State of Play

Pricing point

17 August 2023

This week represents an important week for the Bank of England. The latest inflation data from the Office for National Statistics (ONS) is expected to show that rising prices are continuing to ease in line with expectations, while wages are rising faster than the bank would ideally like. Last week, the UK Economy grew more than forecast in the second quarter of this year, but with warnings of strong headwinds on the road ahead. What does all of this mean for policymakers and how might this impact savings and investments in the weeks and months ahead? Simon Durling from Santander Asset Management shares his thoughts in this week's State of Play.

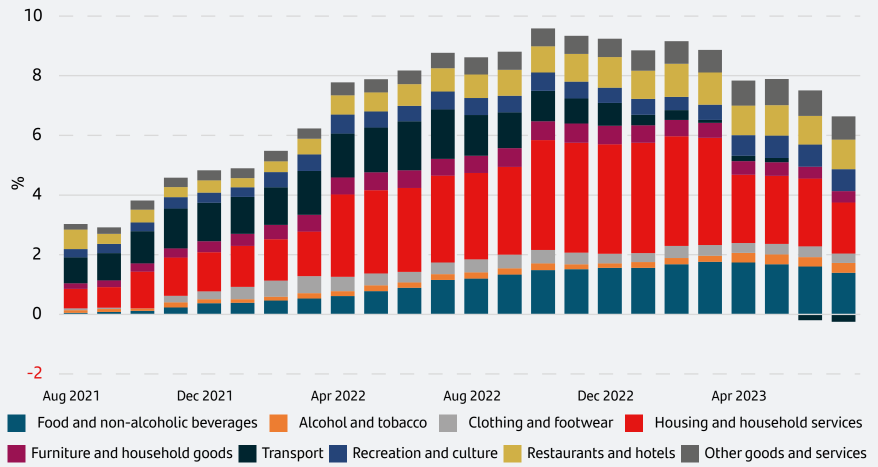
Key highlights from this week's State of Play

- Latest UK inflation summary
- Employment and earnings data
- Policymakers' dilemma
- Market update

Latest inflation numbers

According to the Office for National Statistics (ONS), the rise in prices as captured by the Consumer Price Index (CPI) in the 12 months to the end of July was in line with market expectations at 6.8%, down from the previous month's 7.9%.[1] The energy price cap reduction in July contributed 0.4% of the 1.1% fall as gas and electricity fell 15%.[1] While headline inflation fell, which will be a relief to many, policymakers will be more concerned that core inflation, which ignores both food and energy prices, remained the same as June at 6.9% for the 12 months to the end of July.[1] Core inflation is now higher than the headline rate for the first time since the return of sustained higher inflation post pandemic. The UK economy is dominated by services, where prices actually increased in July by 0.8%, with the annual rate increasing from 7.2% to 7.4%[1], the highest rate on record for this element of the inflation basket.

Contributions to the annual CPIH inflation rate, UK, June 2021 to June 2023



Source: Office for National Statistics
Data as at July 2023

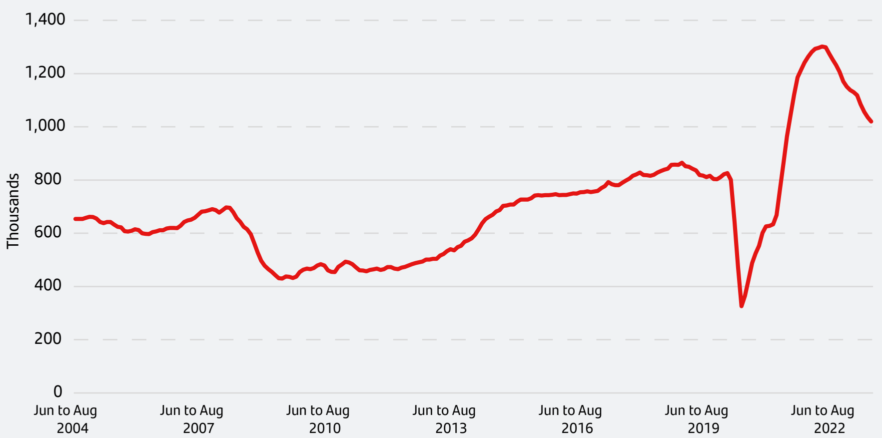
One small silver lining for both the government and the bank is that food prices stabilised in July, rising only 0.1% in the month bringing the annual rate of food price rises down from 17.3% to 14.9%.[1] According to Kantar, the market research group, prices in the grocery sector fell 2.2% in the 4 weeks to 6 August, which represents the fifth consecutive monthly reduction led by a sharp drop in the price of milk and sunflower oil.[2] Another small glint that there is light at the end of the tunnel is a bigger fall in the costs of making and producing goods, called the Producer Price Index. This fell 3.3% ahead of the 2.9% fall forecast by economists.[3] The Producer Price Index (PPI) Input measures a change in the input prices of raw, semi-finished or finished goods and services. If input costs rise, some will be absorbed by the producer and some will be passed on to the consumer. Conversely, if input costs fall, some of the decline will be enjoyed as wider profit margins by the producer and some will be passed on to the consumer in the form of lower prices. Because PPI impacts consumer prices, it is watched by central bankers as part of fulfilling their mandate of price stability.[3]

UK employment and earnings update

The pressure remains on the Bank of England (BoE) in advance of their next Monetary Policy Committee (MPC) meeting in September as they reflect on the latest earnings and employment data released from the Office for National Statistics (ONS). While policymakers may have been keeping their fingers crossed for an easing in wage rises to support an earlier pause in interest rate rises – the latest numbers represent a significant challenge in trying to bring down inflation to their preferred rate of 2%. The ONS data showed that average weekly earnings, excluding bonuses, rose by 7.8% in the three months to June, well ahead of the forecast of 7.4%, and, importantly, the highest in 22 years.[4] They also reported that weekly earnings, including bonuses, rose by 8.2%, a figure that was distorted by the government's payment of a one-off bonus to NHS staff in June.[4] A combination of high vacancy rates, shortage of skilled candidates in certain sectors, low unemployment, and high inflation has supported workers power to negotiate large wage increases. Higher wages feed into higher consumer demand and higher end prices from goods and service providers as they pass on the cost of higher wage demands.

One positive for the MPC is that vacancy rates continued to fall. There are currently just over 1 million vacancies in the UK, a decrease of 66,000 from February to April 2023, although they remained 219,000 above their pre-coronavirus (COVID-19) January to March 2020 levels.[5] In April to June 2023, the number of unemployed people per vacancy was 1.4, up from 1.2 the previous quarter (January to March 2023) as the number of vacancies fell while unemployment rose, evidence of a welcome easing in the labour market. Experts believe this will see wage rises ease towards the end of this year as inflation falls, helping employers negotiate lower wage settlements as we move into next year.[5]

Number of vacancies in the UK, seasonally adjusted, May to July 2004 to May to July 2023



Source: Office for National Statistics
Data as at July 2023

Policymakers' dilemma

Last week, the ONS's latest report on the UK economy showed an underlying resilience that differs from the gloom predicted by the Bank of England last year, when they warned us to expect a recession lasting 15 months. Fast forward nearly a year since this warning was issued, and while not every month has been positive, the second quarter of this year yet again surprised both investors and experts. The ONS report states: "The first quarterly estimate of UK real gross domestic product (GDP) shows that the economy increased by 0.2% in Quarter 2 (Apr to June) 2023. Monthly estimates published last week (11 August 2023) show that GDP is estimated to have grown by 0.5% in June 2023, after an unrevised fall of 0.1% in May 2023 and growth of 0.2% in April 2023. In output terms, the services sector grew by 0.1% on the quarter, driven by increases in information and communication, accommodation and food service activities, and human health and social work activities; elsewhere, the production sector grew by 0.7%, with 1.6% growth in manufacturing."[6]

You may ask, if inflation is falling, and economic growth, while low, is still resilient, surely this is good news for the Bank of England? This brings me to their dilemma. Trying to bring down inflation without pushing the economy into recession was always going to be a fine balancing act. In these circumstances you could describe their mindset as having a "contrarian motive" - in simple terms, bad economic news is greeted with relief because it means that interest rates do not need to go as high and for as long. A cooling economy means less demand, which normally leads to a fall in rising prices. Importantly, this does not mean falling prices, it means that price rises are not as great as we have recently seen. As we have discussed previously, the desired target is 2%, so when the MPC meets on 21 September, they need to balance their desire to win the battle with inflation without creating more pain than is necessary through raising interest rates too far. Crucially, the committee will have not just this week's earnings and inflation data but also the measurements for CPI in August, which are due to be published by the ONS a week before their meeting.

As I have explained in previous updates, interest rate rises are somewhat of a blunt tool that take time to impact demand, especially given that nearly 90% of borrowers are tied into a fixed-rate deal. Over the next 18 months, nearly 2 million borrowers will face large increases in their mortgage payments as their current fixed rate expires, leaving them to find the best deal in a marketplace that differs so much from just two years ago.[7] This means the MPC could raise rates today, which, while cooling consumption (people buying goods and services), would take many months to truly take effect across the whole economy. As a rate setter, you are then faced with your best educated guess as to how high to raise rates before the battle with rising prices is finally won. The danger is that if you continue to increase rates long after the previous rises would have been sufficient, you run the risk of creating an unnecessary recession. All eyes will be on the next round of UK earnings and inflation data in mid-September as a barometer to guide market expectations for the MPC committee's crucial meeting the following week.

Market update

The initial investor enthusiasm earlier this year, triggered in part by renewed interest in artificial intelligence (AI), was largely led by a concentration in just ten global companies. Despite the banking turmoil in March, this initial concentration widened across other companies and sectors in the last few weeks. However, since the start of August, investors seem to be taking a breather, with some appearing to take profits and waiting for further economic data to reveal the road ahead. Last week markets were largely flat in both bonds and shares, although ongoing concerns about tight labour markets, sticky inflation and resilient economic numbers saw bond yields earlier this week climb close to their recent peaks.

At the moment, markets are predicting a pause in rate rises from the Federal Reserve in the US and a further 0.25% rise from both the Bank of England and the European Central Bank (ECB) in the next round of meetings in September.[8] This shadow of uncertainty hangs over investors, although for many lower-risk investors who would tend to buy more bonds than shares, you could argue that, at the current pricing point, the outlook does seem much rosier than current sentiment would suggest. Let me explain what I mean by pricing point. Let's use a house as an example to keep things simple. If two years ago you went to see a property as an investment that was advertised for £100,000 and offered you less than 2% in rental income - you might of thought that it was overpriced and offered little in the way of a competitive investment return (albeit interest rates on cash were probably less at the time). Now fast forward to today, and the same property is on sale for £70,000 and offers a rental income of nearly 5%. I am guessing this would now represent a more attractive investment opportunity. If you take this simple analogy and apply it to bonds, when yields were at record lows, their price relative to history was very expensive. Clearly, the normalisation of interest rates means that the price has fallen to reflect this higher yield. So, the big question you may ask is: will bonds become even cheaper and offer an even higher yield? Nobody can be certain when answering this question, however, what we do have are changing economic conditions and that markets reprice assets to reflect these changes. As we approach a point when central banks may decide to pause rate rises (arguably, the US may already be there), then market participants attention will turn to the possibility of central banks eventually starting to cut rates. What we do know is that bond investors tend to move very quickly when repricing bonds and their respective yields if the outlook improves or worsens. While interest rate cuts may not happen until towards the end of next year as policymakers wait for confirmation that their battle with inflation is won, bonds are likely to fall in the future long before the first expected cut in rates. So, while bonds may become cheaper in the next few weeks, it is probably fair to say that when compared to two years ago, the pricing point today is at worst much more attractive.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

Note: Data as at 17 August 2023.

[1] Office for National Statistics, 16 August 2023
[2] The Times, 15 August 2023
[3] Investing.com, 16 August 2023
[4] Office for National Statistics, 15 August 2023
[5] Office for National Statistics, 15 August 2023
[6] Office for National Statistics, 11 August 2023
[7] UK Finance, 21 June 2023
[8] Refinitiv Eikon, 16 August 2023

Asset Management

A Week in the Markets

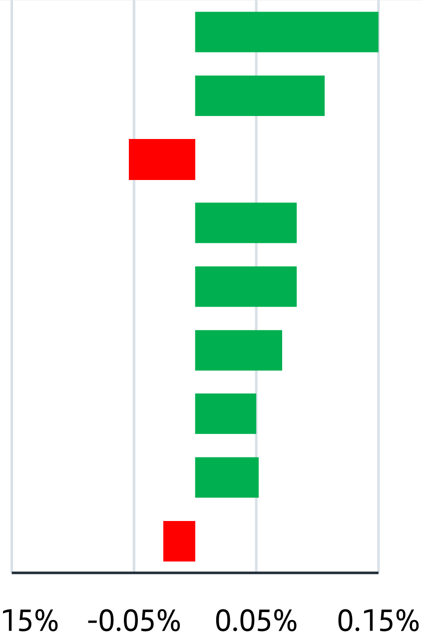
Performance

Index	Value	Change	%	12 Month High	12 Month Low
FTSE 100	7,524	-40.21	-0.53%	8,014	6,826
FTSE 250	18,800	-134.92	-0.71%	20,615	16,611
Dow Jones Industry	35,281	215.78	0.62%	35,631	28,726
S&P 500	4,464	-13.98	-0.31%	4,589	3,577
NASDAQ	15,028	-246.85	-1.62%	15,841	10,679
Hang Seng	19,075	-464.27	-2.38%	22,689	14,687
Nikkei 225	32,474	280.9	0.87%	33,753	25,717
CAC 40	7,340	25.12	0.34%	7,577	5,677
DAX	15,832	-119.69	-0.75%	16,470	11,976
FTSE Eurofirst 300 Eurozone	2,431	-10.69	-0.44%	2,547	1,950
S&P TSX Composite Index	20,408	171.53	0.85%	20,767	18,206
Commodity markets*					
Gold	$1,917.85	-21.90	-1.13%	$2,047.01	$1,628.00
Crude Oil	$87.92	0.56	0.64%	$107.11	$70.96

Source: Refinitiv Eikon, prices displayed in the local currency.
*Gold Bullion London Bullion Market $ Per Metric Tonne Ounce Delay & Brent Forties and Oseberg Dated Free on Board Northsea Crude used for commodity performance.
Source Data from the 7 August 2023 to 11 August 2023.

10-year bond yields

Country	Yield	Variation	12 Month High	12 Month Low
UK	4.53%		4.67%	2.02%
US	4.17%		4.23%	2.79%
Japan	0.59%		0.65%	0.17%
Euro	2.62%		2.75%	0.90%
Germany	2.62%		2.75%	0.90%
France	3.16%		3.24%	1.47%
Italy	4.26%		4.82%	2.98%
Spain	3.64%		3.79%	2.01%
China	2.65%		2.99%	2.62%



Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	$1.27	-0.01%	$1.31	$1.07
Euro	GBP > EUR	€ 1.16	0.00%	€ 1.19	€ 1.11
Yen	GBP > YEN	¥184.01	3.33%	¥184.01	¥154.73

Source: Refinitiv Eikon.
Source Data from the 7 August 2023 to 11 August 2023.