

# Three Strikes and Out

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For a central bank, life doesn't get much better than it has been in the U.K. Since being granted independence, the Bank of England's Monetary Policy Committee (MPC) has presided over a period of extremely well-behaved inflation. Indeed, inflation generally undershot the target, but rarely by very much. Stable inflation has brought the major benefit of increasing credibility for the central bank and has enabled the MPC to focus its attention on managing aggregate demand. MPC watchers have responded by looking closely at signs of growth (for example in the PMI series of manufacturing, construction and services), on occasion at wages, but rarely at headline inflation. All that has now changed.

Over the last year the Consumer Price Index has risen from 1.8% to 3.1%, although excluding the volatile food and energy components the increase has been a more modest 0.6% (from 1.3% to 1.9%). So does the MPC have a problem or not? Price expectations suggest cause for concern, and indeed the MPC is worried. Pricing expectations for firms are at multi-year highs and consumer- and market-implied inflation expectations all suggest that the MPC's credibility is on the line.

So has the MPC let the inflationary cat out of the bag or is this all likely to pass as another occasion where price sensitive buyers will win the day? Without wishing to give you the punch line too early, we fall in the camp of the latter. For the implications for our portfolios you will have to read on.

## Three Measures of Inflation Expectations

Measures of inflation expectations come in many forms but there are three that encapsulate most of the issues: wages, market expectations and corporate pricing power. The good news is that of the three, only one remains a risk at this juncture.

### First Strike – Wages

The primary risk associated with an unexpected rise in inflation has been the well trodden path of higher inflation leading to higher wage demands, which leads to higher costs and so on. This is the so called inflation spiral, a well-documented trajectory for those of us living in the U.K. With this in mind the MPC has already raised rates three times to ensure we break the mold.

So far it looks like the MPC has been successful. Indications from the widely discussed January wage round seem to be favorable, and it appears that consumers have maintained current spending growth via higher borrowing rather than higher nominal wages. However, that is only part of the story.

### Second Strike – Market Expectations

In other areas, inflation expectations remain “elevated”. Many of you will be aware of the persistent buying of index-linked gilts (and more recently inflation swaps), where demand relative to supply has been large. In turn, this has pushed the real yields on index-linked bonds lower by more than yields on fixed-coupon bonds. The difference between the real and the “conventional” yield, in normal market circumstances, defines the market’s medium term expectations for inflation. However these are not normal market circumstances, so before we get too worried about the message from the bond market, let’s return to the real economy.

### Third Strike – Corporate Pricing Power

We know that wage earners have been willing to take the rise in inflation on the chin, but what about the corporate sector? We know that so far inflation excluding the more volatile food and energy components has been rising gently. Of greater concern is the fact that corporate pricing intentions are very much on the rise and, as a result, so are the antenna at the MPC. To use the words of Kate Barker, a long standing member of the MPC, she “will be monitoring these price surveys, and other indicators of inflation expectations, particularly closely.”

So what does the data tell us? Should we be worried? The longest running survey of corporate pricing expectations is the CBI industrial trends survey. It is a survey of manufacturers’ price expectations and it does indeed seem to reflect some of the concerns of the MPC. Namely that price expectations are at the highest levels since the MPC took control of monetary policy. Will manufacturers use the easing in energy prices to push through more traded goods price inflation? The evidence is inconclusive.

The charts show how the price expectations of manufacturers correlate with official manufactur-

ing output prices, and then goods prices (again ex food and energy).

As chart 1 shows, manufacturers’ price expectations correlate well with actual output prices – i.e., expectations explain current prices coming from manufacturers, not future prices. So if they are coincident with prices of products coming off the factory floor, how do these price expectations compare with prices on the high street?

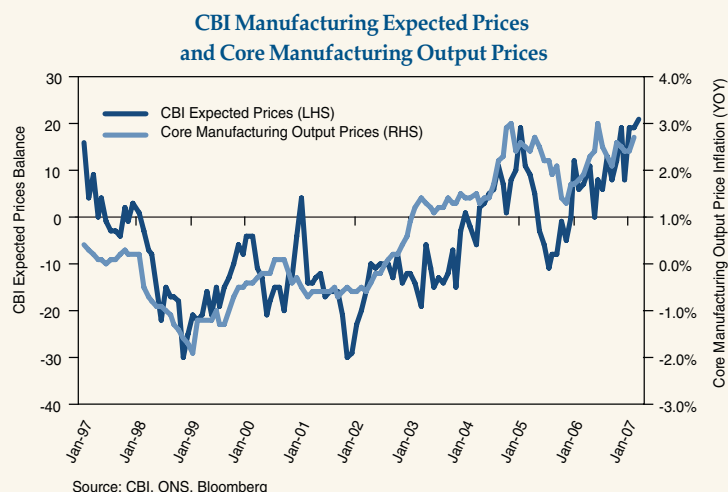


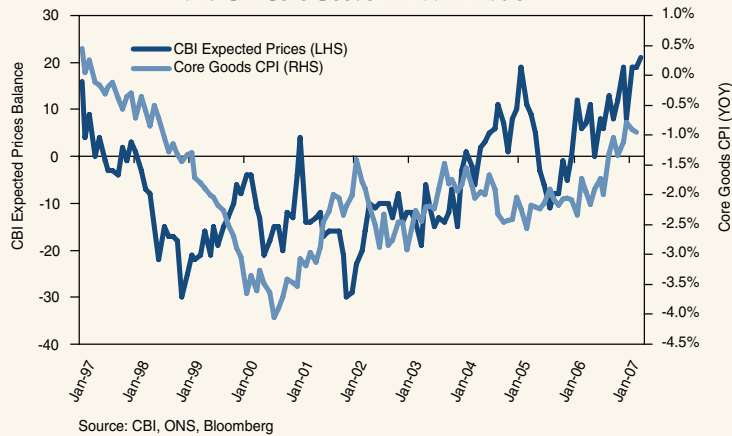
Chart 1

Here, things do get more interesting as shown in chart 2. Manufacturers’ current price expectations do indeed seem to have some power to predict core goods inflation (i.e. ex food and energy) over the subsequent 12 months. However the lead times between the two series seem to be getting shorter (better inventory management?), and hence Kate Barker’s concern over where the price survey data goes from here.

To recap, we know from our own research that manufacturers would like to raise prices, and that there is evidence of these expectations putting some upward pressure on consumer prices. But the lags between expectations and reality are shortening. Thus, the important questions are:

- 1) Are these surveys telling us more about current inflation than future inflation?

**CBI Expected Prices  
and CPI Core Goods Annual Inflation**



**Chart 2**

2) Are there any indicators that can provide an accurate guide to where manufacturers' price expectations are going?

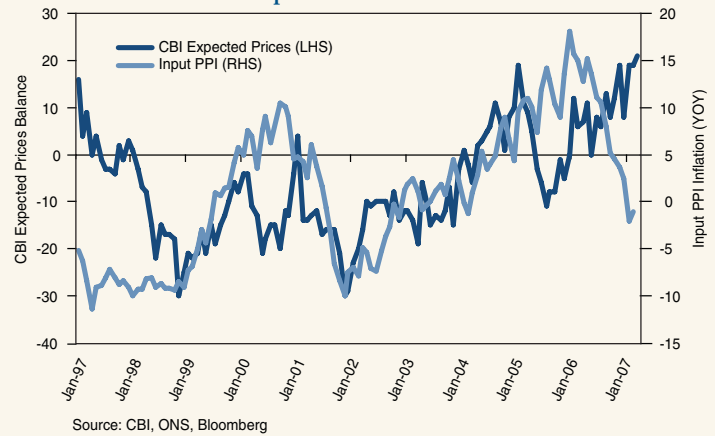
3) Are these rising price expectations simply a response to rising input costs (oil)?

Interestingly, the corporate sector may not be hell-bent on raising margins to further enhance profitability (which is already at a cyclical high), but simply attempting to protect future margins!

If prices are under upward pressure now because of prior rises in input costs, what about current input costs? Well the good news is input prices are now falling. When we consider the correlation between current input prices and manufacturers' future price expectations, combined with the fact that manufacturing unit labor costs are falling as well, the outlook is very encouraging. Whilst we understand the current nervousness surrounding the prices survey, the path of input prices (Chart 3) suggest that this nervousness should abate as 2007 progresses.

To be clear, no central banker, least of all the MPC, would want to call the all-clear on inflation with the current level of headline inflation, and still elevated expectations. There is nothing to be gained from that. Indeed the short-term path of monetary policy looks to lead higher.

**CBI Manufacturing Expected Prices  
and Input PPI Annual Inflation**



**Chart 3**

However the forward indicators, most notably wages and input prices, suggest this latest blip in inflation is relatively transitory and will pass. If that is the case, the second half of the year should see inflation ease and expectations fall, allowing the MPC to refocus on aggregate demand. With the impact of the MPC's cumulative interest rate hikes likely to come through over the second half of the year, we could be faced with falling inflation and falling growth rather than rising inflation and respectable growth. In that environment the MPC's management of aggregate demand would imply that the year would end with monetary policy moving toward supporting rather than restraining growth. In that environment the outlook for the bond markets should be much better, and two and five year bonds, with the greatest sensitivity to the MPC's rate decisions, should be the prime beneficiaries of a policy reversal.

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