Liquid Insight

Misleading UK inflation, past and present, point to UKTi underperformance

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Rates and Currencies Research
Global

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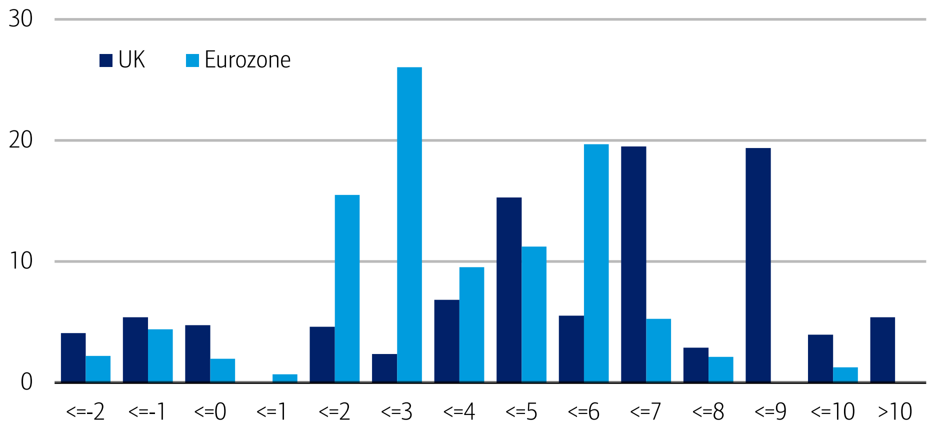
Key takeaways

- A quirk of timing could see UK beat peers to the inflation target. But the inflation persistence problem hasn't gone away.
- We revisit pre-GFC era, when UK inflation printed lower than Euro, to remind ourselves that things were not what they seemed.
- UK needs higher real rates than others to keep inflation in check. Its poor PSNW ranking and huge Gilt call push same way.

By Mark Capleton

Chart of the day: UK and Eurozone core CPI component inflation rate dispersion, weighted, %
UK progress way behind its large neighbour.



Source: Refinitiv, ofA Global Research

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Still bearish Gilts. Let us count the ways…

By a quirk of timing, the April energy price cap reduction is likely to help propel UK inflation to target, but things are not so pretty under the hood, as our Chart of the Day shows. The UK inflation persistence problem hasn't gone away and will need materially higher real policy rates to deal with it, relative to peers. But with UK breakevens so high, bearish UK real rates versus Eurozone equivalents is the cleaner trade.

For those that point to the UK's benign reported inflation pre-GFC to say there's nothing unusual about the UK, we explain inside that things were not quite what they seemed back then. We also revisit the issue of the UK's poor Public Sector Net Worth ranking and update our numbers for the Gilt market's huge call on savings, post-Budget.

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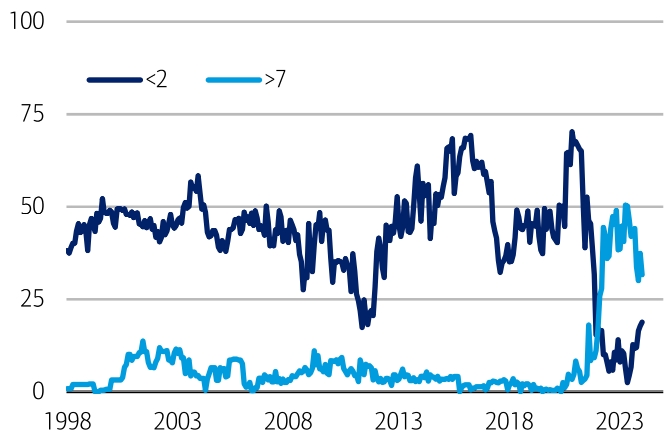
UK inflation – down to target but not obviously sustainably

By a quirk of base effects, the April energy price cap reduction might mean UK inflation beats the Eurozone in the race to return to target. Indeed that, coming hot on the heels of a mild Budget boost, is prompting talks of a May UK general election, despite the government's current pollstanding. But, as our Chart of the Day and the two exhibits below show, the UK's underlying inflation picture is considerably less benign.

Exhibit 1: UK – proportion of core CPI running <2% and >7%
Slow to deal with the fat upside tail, %



Source: Refinitiv, BofA Global Research

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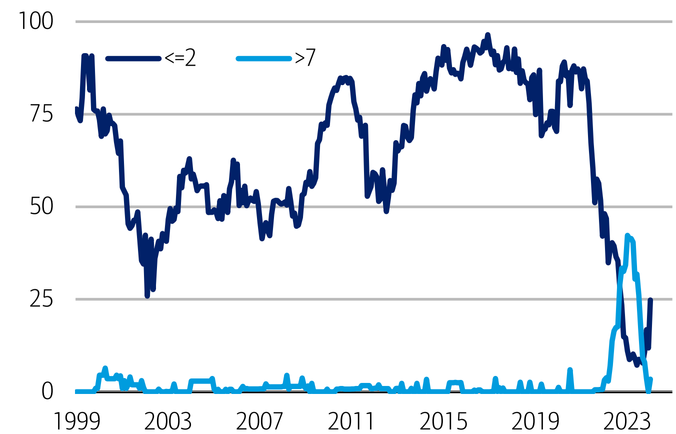
Exhibit 2: Eurozone – proportion of core CPI running <2% and >7%
Better progress lifting sub-2% portion, and >7% share effectively gone.



Source: Refinitiv, BofA Global Research

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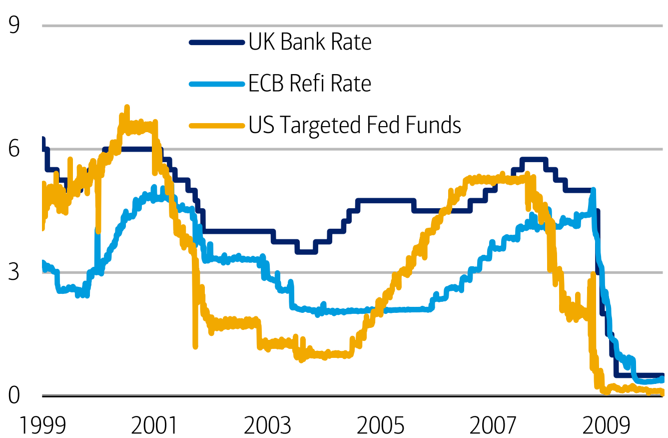
We've said before that the UK's underlying inflation persistence problem long-predates Brexit, although it was aggravated by it. When we point out that the UK "had to wave a bigger stick" than its peers (needing much higher average policy rates, Exhibit 3) before the global financial crisis, in order to keep inflation in check, we are often countered with the fact that the UK did actually report lower average inflation than the US and Eurozone in that period.

UK didn't really have unusually low inflation pre-GFC. It was a fashion victim

Exhibit 3: Pre-financial crisis, UK needed higher average policy rates, %
UK needed a "bigger stick" to keep inflation in check, as we've often said.



Source: Bloomberg

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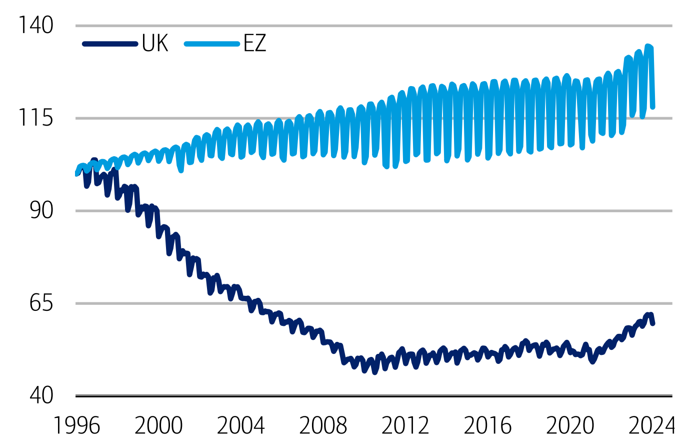
Exhibit 4: The UK clothing price collapse that wasn't
Reported UK and Euro clothing and footwear CPI indices, rebased.



Source: Refinitiv, BofA Global Research

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Except it wasn't really like that. The UK reported severe clothing price deflation that didn't actually happen, as a result of a sampling discontinuity glitch (Exhibit 4), and this persisted for a very long time. Despite the relatively small weighting of clothing and footwear, the BoE estimate that this error resulted in overall CPI inflation being understated by 37bp per annum, on average, until it was fixed in 2010. See the Bank's

February 2011 Inflation Report for a discussion of the issue, and a footnote to a chart in the February 2015 edition for the source of its error estimate (reproduced in Exhibit 5).

Exhibit 5: Read the small print. Ignore the table, look at footnote (a)
UK inflation understated by 0.37% per annum pre-2010, according to BoE.

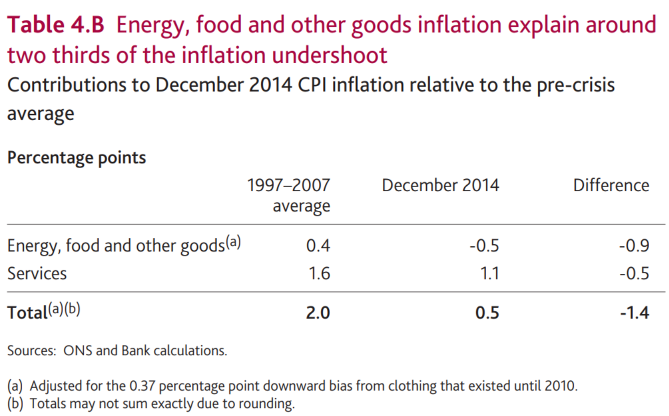

Table 4.B Energy, food and other goods inflation explain around two thirds of the inflation undershoot
Contributions to December 2014 CPI inflation relative to the pre-crisis average

Percentage points

	1997–2007 average	December 2014	Difference
Energy, food and other goods[(a)]	0.4	-0.5	-0.9
Services	1.6	1.1	-0.5
Total[(a)(b)]	**2.0**	**0.5**	**-1.4**

Sources: ONS and Bank calculations.

(a) Adjusted for the 0.37 percentage point downward bias from clothing that existed until 2010.
(b) Totals may not sum exactly due to rounding.

Source: Exhibit from Bank of England (BoE) Inflation Report, February 2015
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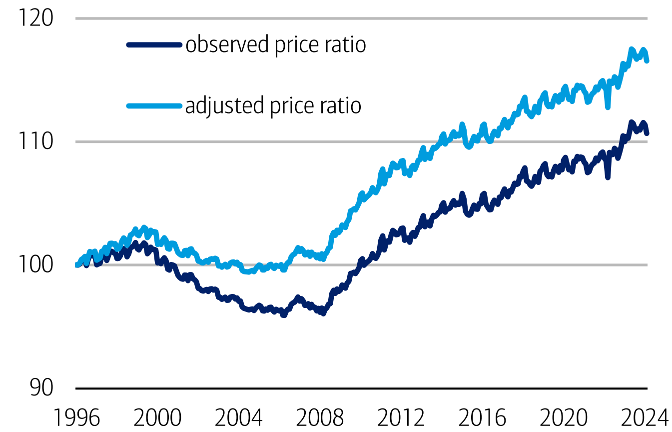
Exhibit 6: Ratio of UK-to-Euro CPI indices, rebased
Adjusting for understatement, UK's bout of low inflation v Euro an illusion.



Source: Refinitiv, BofA Global Research
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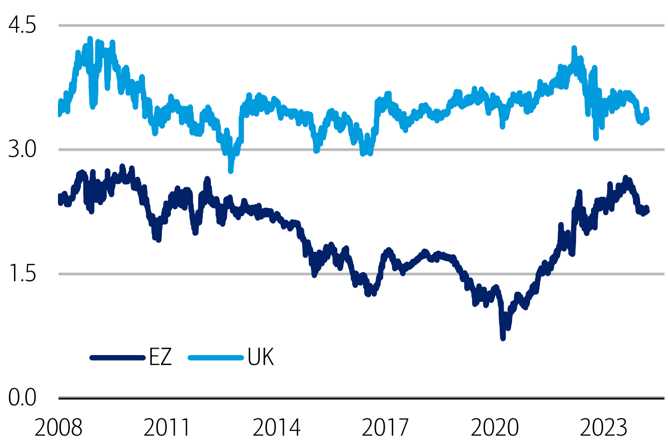
This isn't to say that the UK should price materially higher inflation that Eurozone (although it does). Our take would be that the UK has a much tougher fight on its hands, which will require meaningfully higher long term real policy rates, *and this isn't priced.*

Exhibit 7: UK & Euro 5y5y inflation, %
4 of the 5 years spanned are now beyond 2030 RPI reform date.



Source: Bloomberg
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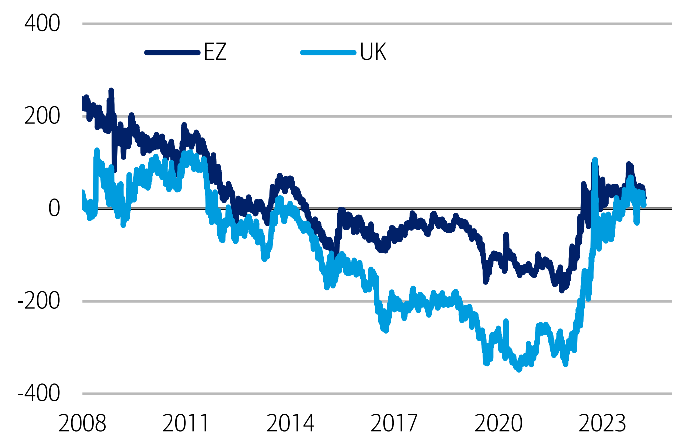
Exhibit 8: UK & Euro 5y5y inflation, %
History makes UK look expensive, but RPI-CPI wedge much less valuable now.



Source: Bloomberg
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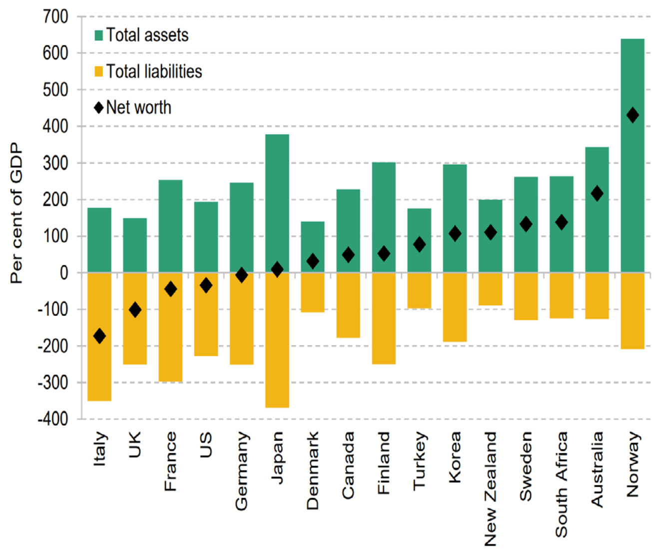
In case you'd forgotten…

We have recently talked about the UK's disadvantageous net external liability position in some detail, so here we will refresh our thoughts other "fragilities" that we keep coming back to, because these also point to higher required real yields over time. Exhibit 9 from the Institute of Fiscal Studies shows how the UK's relative government indebtedness ranking suffers greatly by shifting from standard debt/GDP measures to the less widely understood Public Sector Net Worth (PSNW) measure, which takes account of broader assets and liabilities of the state.

And after the Budget, we can say once more that the Gilt market call on investors is simply huge - relative to GDP, relative to domestic savings, relative to the current stock of privately held Gilts, and relative to the stock of defined benefit pension liabilities (which are now half their 2020 peak market value).

Exhibit 9: Shift from debt/GDP to PSNW/GDP and UK falls down table

With few public assets and large public liabilities, relative to others, UK's Public Sector Net Worth compares unfavourably to most.



Note: Data for 2020 used for consistency, as 2021 data are available only for a subset of countries.

Source: IFS

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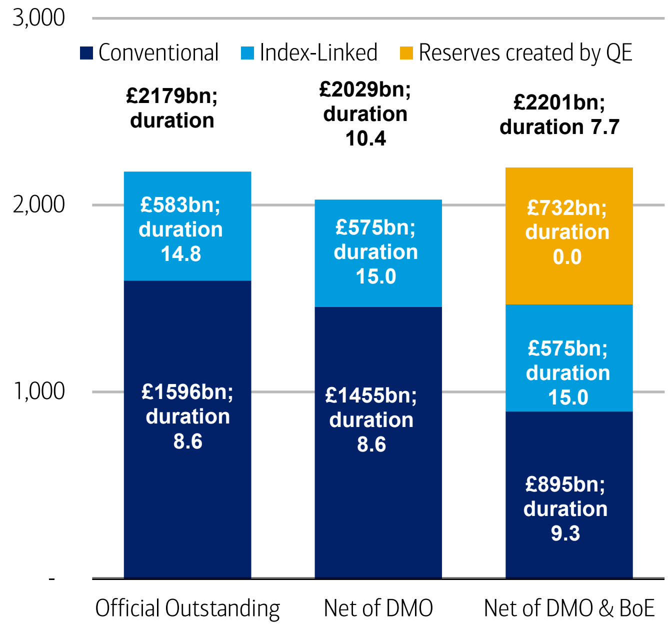
Exhibit 10: UK national debt shown three ways, £bn

UK 2024-25 funding need very large relative to stock of privately held Gilts.



Source: DMO, BoE, BofA Global Research, Bloomberg

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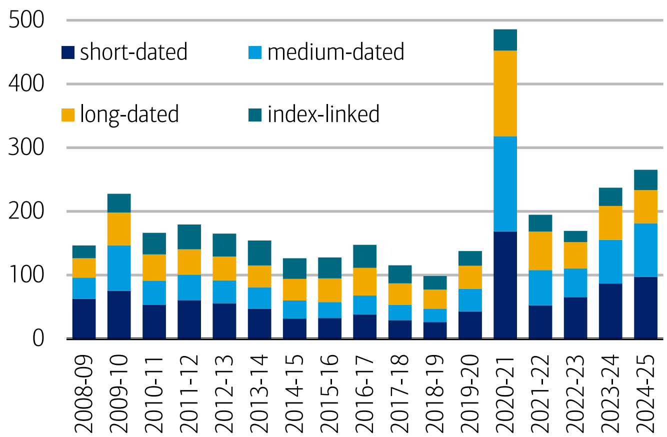
Over the course of the upcoming fiscal year, we estimate that £125.4bn of net Gilt sales from the DMO will be supplemented by £89.7bn net supply from the BoE (£100bn less losses crystalised on sale or redemption) to give £215.1bn – equivalent to almost 15% of the currently outstanding privately held stock of Gilts (Exhibit 10).

Exhibit 11: Gross DMO Gilt sales per fiscal year by "bucket", £bn

'24-'25 would be record but for extreme 2020-21 year with heavy covid bill.



Source: DMO, BoE, BofA Global Research, Bloomberg

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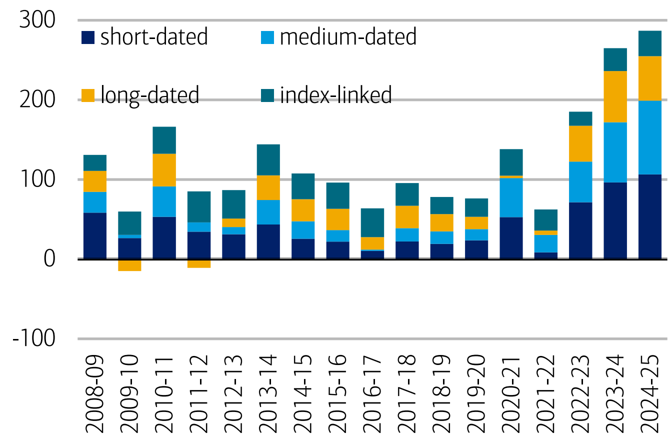
Exhibit 12: Combined DMO & BoE Gilt sales by "bucket", £bn

And it turns into a new record when adding BoE market involvement.



Source: DMO, BoE, BofA Global Research, Bloomberg

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This all leads, perhaps inevitably, to a reiteration of our bearish Gilt bias, relative to other markets. With the UK's breakeven spread already high compared to others, and with UK supply tilted a little more towards medium-dated Gilts, we continue to propose shorting 10-year area UK linkers against equivalent OATei issues.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Ahead of a busy week, **Liquid Cross Border Flows**, 4 Mar 2024

Rates, FX & EM trades for 2024

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: The June target 08 March 2024

Global Rates Weekly: Double WAMmy 08 March 2024

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