



FEATURE ARTICLE

Date: 18th May 2011

Issued by: Andrew Gadd, Head of Research - Lighthouse Group

Inflation

“Inflation is a violent as a mugger, as frightening as an armed robber and as deadly as a hit man.” Ronald Reagan

Inflation is certainly in the news at the moment. UK inflation figures released on the 17th May indicated that the Consumer Prices Index (CPI) rose 4.5% in the year to April, up from 4.0% in March. Indeed looking behind the headline numbers one discovers that prices rose by 1.0% month-on-month, only the second time since 1996 they have increased so much in a single month!

With reference to this increase in inflation the Office for National Statistics suggested the timing of Easter, which of course was in April this year rather than March last year, led to higher travel costs, which accounted for 0.36% of the rise between March and April. (Basically peak fares were charged in April this year, whereas last year they were in March.) In addition the statistics showed that food and non-alcoholic drinks saw costs increase 0.1% month-on-month but were 4.4% higher than a year ago.

Now as I am sure you are probably aware the Government sets the Bank of England a 2% price stability target and if the target is missed by more than 1 percentage point on either side – i.e. if the annual rate of CPI inflation is more than 3% or less than 1% – the Governor of the Bank of England must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation comes back to the target.

In this case in his open letter to the Chancellor Mervyn King continued to blame above target inflation on January's VAT increase, higher energy prices and increases in import prices. The Bank of England Governor went on to explain that:

"The impetus from these factors should gradually diminish and, as it does, inflation is likely to moderate. The extent and timing of that decline are, however, uncertain."



In his open response to Mr King, George Osborne, the Chancellor of the Exchequer, noted that the government's commitment to reducing government spending should provide the Monetary Policy Committee (MPC) with the "space it needs to target low inflation". (Basically implying that the deflationary effect of the government's planned spending cuts should allow the MPC to keep interest rates low.)

Interestingly, at the same time as the CPI figures were announced the Retail Prices Index (RPI) fell from 5.3% to 5.2%. The fall in this index is explained by a drop in council tax, car insurance and house prices which are included in the RPI figure but are not part of the CPI calculation. Compared to the CPI the RPI also has a lower weighting of transport costs and higher weighting of petrol and oil prices (which fell along with other commodities following their strong recent run).

Finally it must be noted that "The Bank's Quarterly Inflation Report", published earlier in May, had already predicted inflation could hit 5% in 2011. Now these Quarterly Inflation Reports always have one factor that is always constant. That is that they will always show inflation returning to the target 2% level at some stage. That is of course a prerequisite; if this were not the expected outcome then monetary policy must necessarily be wrong, whereas by definition it must always be viewed to be correct otherwise why is it being implemented in its current manner?

Now in the latest Quarterly Inflation report Mervyn King explained that: "There is a good chance that inflation will reach 5% later this year and it is more likely than not to remain above the 2% target throughout 2012" and that "...inflation will reach 5%, before falling back through 2012 and into 2013."

So what does all of this mean in simple terms?

Well in economic terms basically we are in a position where domestically driven inflation in the UK is very low and the current high level of inflation (be it CPI or RPI) is being driven by external "cost-push" factors, which are more difficult for the Bank of England's Monetary Policy Committee (MPC) to control. Indeed in light of the current inflation numbers and with interest rates having been kept at 0.5% for over 20 months one has to question whether the MPC is, in fact, seriously concerned about inflation, or whether the majority of members believe its credibility and that of the independent Bank of England are dependent on the risk that higher interest rates would damage the current fragile economic recovery in the UK?

If I am right then interest rates could stay lower for longer than many expect.

So what should individuals do?

Inflation higher than interest rates means that investors are seeing the real value of their capital potentially eroded by inflation. Depending on your attitude to risk and specific aims and objectives a



mixed investment portfolio including equities may be appropriate to tackle this or indeed for those focused on beating inflation the recently reintroduced National Savings Index Linked Certificates (NSIL) might be appropriate.

With reference to NSIL certificates these have many positives but, perhaps controversially, I would like to highlight a few potential drawbacks when considering these at the moment.

Unfortunately unlike the “original” the new issue isn’t quite as good. You used to get inflation (RPI) plus 1% but now you get inflation (RPI) plus 0.5%. In addition there used to be a three year and a five year version but now there is only a five year version. You have to leave your money in for the full five year term to get the full inflation linked benefit although you can cash in early, at the expense of interest and you get no interest if you cash in during the first 12 months.

Most importantly I have seen various return figures quoted for an investment into NSIL certificates. Please do note that these are based on the current historic level of inflation. There is no guarantee as to what the level of inflation is going to be over the next five years and what your return will therefore be and how this may compare to various alternatives. If inflation falls then the expectation is that interest rates are likely to rise.

Finally there appears to be a “buy now while stocks last” mentality surrounding NSIL certificates and this does not, in itself, make them a good investment. As the FSA is so keen for us to point out “Past returns are no guarantee of the future”.

Having said all that NSIL certificates also have many positives and are definitely something for you to consider in the current economic environment as part of a diversified investment strategy but do bear in mind the negatives as well as the positives.

Conclusion

As Ronald Reagan so rightly said, “Inflation is a violent as a mugger, as frightening as an armed robber and as deadly as a hit man.” But ultimately there are potential ways to defend yourself – which is of course where an Independent Financial Adviser comes in.

Or perhaps, following on from Ronnie’s quote, it should be “body guards” rather than Independent Financial Advisers?

Whilst Lighthouse Advisory Services has taken every effort to ensure that the above research is accurate, we cannot accept liability for any errors or omissions. In addition, it should be noted that the research does not constitute advice to invest, or not invest, in any product referred to above. This research is provided in order to assist you to provide your clients with sufficient information on which to make an informed investment decision. The past performance of an investment provides no guarantee as to the future performance of the new



LIGHTHOUSEGROUP

funds. The value of unit prices can fall as well as rise and the return of your capital is not guarantee.

Lighthouse Advisory Services is a wholly owned subsidiary of Lighthouse Group Plc, the AIM listed largest autonomous IFA and wealth management group in the UK. Full details of the group, including regulatory authorisations, can be found at <http://www.lighthousegroup.plc.uk>, or by contacting:

General enquiries phone number: 08000 85 85 90

General enquiries email address: enquiries@lighthousegroup.plc.uk