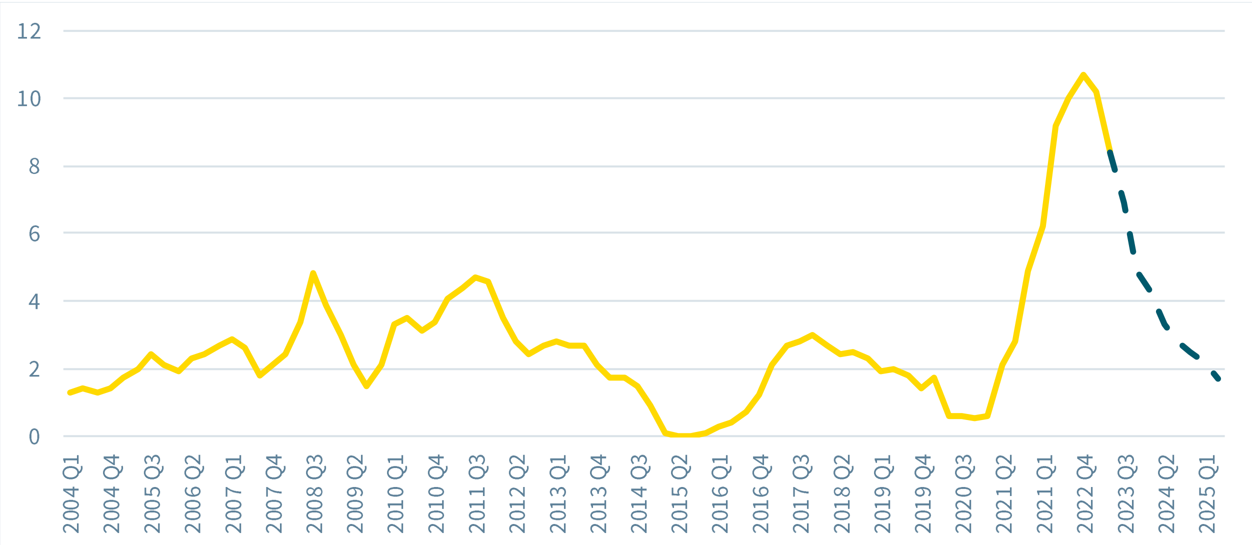
21 August 2023

Client Briefing: Inflation heading down

The UK's most recent CPIH inflation print was 6.4 per cent, down from 7.3 per cent as of end-June,[1] pointing to the lowest level since February 2022. The easing in the annual inflation rates in July principally reflected price changes in the housing and household services division. The main driver behind the change was gas, with monthly prices falling considerably (25.2 per cent) between June and July this year. This was largely because the Office of Gas and Electricity Markets (Ofgem) lowered the price cap in that month. In addition, there were also notable downward effects from food and non-alcoholic beverages, particularly from milk, bread and cereals. Hotels and passenger transport by air provided the largest offsetting upward contributions to the change in the annual rate. The fall in inflation will be welcome, but the fact of the matter is inflation is still high. Furthermore, the underlying componentry shows that inflation remains sticky.

CPIH inflation and forecast



Source: ONS, BoE as at August 2023.

[1] Inflation and price indices - Office for National Statistics (ons.gov.uk)

Looking ahead, market participants are agreed on the direction of travel – inflation is set to fall. However, there are a range of views on the rate of decrease. The Bank of England expects inflation to return to the two per cent target by early 2025. The Aviva Investors House View (published in July, based on end-June data) broadly agrees with the Bank's forecast, with inflation falling close to target by the end of 2024.

The alternative view is that inflation will not decrease as fast as expected. Essentially this view ascribes more weight to the persistence of inflation in the sub-components keeping the headline rate higher for longer.

"*Inflation in the UK has eased from the highs but the path to the two per cent target is not a clear one. There are additional pressures building, such as the termination of the grain supply deal between Russia and Ukraine, the banning of rice exports by India and the decimation of the olive oil crop in Spain that could see food and therefore headline inflation go higher again. With core inflation still high, this isn't supportive of inflation moving to target in the near future."* **Richard Hallett, Head of Liquidity**

Implications for rates and yields

The Bank of England looks to be close to finishing the tightening cycle but has stated rates are likely to stay higher for longer as inflation in the UK proves sticky. This is a positive for cash investors as it means they can reasonably expect high yields on money market funds (MMFs) for the foreseeable future.

The Bank of England has stated that: "*The [Monetary Policy Committee] will ensure that Bank Rate is sufficiently restrictive for sufficiently long to return inflation to the two per cent target sustainably in the medium term, in line with its remit.*" [2]

The Bank of England increased the base rate to 5.25 per cent in August 2023. Current market forecasts price in one to two more rate hikes, with a terminal rate of around 5.75 per cent. Any further rate hikes will feed through to MMF yields quickly. Our Sterling Liquidity Fund's yield was 5.25 per cent (gross) as of 10 August 2023. In other words, it took **just seven days** for the rate rise to feed through, in full, to the fund's yield. The next rate decision is on 21 September.

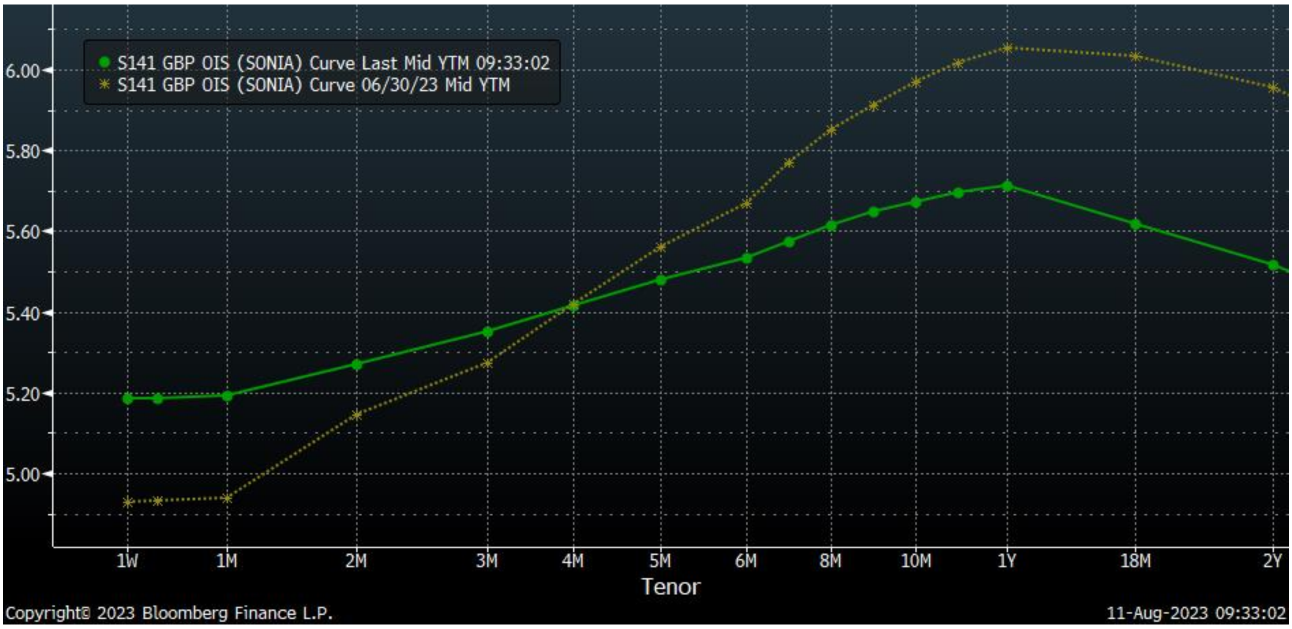
Time taken for the latest rate rise to feed through to Sterling Liquidity Fund yield:
7 days

[2] Bank Rate increased to 5.25% - August 2023 | Bank of England

Current positioning and outlook

"The curve is currently pricing in a terminal rate of 5.75 per cent and, whereas this is our central scenario, we do not have high conviction. To mitigate the risks we have adopted a disciplined approach to duration risk, taking smaller positions in long-dated fixed-rate certificates of deposit, spread out over time to gain positive interest-rate carry, whilst favouring floating-rate investments to keep duration shorter." **Richard Hallett, Head of Liquidity**

The SONIA curve has flattened



Source: Bloomberg, 11 August 2023

The market is currently pricing the terminal rate in around a year's time, or around mid-2024. Clearly there is uncertainty as to the path to that point, as much as there is to the eventual terminal rate itself. We expect the journey to be materially data-dependent. The stronger inflation print in June 2023 was a key driver of the +50bp interest-rate increase from the MPC.

If market pricing is to be believed, the terminal rate will be short-lived. Current pricing suggests cuts later in 2024, albeit to levels at or above the current rate.

"We are far from convinced that the cuts the market is pricing as early as Q2 2024 will materialise. We do not think inflation will continue to fall in a linear fashion, as it has so far in 2023. This means policy rates will remain restrictive for longer." **Josh Bramwell, Portfolio Manager**

Conclusion

Inflation remains high, although it is clearly on a declining trend. Opinons vary on the pace at which inflation will decrease from here, but the implications for policy are clear: rates are highly likely to remain high for a sustained period of time. For cash investors, this means they can expect yields to remain high on MMFs. With the potential for rate cuts on the horizon, however, investors may wish to begin considering “standard” MMFs, due to their greater ability to term out exposures compared with short-term MMFs.

Key Risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

The Fund invests in money market instruments such as short term bank debt the market prices/value of which can rise as well as fall on a daily basis. Their values are affected by changes in interest rates, inflation and any decline in creditworthiness of the issuer.

This is not a guaranteed investment, an investment in a Money Market Fund is different from an investment in deposits and can fluctuate in price meaning you may not get back the original amount you invested. This investment does not rely on external support for guaranteeing liquidity or stabilising the NAV per unit or share. The risk of loss of the principal is to be borne by the investor.

Important information

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Where relevant, information on our approach to the sustainability aspects of the fund and the Sustainable Finance disclosure regulation (SFDR) including policies and procedures can be found on the following link: https://www.avivainvestors.com/en-gb/capabilities/sustainable-finance-disclosure-regulation/

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