

10th January 2022

UK cost of living surges: how to protect portfolios

- UK cost of living surges
- Food, rent, energy and transport costs on the rise
- The role of real assets for inflation protection

UK cost of living surges

Pent up demand, disrupted supply chains and an energy crisis are hitting UK consumers hard.

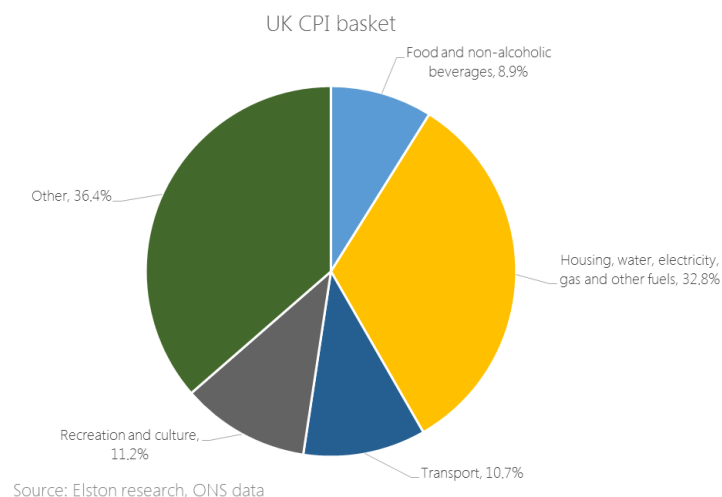
This is becoming a problem that is as political as it is economic.

A deeper look and understanding of inflation within different segments of the CPI basket is informative.

First of all, what makes up the CPI basket?

Housing, Energy and Transport make up 43.5% of the CPI basket – a representative basket of consumer spending. Whilst Energy only makes up 2.5%, the focus on energy prices is key because it is an input cost to every other goods and services.

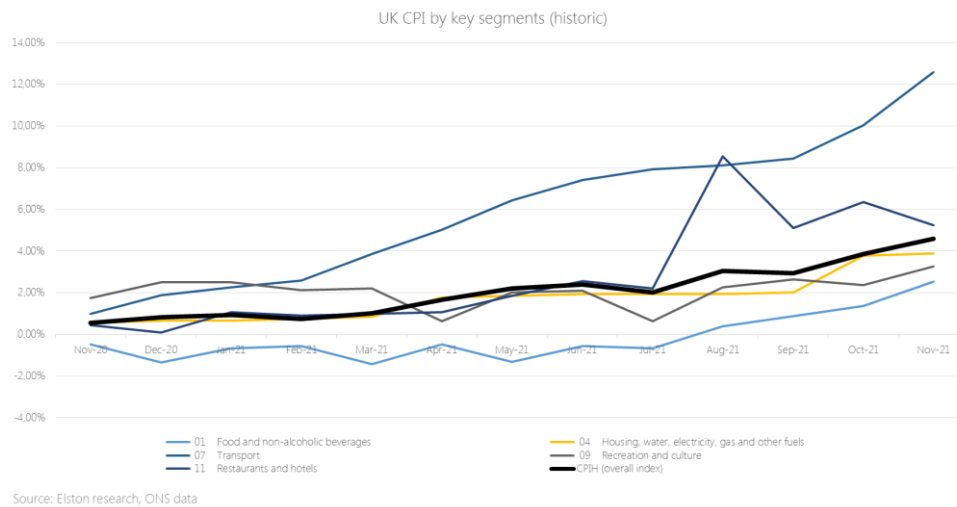
Fig.1. The UK CPI basket (summarised), by segment



Food, housing, energy and transport costs are on the rise

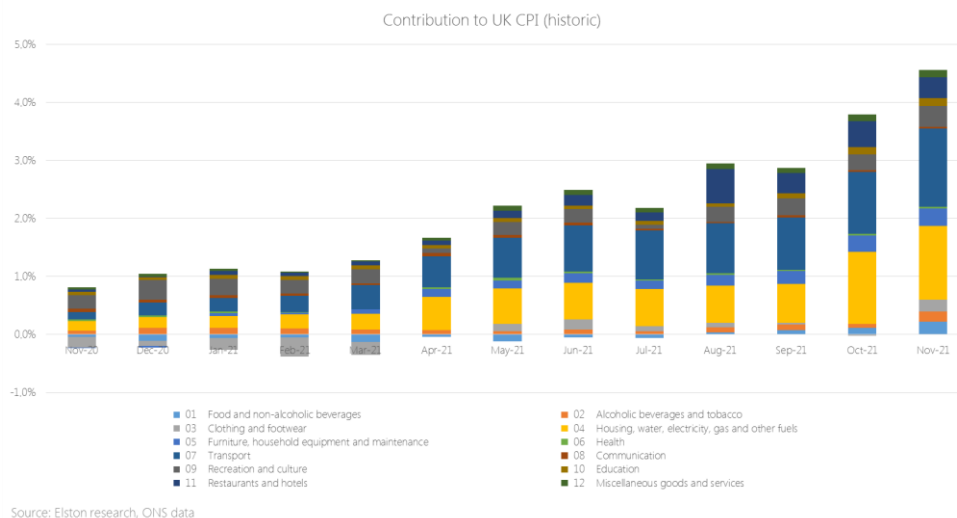
Inflation is running at long-term highs, driven by Housing, Energy and Transport.

Fig.2. Inflation rates, by segment



By looking at the inflation rate, by segment and the weight of that segment in the CPI basket, we can see the largest contributors to inflation.

Fig.3. Contributors to inflation



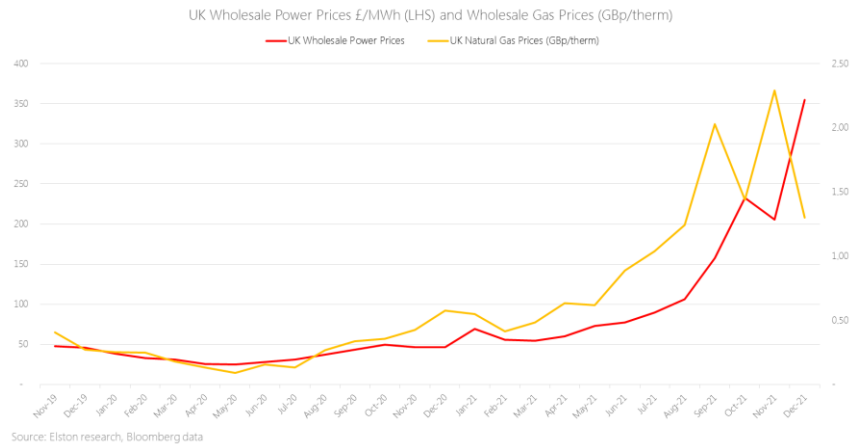
Energy crisis and energy transition tensions

The combination of a global gas shortage, dismantled UK gas storage, reduced nuclear capacity and intermittent renewable energy means that UK power prices have gone through the roof.

This is a direct consumer impact and an indirect “pass-through” to other goods and services.

Policy response needed, following years of flip-flopping around national infrastructure plans and skewed incentives.

Fig.4 UK wholesale gas and baseload power prices



There will be rising tension between the desire to transition to renewable energy (subsidised by consumers), and the need for cheap clean energy – mainly nuclear and gas.

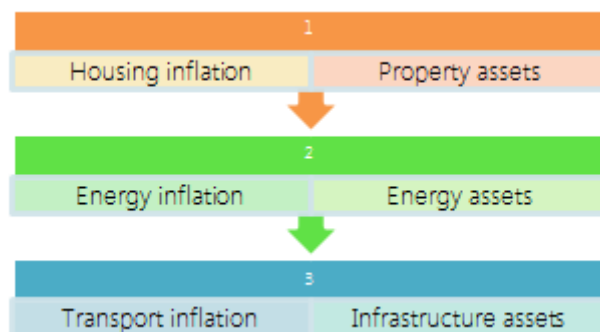
Whilst the shift to Electric Vehicles is great for emissions, in the near-term it will actually generate more electricity demand, which – will only be “clean” if there is sufficient renewable capacity. If not, it’s just an inefficient way of moving emissions from petrol in the cities, to coal-fired power stations out of town.

The tension between “clean” expensive and “dirty” cheap energy will become increasingly politicised, in our view. Particularly the green taxes for clean energy are a levy on all that disproportionately benefits landowners.

Hedging inflation risk

Managers and advisers can hedge inflation risk from a portfolio perspective by owning the assets that are benefitting from inflationary pressures. For example, by owning property assets, investors can benefit from housing inflation. By owning energy assets, investors can benefit from energy inflation. From owning infrastructure assets, investors can benefit from transport inflation.

Fig.5 Example of inflation hedging

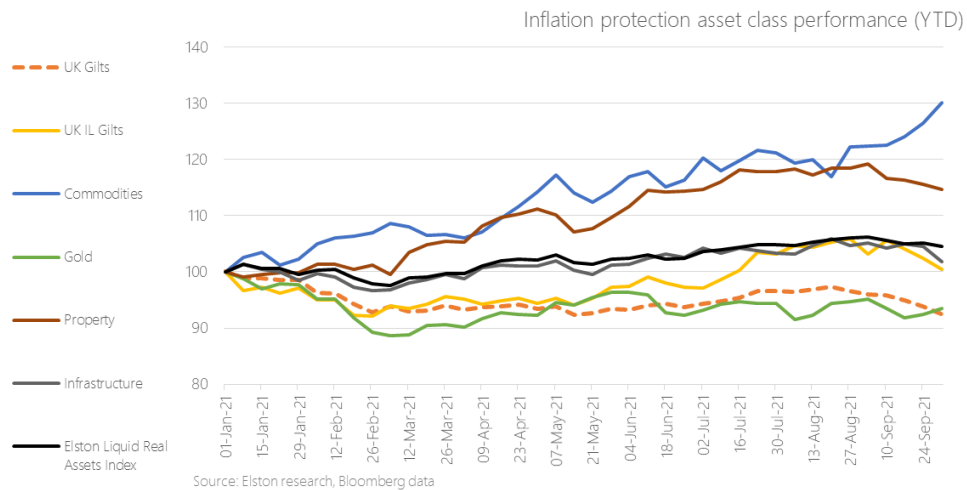


Real asset exposure, with bond like volatility

Our Liquid Real Assets Index provides exposure to a wide range of inflation-protection asset classes such as property, infrastructure, commodities, energy, water, timber and gold.

These are typically higher risk-return, so by combining them with lower risk rate-sensitive assets (which benefit from rising interest rates), the index represents a strategy that delivers real asset exposure with bond like volatility,

Fig.5 Performance of Liquid Real Asset Index and components



Summary

Inflation is proving persistent. Even once past the peak this summer, it is expected to settle at a higher level than pre-COVID, and remain above the Bank of England target rate of 2.0% for the medium-term.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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