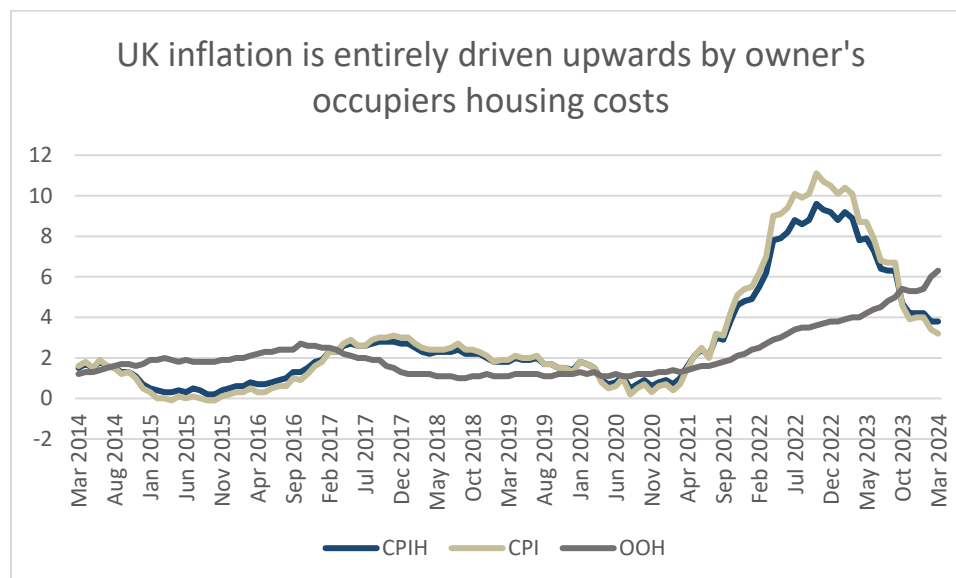


Why the market and central banks could be very wrong on inflation

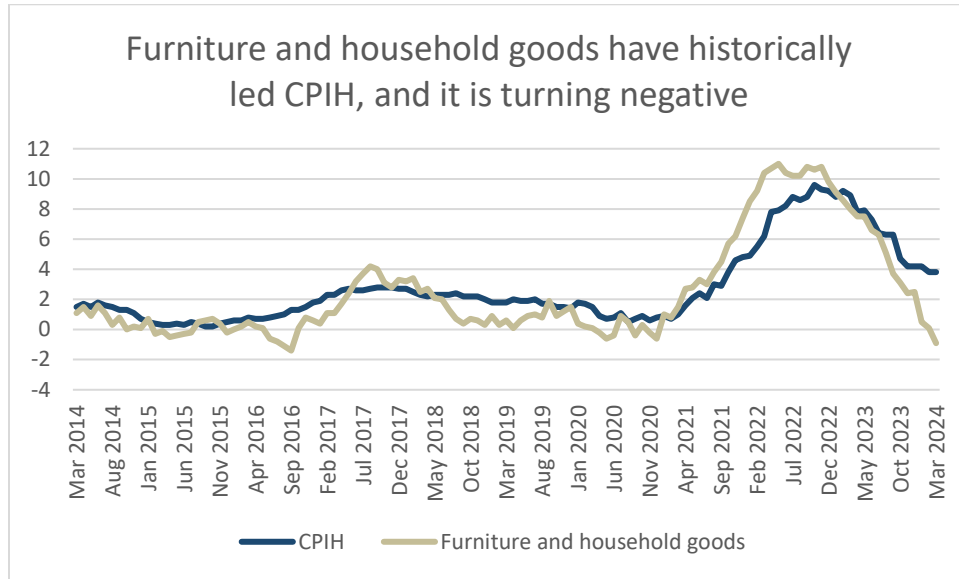
The last few weeks' repricing of first rate cuts and (particularly the Fed's) central bank talks, even considering no rate cut at all this year, have been a miracle in my eyes. The data tells me that inflation is coming down and that owner occupiers' housing costs/rent of shelter, i.e. the largest component of service inflation, is a very poor indicator of inflation. Why that is I'll explain below, beginning with the UK.

Inflation in the UK

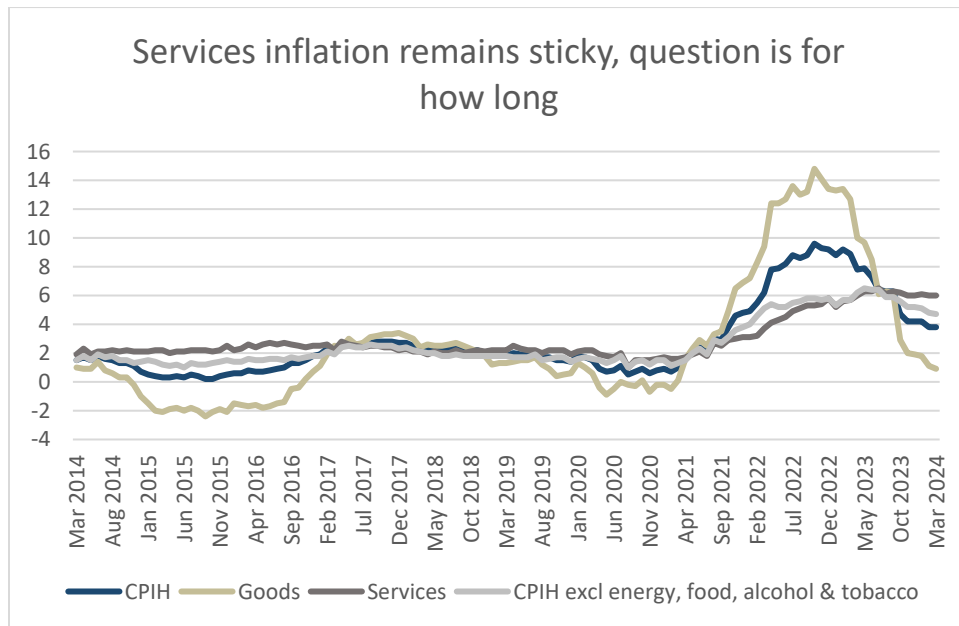
March 2024 CPI came in at an annual rate of 3.2%, which, although still above the 2% target, is the lowest figure since September 2021 when rates were rock-solid at near 0%. Furniture and household goods are now printing at -0.9% annual deflation. This category has been a leading indicator of how CPIH will print in the future. However, service inflation has remained somewhat sticky at 6% and Core CPIH is still printing at 4.7% annualized. What is keeping service inflation elevated? It is purely down to owner occupiers' housing costs and rent. But are these costs really still rising?



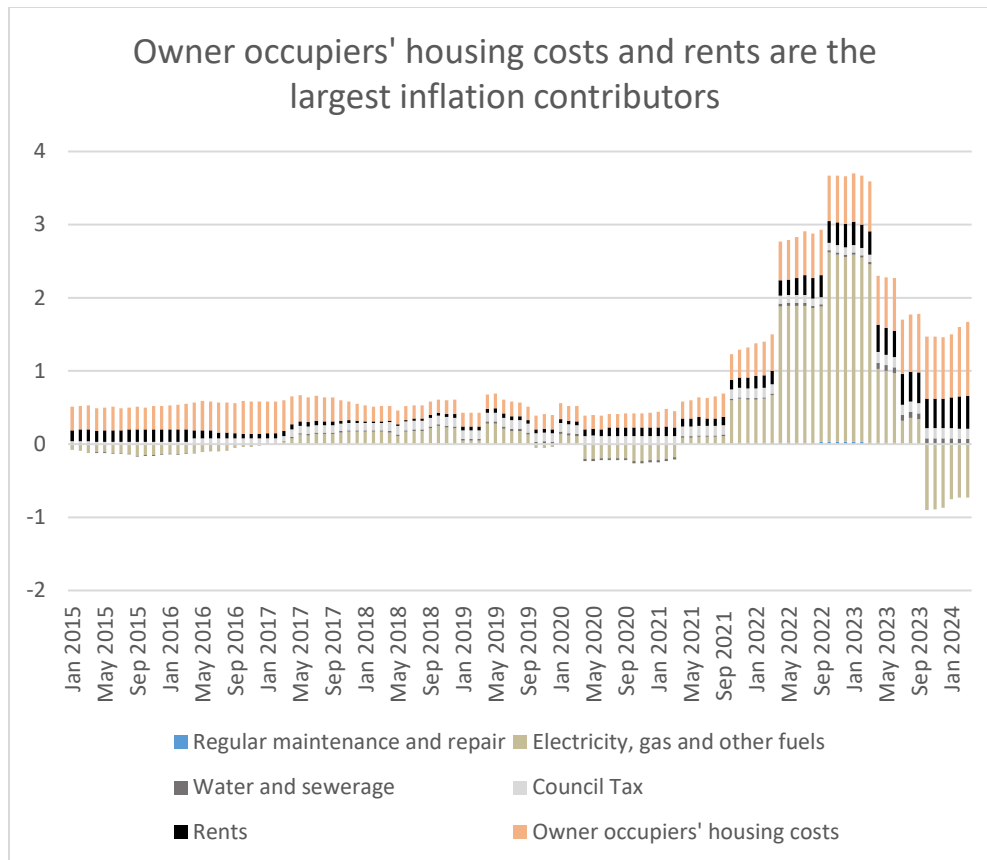
Source: Office for National Statistics



Source: Office for National Statistics



Source: Office for National Statistics

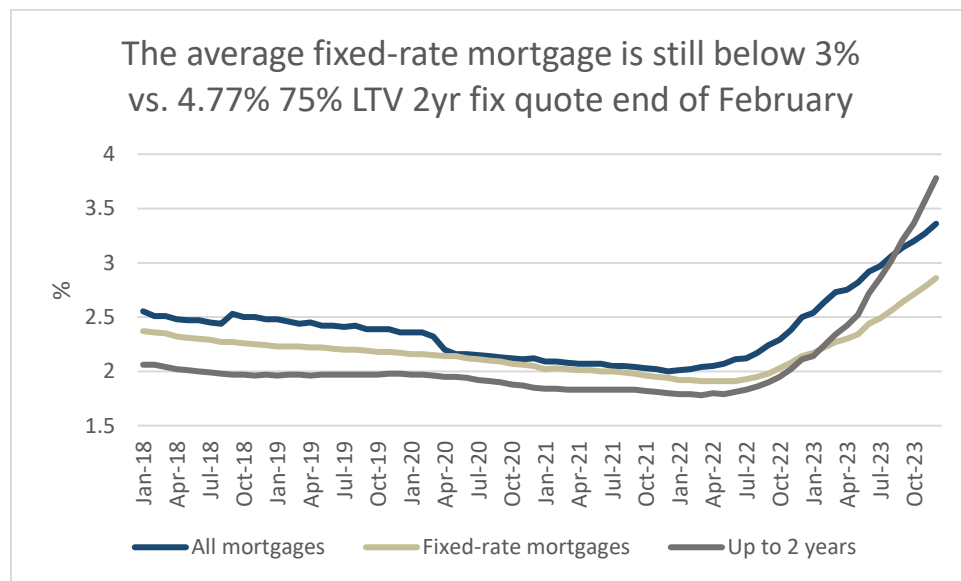


Source: Office for National Statistics

Rent and owner occupiers' costs are delayed

After the global financial crisis, the fear was quite high that the zero % interest rates could cause a spike in inflation. At the same time, lower interest rates enabled low mortgage costs and low financing rates in general. In the end, this led to an investment boom, an increase of supply of everything and as a result sustained low inflation. Central bankers then began to use core inflation and CPIH (UK) as one of their preferred measures, partly because it was more stable and less impacted by fluctuations in commodity prices. Today, we are facing the exact opposite effect, as commodity prices have fallen drastically, creating deflation, yet core Inflation and CPIH is stable y-o-y and rising m-o-m, driven by rent and owner occupiers' costs. However, rent is already falling and mortgages rates, too, and are only being kept high due to higher interest rates. So why is owner occupiers' costs still rising? It is because the mortgage costs and rent are being calculated based on the payments approach. This means that when Zoopla, Rightmove, Nationwide or other providers report rising (or falling) rents and house prices, the CPIH and owner occupiers' costs

will only rise (or fall) to the extent to which people's payments are affected¹. Hence, if you are locked in a 2yr rental agreement or 2yr fixed rate mortgage, only when it comes to renewal will the CPIH and owner occupiers' costs adjust. The below chart demonstrates this in detail, as the average fixed-rate mortgage is still below 3%, yet a 75% loan-to-value (LTV) was quoted at 4.77% at the end of February 2024 according to Lendinvest². The peak in mortgage rates was seen in July at 6.18%. This suggests that owner occupiers' costs will keep rising until the average mortgage rate reaches either close to the 4.77% quote from end of February, or until rates are cut to such an extent that quoted mortgage rates will match the average mortgage rate taken out on loan. This also shows just how much more restrictive monetary policy gets in the coming months, purely by people remortgaging at higher rates or renewing their rents at higher levels.



Source: Office for National Statistics

¹

<https://www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/roleofowneroccupiershousingcostsinthehouseholdcostindicesuk/2023>

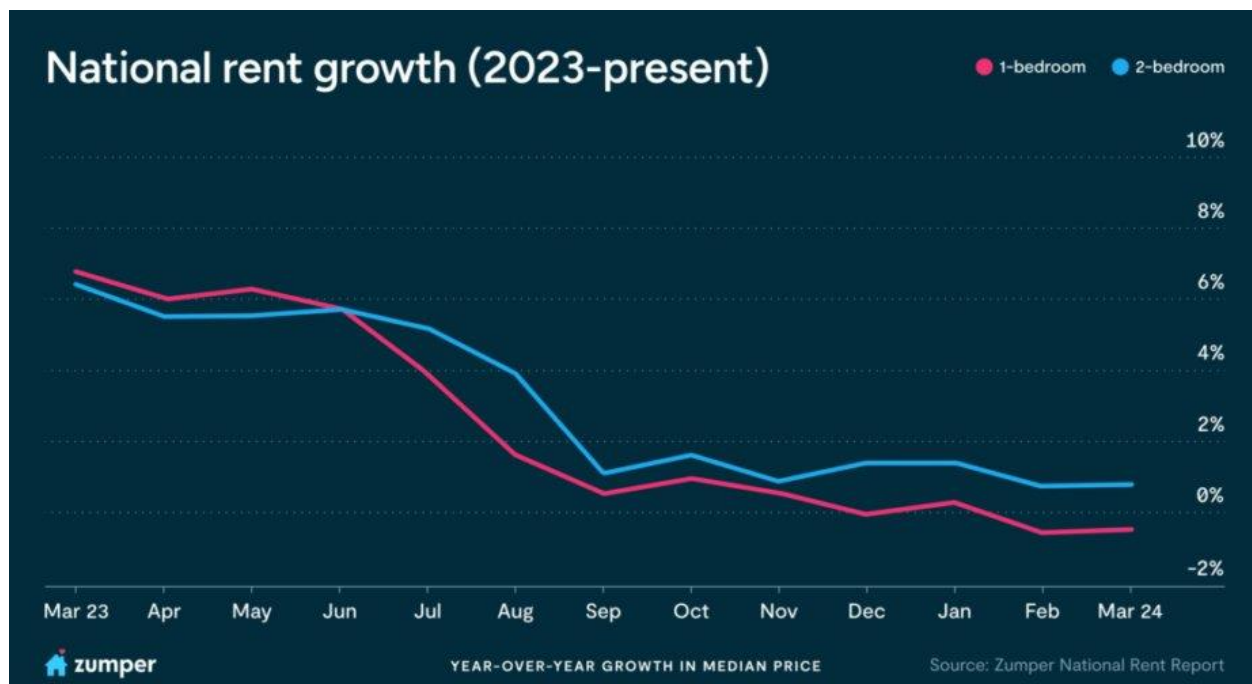
² <https://www.londonstockexchange.com/news-article/market-news/trading-update/16428644>

What about the US?

The US has the very same problem, as rent of shelter is also measured in a very similar way via the payments approach, quote from the Bureau of Labor Statistics:

“The CPI program collects rent data from each sampled unit every 6 months. Many rents change infrequently, being locked in place for a given lease term, and collecting rent data less frequently allows for a larger sample. Most rents included in the sample are continuing rents, and only a minority of observations are rents which have changed since the previous observation period. The CPI program divides each area’s rent sample into six subsamples called panels. The rents for panel 1 are collected in January and July; panel 2, in February and August, etc.”

The Zumper US national rent price growth is either negative or stable at below 1% since September 2023. No inflation whatsoever! The only inflation driver are interest rates!



Source: Zumper

What do companies say – Recruitment firms

What companies are reporting is not positive. Considering the Fed's dual mandate of inflation and unemployment rate, while unemployment is near a record low, recruiters are not painting a rosy picture at all. UK listed recruiters, such as Robert Walters, Page Group and Hays saw revenues decline by an average of -17% to -21%³, with temporary hiring outpacing permanent for over a year now. This is not a sign of a strong labour market, despite some high skilled labour shortages continuing.

Page Group: *"Trading conditions in Asia, the UK and the US saw no improvement with low levels of client and candidate confidence continuing to delay time to hire, particularly in permanent recruitment. As clients' recruitment budgets have tightened, they have become more risk averse which has slowed the recruitment process. Although salary levels remain strong, offers made to candidates were not as elevated as they were in 2022 and early 2023. However, against this backdrop activity levels remained good and we continued to experience acute shortages of highly skilled candidates in nearly all our markets, which was supportive of continued high fee rates"*

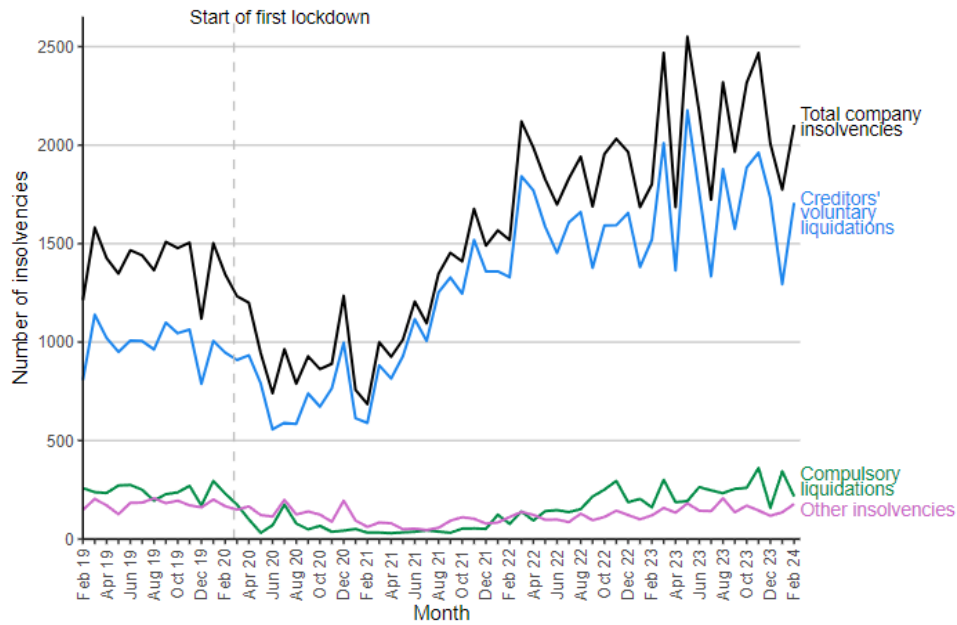
What do companies say – Litigation firms

Company insolvencies in the UK have been rising for months, but now have reached the highest level for 30 years and Creditor Voluntary Liquidations, the largest constituent of UK insolvencies, are at the highest level since 1960 according to Manolete Partners⁴. There is a small caveat, however, as individual bankruptcies still remain below pre-Covid levels (although rising).

³ <https://www.londonstockexchange.com/news-article/PAGE/trading-update/16422111>,
<https://www.londonstockexchange.com/news-article/RWA/q1-2024-trading-update/16424340>,
<https://www.londonstockexchange.com/news-article/HAS/third-quarter-trading-statement/16424348>

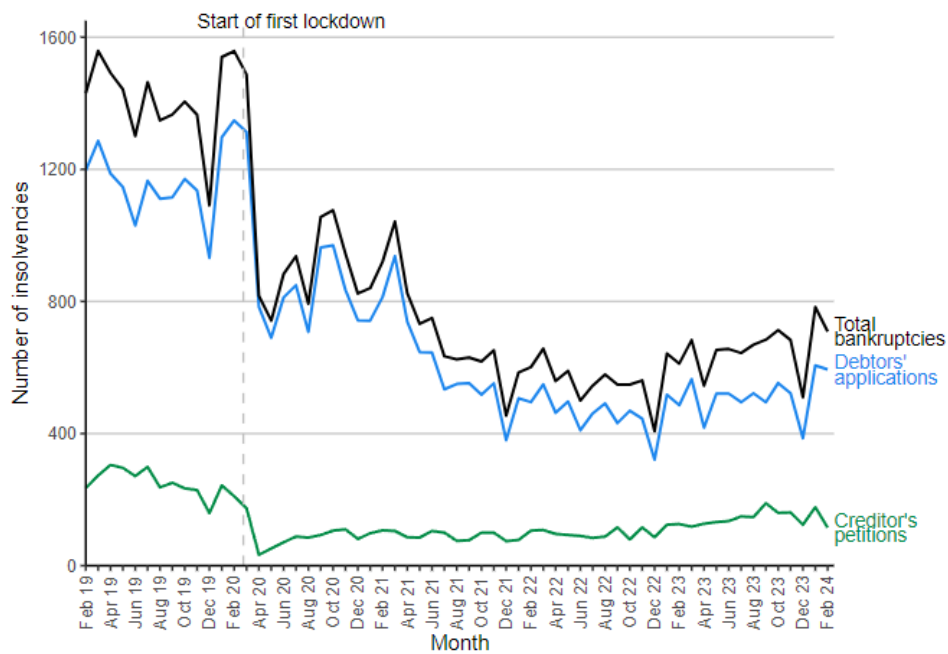
⁴ <https://www.londonstockexchange.com/news-article/MANO/trading-and-business-update/16428671>

Number of UK registered company insolvencies in February 2024



Sources: Gov.uk

Number of UK individual bankruptcies that resulted from creditor's petitions in February 2024



Sources: Gov.uk

What do companies say – House rental and sales agents

House rental and sales agents remain optimistic. As sales cratered amidst higher interest rates last year, the rise in rental prices has given UK housing agents, such as Foxtons, Chestertons and Winkworth a boost. However, the imbalance of supply and demand for rental homes has improved according to Zoopla⁵ and confirmed by Foxtons⁶, Winkworth⁷ and Chestertons, and instead they see a slight recovery in sales now. However, rental unaffordability is only expected to peak by December 2024 with a record 29.9% of average rent as % of gross earnings spent on rent.

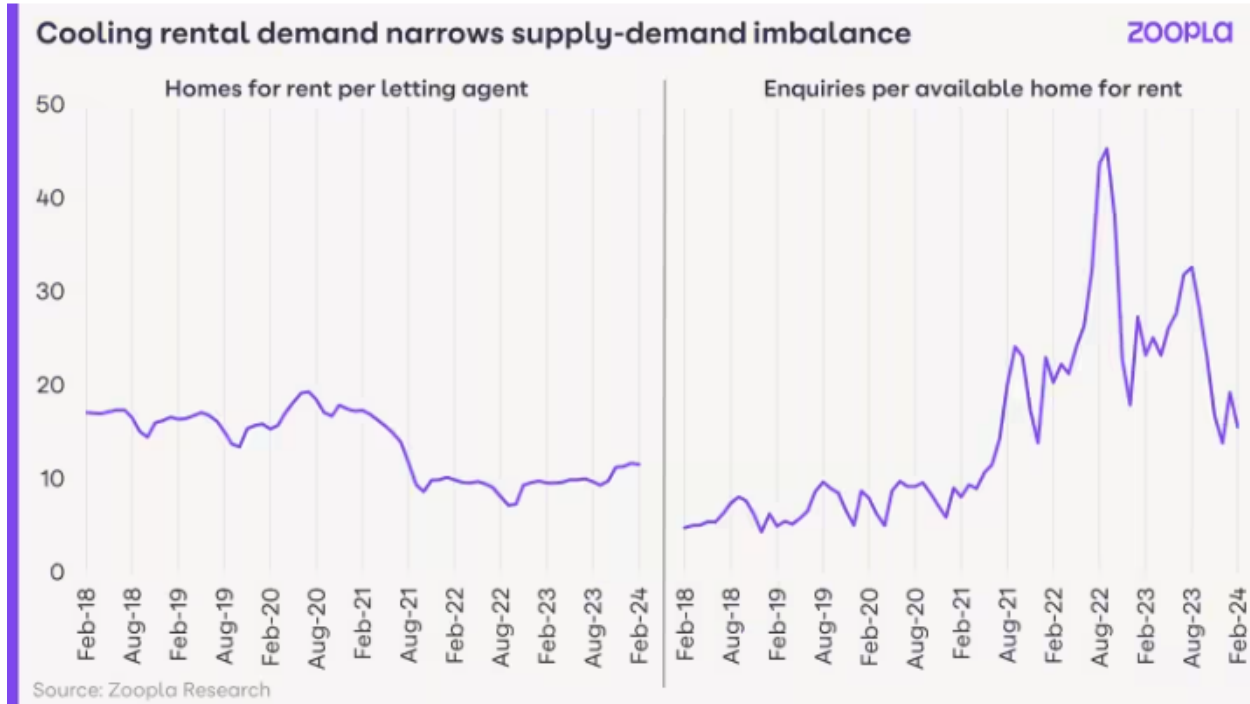
Chestertons on rental market: *“Not only did February’s rent reductions fuel new tenant demand throughout March, it also boosted the number of tenants renewing their existing tenancy agreement (+4%) as they were in a stronger position to negotiate any planned rent increases and settle at a more favourable level. However, as we head further into spring, demand for rental properties will only grow which will see rents going up again if supply doesn’t follow suit. In March, we already saw a 1.5% decrease in the number of available rental properties compared to the previous month. Due to this and the uplift in tenants wanting to move, we are beginning to see fewer landlords who are willing to accept a rent reduction compared to February. Having said that, any rent increases are likely to be subtle”*

Chestertons on sales market: *“Historically, spring is the time of year when more house hunters start their search, creating more favourable conditions for sellers. To generate as much interest in their property as possible, the majority of owners have been waiting for the Easter holidays to end before putting their home up for sale. We therefore expect the spring market to reach its full potential over the coming weeks. Due to homeowners delaying their sale, We registered only a 2% uplift in the number of available properties in March vs February. Although we are expecting more sellers to list their properties over the coming weeks, demand will still outweigh supply and buyers are facing competitive conditions with even less room for price negotiations.”*

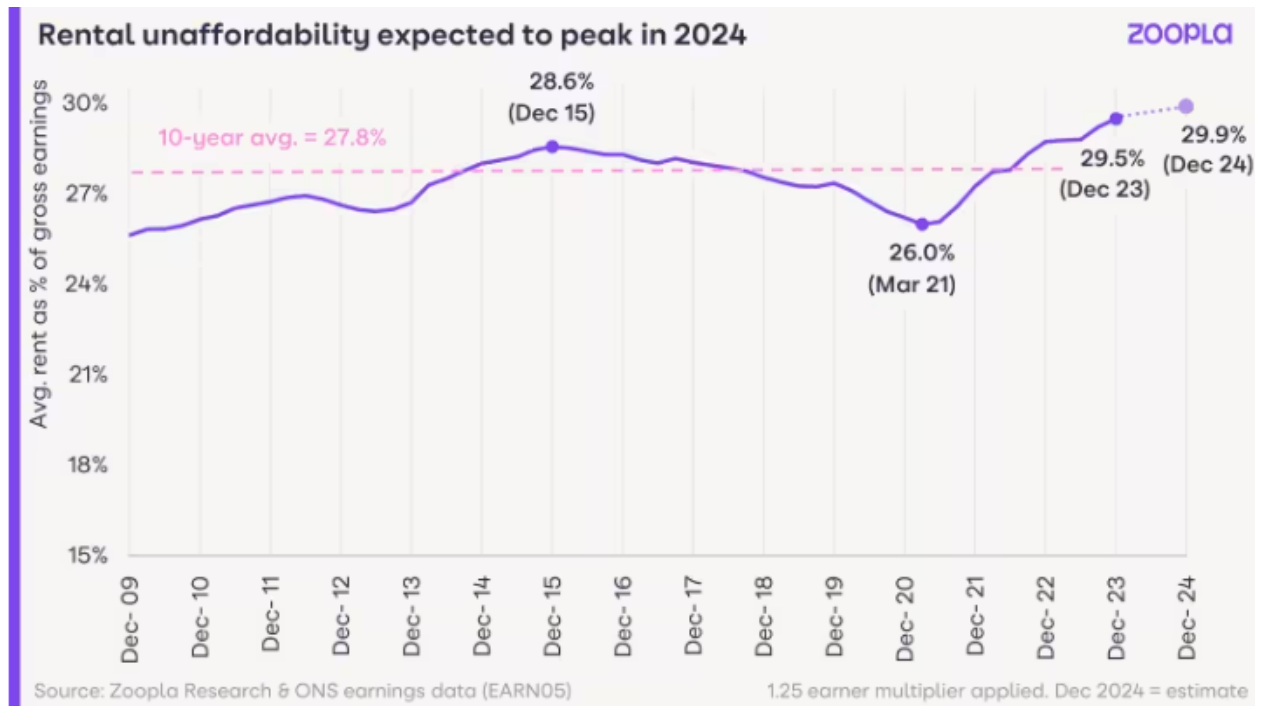
⁵ <https://www.zoopla.co.uk/discover/property-news/rental-market-report/>

⁶ <https://www.londonstockexchange.com/news-article/FOXT/q1-2024-trading-update/16428605>

⁷ <https://www.londonstockexchange.com/news-article/WINK/final-results/16426411>



Sources: Zoopla



Sources: Zoopla

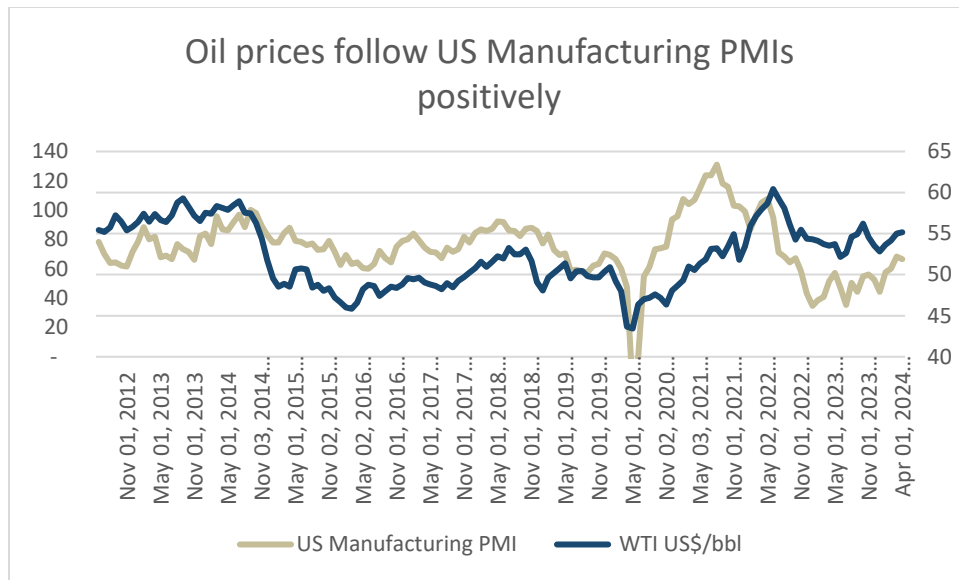
The fear of commodity price inflation

All the reasons above make me wonder why central banks are so hawkish? On the one hand, the BOE and ECB and other central banks around the world noted the danger of a stronger dollar, which would mean they would import inflation if they cut rates, impacting their USD FX negatively. On the other hand, there is a general fear out there that we see a revival of commodity price inflation, as Manufacturing PMI is in growth territory again and China stimulates the economy. I have noted in the past that the current state of the economy and stock market has similarities of many historic periods before a crisis hit:

1. The US stock market's concentration in the "magnificent 7", high valuations and high AI expectations show similarities to the 2000 dotcom bubble
2. The China housing and financial crisis is similar to that of the US subprime mortgage crisis, just without the internationally sold CDOs
3. The wars in the Middle East are reminding us of the 1970s geopolitical crisis
4. & most of all, the pandemic, resulting lockdowns, the level of globalization and the resulting high level of innovation but also geopolitical tensions, as well as the wide imbalance between rich & poor driven by excessive asset appreciation, which was led by high government debt levels and low interest rates, very much resemble the time period of the 1920s

Therefore, in order to avoid a commodity shortage and price squeeze, the central bank should have cut rates much earlier already, in my opinion. As prices have plummeted and there was no end in sight of high interest rates, commodity producers began cutting production. OPEC is only one example, but similarly the largest PGM producers, such as Impala Platinum and Anglo American⁸, have cut production due to low prices.

⁸ <https://www.reuters.com/markets/commodities/impala-platinum-cut-spending-after-metal-price-decline-2023-10-31/>, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/anglo-american-lowering-2024-mine-output-to-cut-costs-adapt-to-market-79741167#:~:text=Anglo%20American%20PLC%20will%20reduce,8%20investor%20presentation.>



Sources: Investing.com, FRED St. Louis

Geopolitical tensions & conclusion

Given that our (the West's) enemies are also one of the largest commodity producers in the world, keeping commodity prices low is a difficult task, especially amidst the movement towards renewables, which actually makes us more reliant on our enemies in the short-term. This in turn makes the enemies stronger, especially during an election year, as Biden will do everything to keep gasoline prices low. The recent sanctions against Iran⁹ and Venezuela¹⁰ showcase this point, as the sanctions really don't change anything to reduce their income from commodity sales and are purely symbolic. This leaves me to conclude that the longer we wait with rate cuts, the worse the coming crisis gets, and the more dramatic a spike in commodity prices could become once central banks finally cut – perhaps due to panic combined with geopolitical panic. Nevertheless, there is really no justification of arguing that inflation can only be fully reined in by keeping monetary policy tight. We are heading this way, but perhaps scientists should stop studying mass whale stranding and instead look at how humans, who should focus on being “data dependent”, lose the forest for the trees...



⁹ https://www.gov.uk/government/news/the-uk-and-us-sanction-leading-iranian-military-figures-and-entities-following-the-attack-on-israel?utm_medium=email&utm_campaign=govuk-notifications-topic&utm_source=b6ca991a-ed52-4166-bfb4-f1d7ceb07a28&utm_content=daily

¹⁰ <https://www.reuters.com/markets/commodities/us-signals-venezuela-oil-sanctions-relief-risk-deadline-looms-2024-04-17/>

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