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EUROPEAN MARKET COMMENT: U.K. REFLATION WATCH

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U.K. Reflation Watch
Inflation: Creeping Higher, But Under Control

The abrupt jump in oil prices and the growing evidence that global economies have bottomed have led many to question whether inflationary forces may be gaining steam. While global disinflationary forces, such as excess capacity and cheap imports from China remain intact, reflationary pressures carry the potential to turn benign early-cycle economic activity into a more malevolent type of inflation. We examine these issues on a global basis in this month's "Global Market Comment," and focus on the United Kingdom in this report.

In the United Kingdom, inflation appears to be firmly under control, but has been increasing over the course of the year. The retail price index (RPIX, excluding mortgage payments) increased 2.3% in the year ending March 31, 2002, up from the 1.9% growth in 2001 (see Table A). The most significant drivers of this increase have been the continuation of strong consumer spending and the rise in oil and housing prices. At least at this point, most pundits expect inflation to remain under the government's annual 2.5% target this year.

The United Kingdom faces a potential threat from higher petrol prices, even though it is a net exporter of oil. The consensus believes that the recent surge in oil prices, up 35% since November, will not threaten to ignite broader inflation, unless prices rise and stay at about $40/bbl through 2003, which most experts believe is unlikely.

The improving domestic economy is gradually generating pricing pressures, but to date, they have been limited. The U.K.'s beleaguered manufacturing sector may be turning up, as positive growth was reported for the first time in six months in February, while demand for exports will expand as global economic growth picks up momentum.

Consumers hold the key to the future of inflation in the United Kingdom. Household consumption is currently high, and the housing market is red hot, propelled by 38-year low interest rates—prices jumped 16% in March from a year earlier (see Table B). RPIX is particularly sensitive to changes in housing prices, its largest component, accounting for 16.9% of the index. (Petrol and food are the second and third largest components, accounting for 14.6% and 11.8% of RPIX, respectively.) Housing was responsible for the 1989 spike in inflation, as housing prices rose 43% between January 1988 and July 1989, feeding into general price inflation after a bit of a lag. The Bank of England (BOE) subsequently popped the housing bubble by raising its benchmark rate 7.5 percentage points over 17 months. If the housing market and consumer spending do not cool down by themselves, the central bank may soon initiate a similar cycle. In recent days, BOE watchers have predicted an imminent rate hike because the just-released government budget has delayed a proposal to increase personal taxes. This delay, they believe, will leave consumer spending unchecked and stimulate the housing market even further, thereby forcing the BOE to hike rates in the coming months.

Another potential source of inflation is the services sector, which accounts for two-thirds of the economy. Following a similar pattern as the rest of the developed world, services inflation in the United Kingdom has been outstripping goods inflation (see Table C). While the goods component of RPIX remains at low levels, rising only 0.1% for the year ending in March 31, 2002, prices in the services sector rose 4.6% chiefly due to rising insurance costs.

These stress points may have begun to catch the attention of capital markets. Since the beginning of February, the break-even spread of ten-year nominal gilts and linkers rose 38 bps to 2.2%, as real yields remained relatively stable and nominal yields increased (see Table D). While a ten-year inflation expectation of 2.2% is low by historical standards, this is the highest break-even rate of inflation priced into the markets since August 2001.

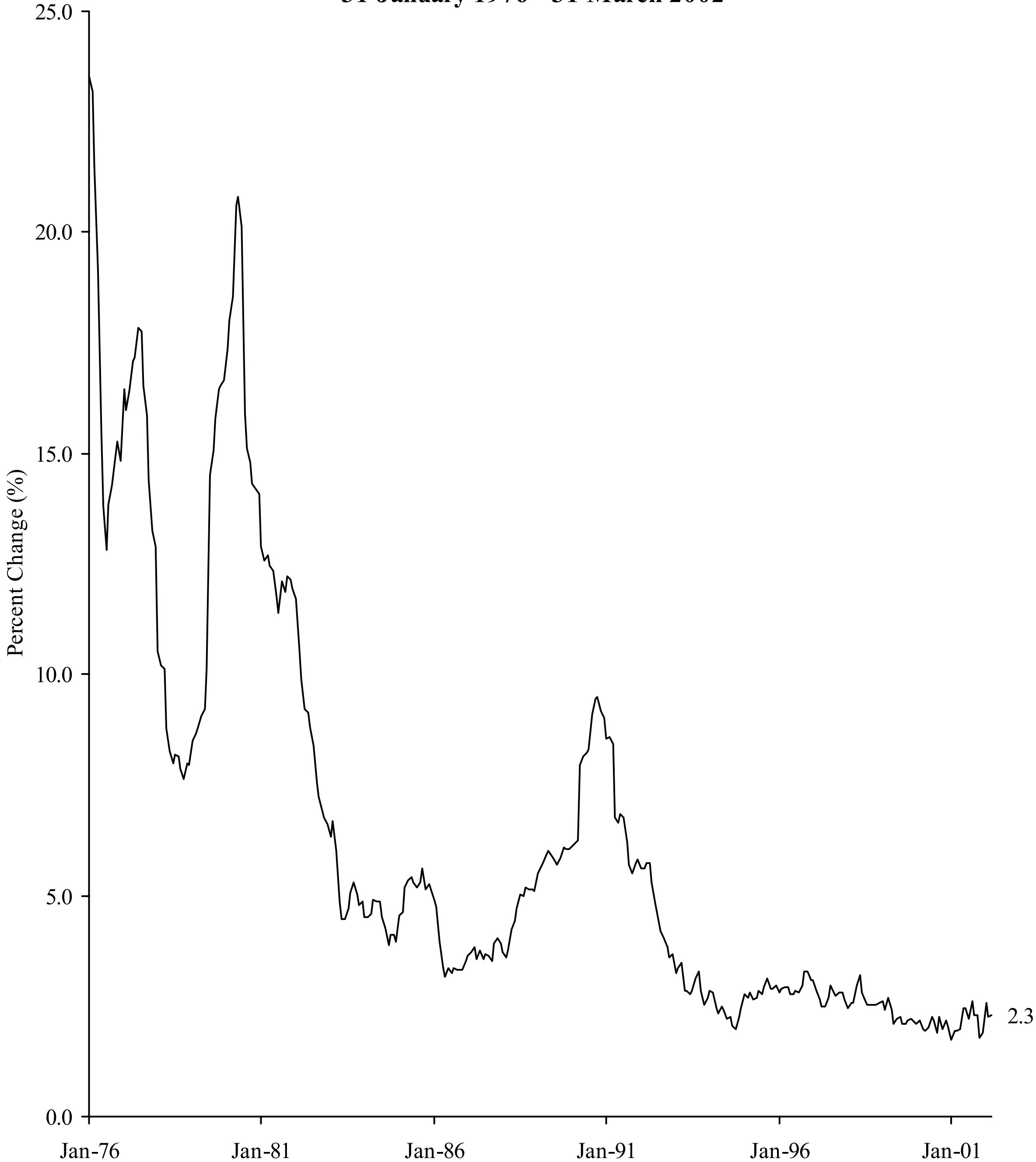
One force that holds the potential to set off inflation is the pound/euro exchange rate. If, in anticipation of joining the European Monetary Union, the pound sterling depreciates, inflationary pressures could build. Recent media reports indicate that the government foresees depreciation in the order of 30% against the euro, which is double the consensus among City forecasters. If the government is right, the United Kingdom would import a good deal of inflation.

While inflationary forces do seem to be picking up, the prospects of a sharp spike in inflation seem limited. Nonetheless, institutions that believe unexpected inflation would hamper their ability to support their spending without selling assets at depressed prices should consider including inflation-hedging assets in their portfolios. The best time to buy these assets is when they are relatively cheap, which is often when inflation expectations are subdued. Valuations among inflation-hedging assets are varied, with oil and gas partnerships and commodities on the inexpensive side from a long-term perspective, despite the recent run up in the price of oil. U.K. property has experienced strong returns over the last couple of years; however, yields remain relatively attractive, particularly given the low interest rate environment. In addition, the property market is heterogeneous and inefficient, leaving room for skilled managers to earn above average returns. U.K. ten-year linkers, with a real yield of 2.93% at the end of March, are expensive relative to historical real yields in the United Kingdom and relative to real yields available on inflation-indexed bonds in other countries, but offer compelling valuations relative to U.K. gilts, as the yield spread between linkers and gilts is only 2.2%, indicating linkers would outperform gilts if inflation is above that rate.

Table A

U.K. RETAIL PRICE INDEX EXCLUDING MORTGAGE INTEREST PAYMENTS

31 January 1976 - 31 March 2002



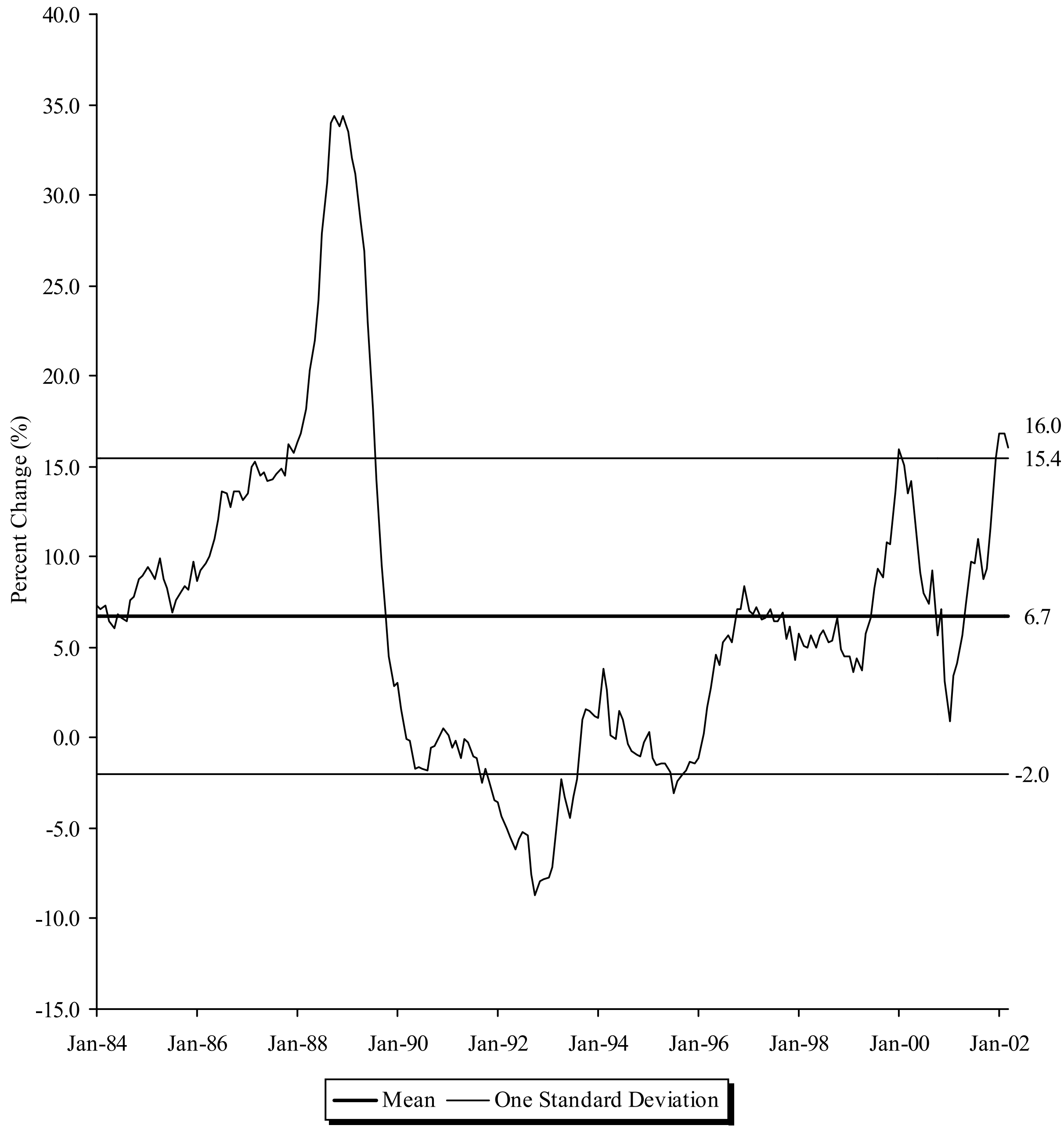
Source: Thomson Financial Datastream.

Note: Data reflect year-over-year price changes.

Table B

U.K. HOUSING PRICES

31 January 1984 - 31 March 2002



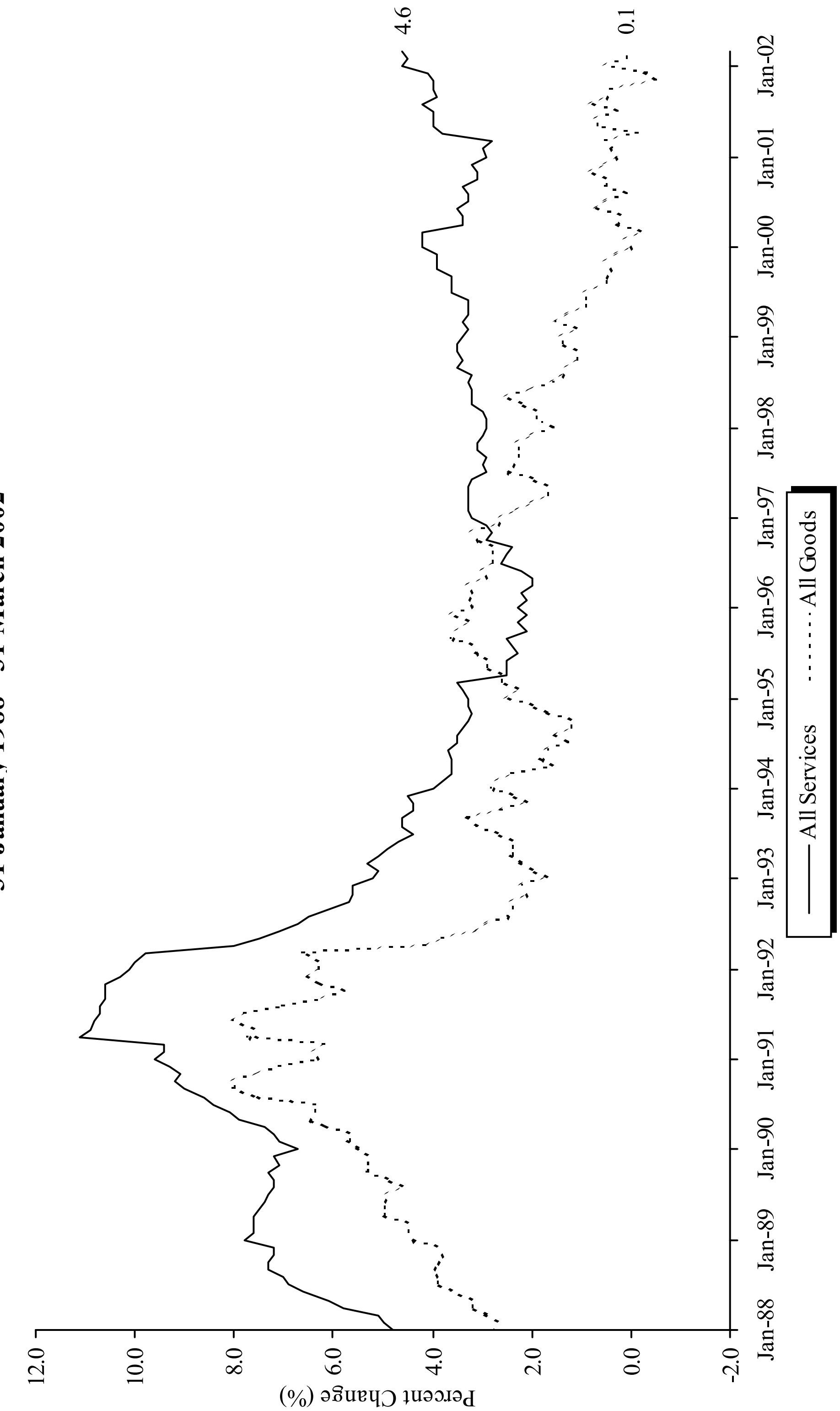
Source: Thomson Financial Datastream.

Note: Data represent the year-over-year percent change of the U.K. Halifax All Houses Price Index.

Table C

U.K. GOODS AND SERVICES INFLATION

31 January 1988 - 31 March 2002



Source: Thomson Financial Datastream.

Note: Data reflect year-over-year changes.

Table D

TREASURY AND LINKER YIELDS FOR THE UNITED KINGDOM

30 September 1993 - 31 March 2002