State of Play

23 September 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. Since the start of 2000 average inflation has been lower when compared to the latter half of the 20th century, helping investors and savers alike. Are we now facing the first sustained price hikes for a generation caused by the perfect storm? And what are the driving factors behind this threat?

Perfect storm

I would imagine the key benefits of being a freelance journalist is choosing what to write about rather than being given the subject or story by somebody else. Sebastian Junger started his career with exactly this choice, leading him to explore dangerous occupations like commercial fishing. He was the first to coin the phrase 'The Perfect Storm' as the title of his best-selling book in 1997 that was then adapted to a film in 2000 starring George Clooney. The definition of perfect storm is an unusual combination of events or things that produce an unusually bad or powerful result.

The UK, and other developed countries around the world, have been hugely reliant on fossil fuels to heat and power homes and businesses over the last 100 years or so. Switching to renewable energy has been a slow and difficult process, not helped by the unpredictable British weather. Since the start of 2021, as the world emerged from lockdowns and restarted the economic engines fully, wholesale gas prices have risen 250% according to the Organisation for Oil and Gas UK. What has caused this and importantly why does this matter for savers, investors, and consumers alike?

Energy price rises

As in the case of a perfect storm, a combination of events or factors have caused the recent massive hike in wholesale gas prices. Firstly, it is important to recognise the impact the pandemic has had not just economically but also in the way we work and play. Millions of workers across the world have shifted to home working since the virus started to spread. Last winter and early spring were colder, not just in Europe but also Asia, causing people to use more energy, which in the UK means gas fired central heating rather than electric run air conditioning which is mainly used to heat and cool offices in our major towns and cities. 23 million homes in the UK (about 85%) rely on gas for their central heating and hot water in addition to gas being used to generate approximately 35% of Britain's electricity.

The UK now imports 56% of the gas it needs from abroad following the gradual decline of North Sea gas since the peak in the 1980's, when we were once a net exporter of gas. The cold weather has triggered a global gas shortage reducing gas held in storage facilities well below the normal levels. Added to this, particularly in the UK, is several other considerations which have combined to make matters much worse. Our renewable energy relies heavily on wind farms, yet according to the consultancy EnAppSys the last few months in Europe, including the UK, has been the calmest period since 1961. Three ageing UK nuclear reactors also shut down for unplanned maintenance and last week a fire at a National Grid site in Kent knocked out a crucial power link that is used to import electricity from France which will not be fully repaired until March next year - causing our reliance on electric generation from gas to rise at precisely the wrong time.

Lastly, politics has also been a factor. Russia supplies Europe with a significant portion of their natural gas. The Nord Stream 2 pipeline is yet to be signed off by Europe as it has concerns that this provides Moscow with too much leverage over gas supplies. In response Russia has been reducing the supply to Europe over the last few months, claiming it needs more gas domestically and providing just 20% of the level of supply before the pandemic began despite most economies in Europe being back to somewhere near normal, again pushing up prices as stored gas is used to fill the void.

So, what does this mean for the humble consumer? The UK Government introduced an energy price cap system in 2019 which is reviewed and set every six months. Last month Ofgem (The Energy Regulator) said that it would increase the energy price cap, which limits tariffs for 15 million households, by 12% from October, translating to an increase of £139 a year for most households to £1,277. The latest cap increase is likely to cause a number of smaller energy firms to go into administration and force the UK Government to spend millions on transferring these customers to larger energy firms and guaranteeing the credit on their accounts but not protecting their tariff contract leading to an increase in their gas and electricity bills. Industry leaders have urged the UK Government to take immediate and decisive action before the winter arrives or else the consequences for many energy users could literally be very dark.

Unintended consequences: food supply and prices

Commodity prices, and in particular gas, have wider ramifications on other aspects of our lives that we often take for granted. Wholesale gas prices have a knock-on effect on the production of carbon dioxide (CO_2) used in food packaging, especially meat and fish. The privately owned US firm CF Industries, Britain's biggest supplier of CO_2, had stopped production because of rising natural gas costs which is used to make fertiliser in which CO_2 is a by-product of the process. CF Industries sites account for 60% of the domestic commercial production of CO_2 and 40% of the UK's fertiliser requirements. In a bid to avoid further disruption the UK Government announced late on Tuesday night that it would meet the full operating costs to run CF Industries' Billingham plant in Teesside for three weeks. The costs are expected to be in the 'low tens of millions' and will be below £50m. Environment Secretary George Eustice said 'It will be not a loan, it will be a payment to underwrite some of their fixed costs'. At the end of the three-week period, it is hoped that the price of CO_2 will have risen sufficiently to make it economically viable for CF Industries to keep production running.

Savers perfect storm

I believe the energy price rise perfect storm is not unique. If we reflect on the time since economies, both here and abroad, have reopened following the successful launch of the mass vaccination programmes, a combination of factors is placing savers under enormous pressure and threatening the ongoing real value of their wealth.

Firstly, in response to the pandemic governments and central banks have cut interest rates to zero or near zero causing savings rates to fall even further than their recent pre-pandemic lows. The economic recovery from the crisis has been rapid even when compared to most expert predictions. But this recovery is uneven and comes at a price. When pent up demand and lack of supply crash into one another prices rise. In 'normal' economic conditions central banks would respond by increasing interest rates as a reaction to over heating economies and price rises. This response is designed to cool the economy and limit inflation. However, the financial response to support individuals and businesses globally has cost trillions of dollars which may take many generations to repay. Governments and central banks are aware how fragile any recovery could be and have already expressed patience and restraint in even indicating rate rises in the immediate future.

So, the average saver faces food price rises caused by supply chain difficulties, shortages in CO_2, shortages of fruit pickers and not enough lorry drivers to deliver food. At the same time energy prices are rising faster than at any time in our recent history, as we approach this winter hoping that the weather is kind to us so we avoid gas supply shortages but just enough wind to help energy production without bringing down our fences. Add this to the increasing cost of petrol and air fares, or the shortage of components to manufacture cars, the average consumer is paying more for a larger proportion of the goods and services in their basket.

Lastly, inflation is very personal. If you have savings or income, how you spend this money and when will depend on your circumstances. What we spend this money on will directly impact how price rises affect our wealth. Those who have been saving throughout their working life tend to reach the wealthiest point in their lives just before or at retirement. When we do, we spend more time at home heating our properties, are more likely to go out for lunch or dinner and travel more as we attempt to tick off the bucket list built up over a lifetime of experiences and dreams created. Many employees who retire buy their dream car with the proceeds of any tax-free cash they release from their pension plan.

The key question for most who have just retired is how long will my money last and what can I pass onto my family? Inflation at present represents public enemy number one. If inflation remains stubbornly high and interest rates remain as low as they are for the foreseeable future the real value of money erodes remarkably quickly. What you can buy today will not buy you the same in a few years' time. Many are unsure what steps can be taken to combat this threat, assuming this is possible. Clearly, every individuals' circumstances are unique and may or may not prompt a change of plan, however, the principle of diversifying savings or investments over the right time frame and at the right risk level could help to mitigate these factors. If you are unsure about your saving and investment options we recommend you seek professional financial advice before making any decisions.

Market update

Stock markets around the world fell earlier this week with Japan's benchmark Nikkei 225 Index falling more than 2% lower and the Dow Jones Index in the US ending 1.8% lower. The sell-off was primarily triggered by concerns that Evergrande - one of China's biggest property developers - is struggling to meet interest payments on more than $300bn (US dollar) of debts. The wider impact of this is about confidence in the Chinese economic outlook and the strength of its financial system. Investors fear this could hit big banks exposed to Evergrande and companies like it, causing contagion in global markets. This follows weaker Chinese economic data indicating a stalling recovery from the pandemic.

The main question on markets' minds going into this month's highly anticipated Federal Reserve meeting is whether the recent poor jobs data in August will derail plans for a September taper on financial support? Federal Reserve members have been relatively hawkish in recent months as inflationary pressures build and the US economy rebounds strongly from the

COVID-19 pandemic. Minutes from their July meeting indicated that most policymakers saw a reduction in the pace of asset purchases as likely before the end of the year assuming the economy continued to evolve as expected. Since then, US inflation has remained sky-high with the headline rate of consumer price growth just shy of a 13-year high of 5.3% year-on-year in August, with the core measure above 4% for the third straight month. Whilst global shares, and the US technology sector in particular, have rallied since economies reopened, September so far has been poor for global shares as markets display sensitivity to any economic data surprises and lack momentum. Only time will tell whether decisions by the Federal Reserve will prompt a new wave of momentum or signal an increase in market nerves.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 21 September 2021.

Santander
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