arithmetic averages, while HICP uses unweighted geometric averages; the former has been faulted for giving the greatest weight to the highest-priced products.

HICP excludes a range of owner-occupier housing costs, such as the council tax, house depreciation, mortgage interest payments, road tax, buildings insurance and ground rent, and house transaction costs. These costs accounted for 9.5% of RPIX in 2003. The Office for National Statistics (ONS) decided to exclude these housing costs primarily because of the difficulty in achieving an international or national consensus concerning their treatment in consumer price indices. For example, depreciation costs are strongly influenced by land prices, particularly if land represents a high proportion of overall house prices and if prices diverge from house construction costs. In addition, CPI covers all private households, while RPIX excludes the top 4% by income and pensioner households who derive at least 75% of their income from government benefits.

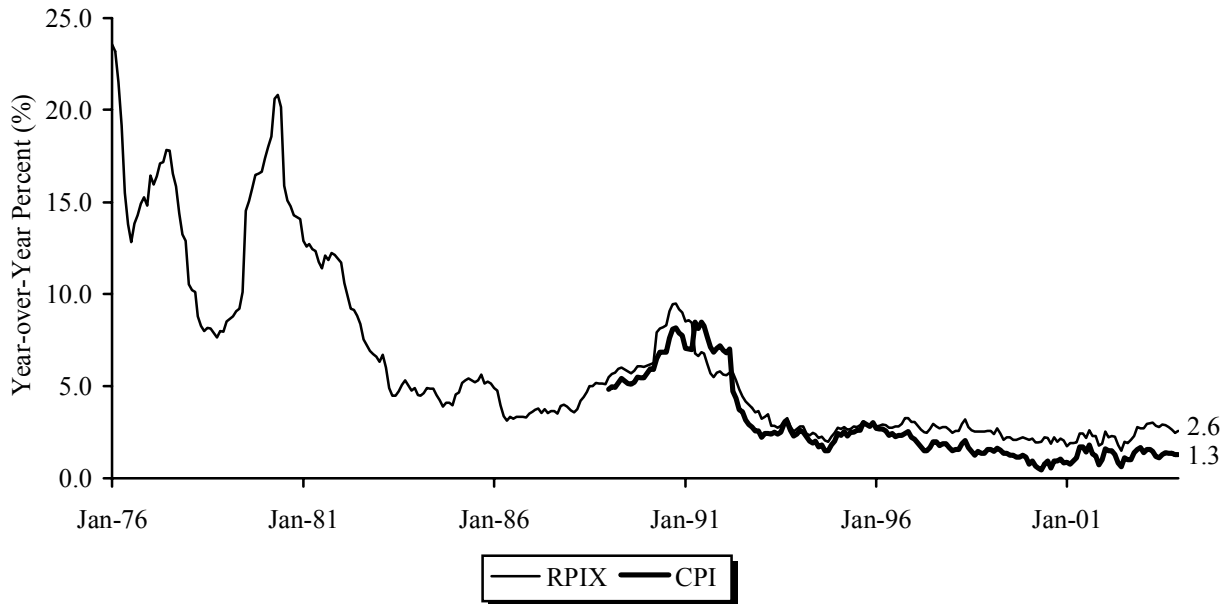
According to the ONS, RPIX inflation has exceeded CPI inflation by an average of 0.7 percentage points annually since 1989 (see Table A, bottom panel), due to the exclusion of housing costs. This disparity should have little material impact on investors, however, since pensions, benefits, and index-linked gilts will continue to be calculated according to RPI.

The European Union developed HICPs as cross-country measures in order to determine whether prospective members of the European Monetary Union would pass the inflation convergence criterion. The index is the measure used by the European Central Bank to assess price stability.

**Table A**

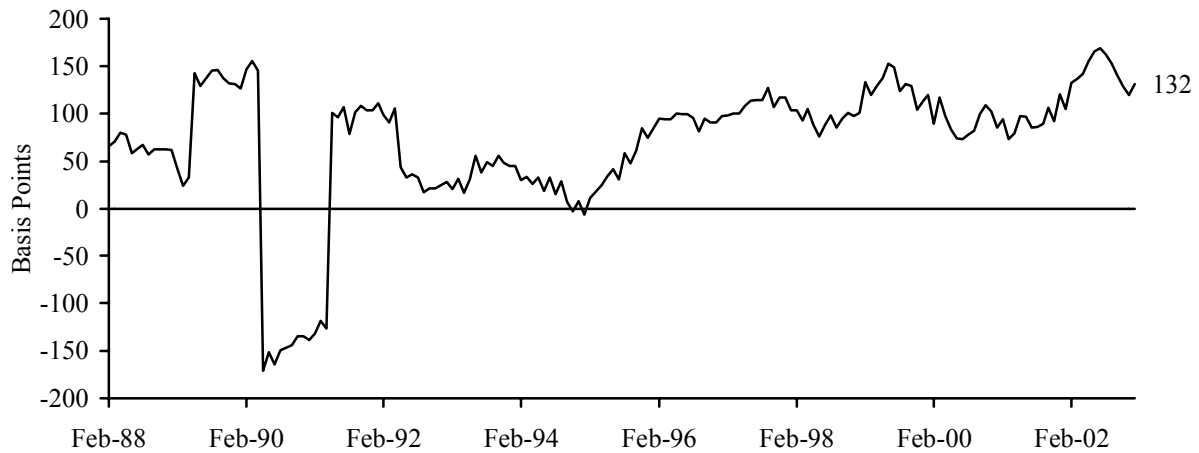
**U.K. RETAIL PRICE INDEX EXCLUDING MORTGAGE INTEREST PAYMENTS AND THE CONSUMER PRICES INDEX**

**31 January 1976 - 31 December 2003**



**Spread between the U.K. Retail Price Index and the U.K. Consumer Prices Index**

**28 February 1988 - 31 December 2003**



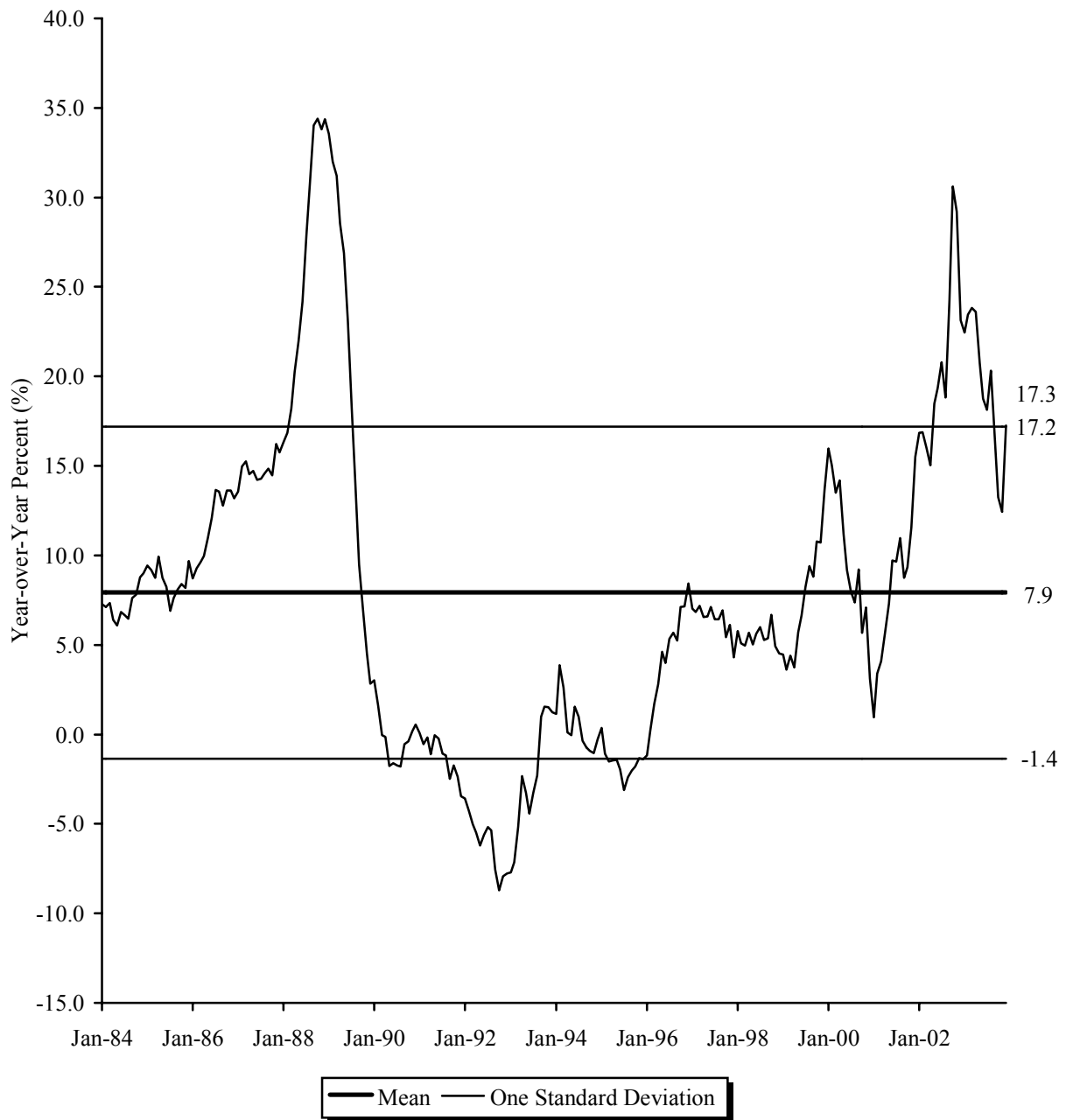
Sources: National Statistics website: [www.statistics.gov.uk](http://www.statistics.gov.uk) and Thomson Datastream.

Notes: The official CPI starts in 1996 but historical estimates back to 1988 have been calculated based on archived RPI data. Prior to 10 December 2003, the CPI was published as the Harmonised Index of Consumer Prices.

**Table B**

**U.K. HOUSING PRICES**

**31 January 1984 - 31 December 2003**

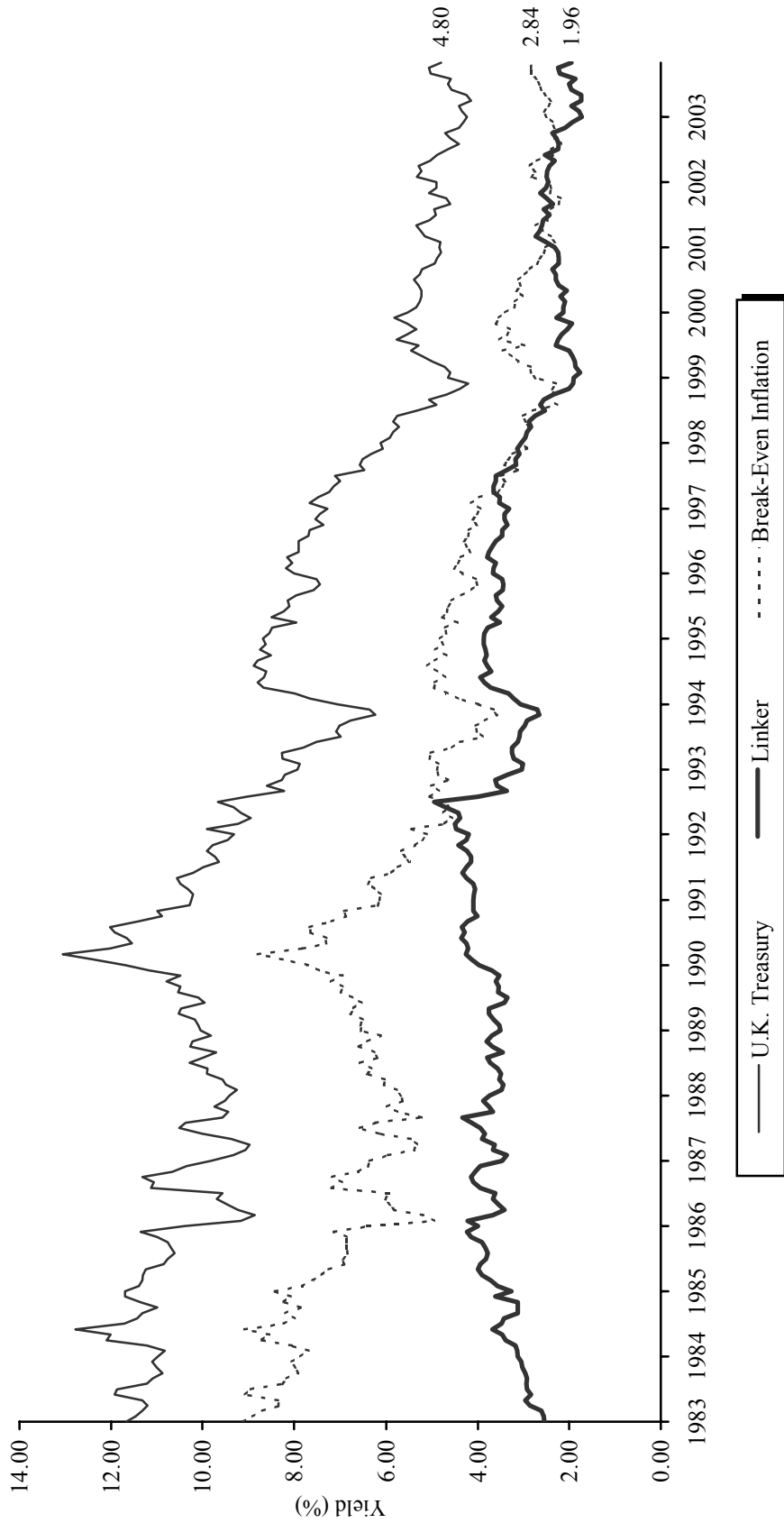


Source: Thomson Datastream.

Note: Data represent the U.K. Halifax All Houses Price Index.

**Table C**  
**TREASURY AND LINKER YIELDS FOR THE UNITED KINGDOM**

1 February 1983 - 31 December 2003



Source: Global Financial Data.