Henwood
COURT

Creating your tomorrow

Long term inflation report

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04/12/2020

Abbreviations

EU	European Union
CPI	Consumer Price Index
RPI	Retail Price Index
SEPA	Single Euro Payments Area

INTRODUCTION

Each year Henwood Court undertakes an assessment on what the long-term rate of inflation is expected to be. This will then be used within client financial plans. The rate of inflation is probably the most important variant in all of the economic numbers we use in financial plans. It will impact on the expected rise in future expenditure, assumed increases to inflation protected pensions (including the state pension), while it interacts with other assumptions on cash returns, investment, and property growth. Due to the compounding effect, even just a 1% variant on inflation can have a significant positive or negative impact on future cash flow forecasting.

The current rate of CPI is 0.7%[1] and RPI 1.3%[2]. This has been flattened of course due to the reduction in consumer spending as a result of Covid-19. You, like me, I am sure have had to cancel or defer our trips away, while trips to the shops have been curtailed. This has had a disinflationary effect.

Looking forward, the uncertainty created by the global pandemic makes inflation forecasting very difficult, particularly if you then throw in the impact of Brexit.

However, while we may see inflation bounce back to levels pushing 3% or 4% next year as pent-up consumer spending gets released, most experts predict inflation will settle down to the government's target rate of 2% in the medium to longer term.

Over the past 12 months we have assumed inflation will be 2.5%, and it will be no surprise, given the expectations, that this is the rate we will continue to use in client's financial plans. This takes the government's target return, and for prudency, adds 0.50% to the rate, making our cash flow forecasting a little more cautious.

[1] Consumer price inflation, UK: October 2020- ONS
[2] RPI All Items: Percentage change over 12 months: Jan 1987=100- ONS

SUMMARY

LEADING RISKS TO CURRENT AND FUTURE INFLATION RATE

The ongoing Coronavirus pandemic and no deal Brexit uncertainties represent the biggest risks to inflation within the next 12 months, with other risks being slow negotiations with the US for a trade deal. However, the coronavirus pandemic is likely to be the bigger threat to a stable inflation rate in the short term to medium term as it prevents certain companies from trading. COVID-19 risk will mean that foreign holidays will be purchased less and since foreign holidays are one of the big purchases that have been hugely curtailed due to COVID-19 it will result in inflation staying below the 2% target as set by the government[3]. All this means that forecasting inflation has never been as hard as it is currently, as uncertainty over the long run economic effects of the coronavirus and a Brexit outcome among other issues means making an accurate inflation forecast has become more complicated and more prone to inaccuracy. We wouldn't be surprised therefore if inflation in 12 months' time would therefore be around 3% or 4% as consumer spending rebounds and the government invests money into different projects across the UK creating jobs. Beyond the next 12 months however, inflations course is less predictable particularly in the current circumstances, and more speculative as the economy recovers from Brexit and the Coronavirus, inflation is expected to return to around 2% until an unforeseen crisis or recession forces it to move above the government's target but inflation will then move back to the 2% inflation target set by the Bank of England.

THE CASE FOR STABLE INFLATION

In the long run inflation is more likely to be stable as it is of great importance to overall economic health and so the government will take action to move it to the target. In the short run inflation is less likely to be stable given current circumstances but the government has initiated a period of unprecedented expansionary fiscal policy in an attempt to stymie the potential loss of jobs that could have resulted from the COVID-19 lockdowns. This put national debt at the £2 trillion[4] level which means that the government will be paying for the increase in debt for a long time. Despite the turbulent economic times, inflation has not increased beyond the government's target. However, CPI has fallen since the start of 2020 to its current level of 0.7 while RPI has been steadily declining since quarter 3 2017, presently 1.3%. This is because of a collapse in consumer demand as a result of the lockdowns, as the COVID restrictions are lifted inflation should return to pre COVID-19 levels and even exceed them depending on foreign holiday restrictions. See appendix 1 and 2 for details. Into the long-term inflation is expected to become stable for a few years before it shifts again due to economic pressure this has been the case over the past years so any future deviations (no matter how large) of the inflation rate will be tempered in the long run.

THE CASE AGAINST STABLE INFLATION

Threats to a stable inflation rate will affect it only in the short run for example with the UK officially in the transition period for leaving the European Union and no trade agreement set up with the EU the potential for a higher inflation rate has increased. Without a trade agreement in place prices on foreign goods and services would increase drastically. However, the current Coronavirus pandemic has stumped

[3] Inflation and the 2% target – Bank of England

[4] Public sector net debt hits £2 trillion for the first time – Office of Budgetary Responsibility

consumer spending as regions are placed into lockdowns both local and national and animal spirits are low. Nevertheless, the effects of Brexit can already be felt with 35% of Corporate CFO'S and treasury officials, who were interviewed by Barclays considering relocating their bank accounts because of Brexit as they want to gain access to the SEPA[5]. There are long-term impacts however such as the coronavirus and Brexit which will be felt for years to come and in 10 years they will likely still be felt however, they will be lesser and not have such a wider impact on the economy but in 10 years' time there maybe another crisis or economic recession that will affect inflation but this will pass again in time. See appendix 3 for an example of this with the inflation caused by the financial crisis of 2009.

BACKGROUND

The Coronavirus pandemic is proving to be the biggest challenge to central banks and government planners of the decade. This will likely be the case until an effective vaccine is discovered and distributed. Therefore, until that time the economy will not be operating at full capacity and job losses and increasing debt will continue to affect markets. The earliest vaccines will be delivered to health care workers and care home workers across the UK in December 2020, from here the vaccine will be delivered to the over 65's and those who are at high risk, this will have little effect on economic activity and is primarily meant to protect those most at risk from the virus. Then the vaccine will be delivered to the general population, any significant economic impact will be felt only when the general populace has been vaccinated but this could take a whole year of work to complete[6].

However, the uncertainties and opportunities presented by Brexit have not gone away. With the UK having officially left the EU and with no compromises being reached by the EU and UK over a trade deal uncertainty over inflationary pressure is justified. As a no deal Brexit is generally seen to be the worst possible option for negotiating with the EU. The UK has also secured some trade deals with non-EU countries such as South Korea and Israel and that number will continue to grow over time[7].

The US presidential elections are over, and Joe Biden is going to be the new President on January the 20th, President elect Biden is often seen as the polar opposite of President Trump. However, in order to heal the political divide across his country (a cause which Biden is passionate about) Biden will have to keep some of Trumps trade war era tariffs. It is most likely that he will keep the tariffs on Chinese goods and relax the tariffs on the EU. This will have a positive effect on Atlantic trade which the UK will benefit from however marginally. With President Trump gone the priority for the US quickly signing a trade deal with the UK has decreased rapidly as Mr Biden will have to focus on COVID-19 and reconnecting with his European allies[8], and so starting the trade deal negotiations will take longer and so Brexit uncertainty will continue to increase in this time.

[5] A fresh look at post- Brexit Treasury – Barclays
[6] JCVI: updated interim advice on priority groups for COVID-19 vaccination- UK gov.com
[7] Existing UK trade agreements with non-EU countries – UK gov. com
[8] Joe Biden's trade policy will take aim at China, embrace allies – The Economic Times

FORECAST

In the next 12 months there will likely be anywhere from 4-8 vaccines of suitable effectiveness which can be used to fight COVID-19 so the NHS will be in the process of distributing them throughout the country. Depending on how successful the distribution process is the lockdowns and restrictions caused by the Coronavirus will be lifted slowly and the whole economy will be starting the process of recovery. However, this may be hampered by a no deal Brexit and slow trade deal negotiations with the United States. This will be reflected by inflation remaining low (below the governments normal 2% target) but as the Coronavirus restrictions are released as the effective vaccines are distributed, inflation will return to its 2% target and possibly pass it as consumer spending could exceed pre pandemic levels (at least for a short time), combined with government investment in the green revolution[9] and other areas[10].

The effects of a no deal Brexit will be felt later on as British exports would become more expensive and endanger the job security of their workers which will create disinflationary pressure as companies struggle to find new trading partners and the government struggles to creates more trade deals. Assuming that a trade deal with the EU is reached then inflation in a years' time could rise beyond the government's target to 3%. These long run effects will set back economic growth in the short to medium term however, in 10 years inflation and economic growth will be minorly affected by these issues therefore, so leading experts expect that inflation will continue to trend towards the 2% target but will most likely fall short of this target as can be seen in Appendix 3.

LONG TERM INFLATION

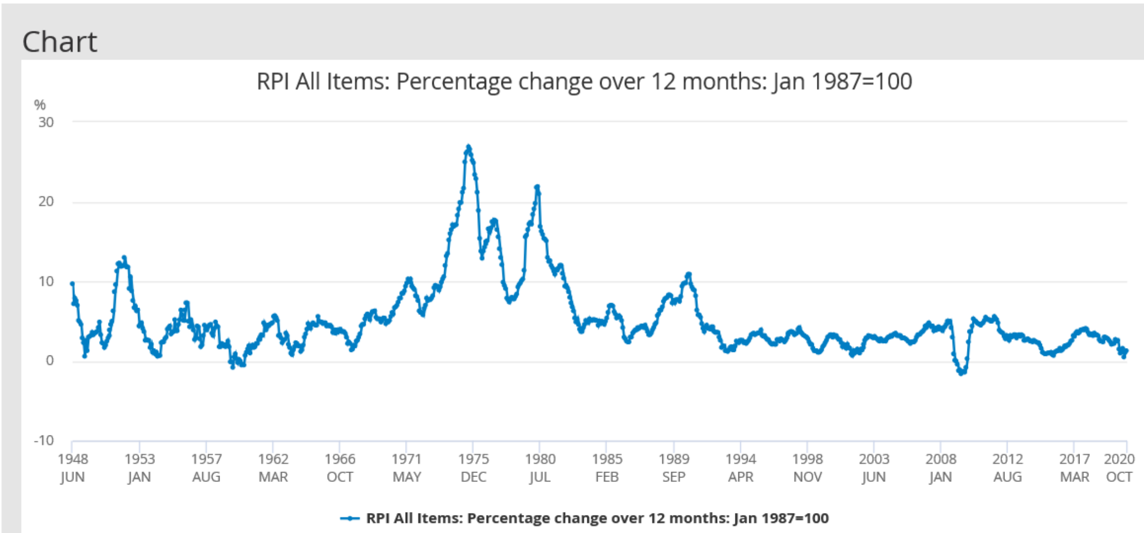
So, in the long run (about 10 years) inflation is expected to be around 2.5% (It is important to note that the long-term target for inflation has also had 0.5% added onto for prudency) as over time the inflation rate trends towards the government's target but within the last 10 years or so the rate of inflation has been increasing more than decreasing[11]. Over time issues such as Brexit and COVID-19 will affect inflation less and less and while there will be different short-term issues comparable to COVID 19 and Brexit in 10 years, inflation will always trend towards the government's target of 2%. Helping inflation stay low is the new long-term investments that the UK will engage in which will bring in new jobs in the long term, this however relies on all other things being equal and no substantial change in policy from future governments. Longer term risks are a substantial change in government policy and direction however if any government were to change or remove these investments then it would be counterproductive, and this is not likely to happen.

[9] Government to invest £4bn to create 250,000 new green jobs- BBC news
[10] UK military to get biggest spending boost in 30 years – BBC news
[11] UK Inflation rate 1989-2020 data, 2021-2022 forecast – trading economics

APPENDIXES

Appendix 1 source - ONS Consumer price inflation, UK: October 2020

Appendix 2 source – ONS: RPI All Items: Percentage change over 12 months: Jan 1987=100



Appendix 3 – source Trading Economics, United Kingdom Inflation Rate1989-2020 Data | 2021-2022 Forecast