State of Play

25 November 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. Inflation is now at the highest it has been in the UK for 10 years, throwing the spotlight back on policymakers who wanted to assess the end of the furlough scheme before raising rates. This week State of Play explores the delicate correlation between the jobs market and price rises, and the impact these may have on interest rates over the next few months.

Furlough scheme ends

When the UK Prime Minister, Boris Johnson, stood at the lectern in Downing Street on 23 March 2020 to announce the first lockdown, many commentators feared the worst when it came to the impact on the economy and the jobs market. Staff were asked to work from home where possible, but many businesses in sectors like hospitality, construction, and manufacturing simply closed with the prospect of job losses seemingly inevitable. The gloomy forecasts from most experts, including the Bank of England (BoE), were that unemployment would rise sharply into double digits from the near record low of 4%.

Chancellor of the Exchequer, Rishi Sunak, launched the Coronavirus Job Retention Scheme on 20 April 2020. It paid 80% of workers' pay capped at £2,500 per month. Initially intended as a short-term measure it continued until the end of September 2021 having supported over 11 million jobs in the UK. The principle of 'furlough' was to maintain the link between the employer and employee, rather than companies laying off their staff and then, after the shock of the pandemic and lockdowns passed, re-hiring them. The scheme enabled them to keep their employees on the payroll but still save on the costs of wages whilst the business was closed. Gradually as restrictions were lifted the scheme was phased out, asking employers to start contributing a proportion of the furlough cost in the last couple of months.

Without doubt the Chancellor and the Treasury hoped this extreme intervention to support the jobs market, although very costly to the taxpayer in the short-term, would help to avoid the gloom predicted and a much bigger long-term cost to the economy. The success of the scheme has been beyond their wildest dreams as the financial protection safe-guarded jobs and kept businesses from going bust. When the scheme finished at the end of September, around one million people were still being paid by furlough. This prompted the BoE to vote against an interest rate rise this month, surprising the financial markets having hinted strongly for many weeks that they would increase rates if inflation continued to rise.

Strong employment data

In the first real test since the furlough scheme concluded, the latest UK jobs market data surprised analysts as according to the Office for National Statistics (ONS) 160,000 jobs were added to UK payrolls in October bringing the unemployment rate down to 4.3% with 29.3 million people now in the workforce, higher than when the pandemic began, thus proving fears that those left on the furlough scheme would end up on the dole queue unfounded. The immediate challenge facing the BoE is a complex labour market dynamic as a significant shift in the demands placed on different sectors starts to emerge. So, what are the factors and what role do they play in the economic engine as it shifts up and down the gears in direct response to their impacts?

Firstly, it is too early to conclude that those left on the furlough scheme have remained employed. If businesses did indeed make some of their workforce redundant many will have to provide sufficient notice to these employees especially if they have worked at the company for more than two years. Whilst this is possible, the ONS says that the results of a business survey they conducted suggests that the numbers being made redundant was likely to be a small share of those still on furlough at the end of September. There may be a small number that fall into unemployment in the next few months, but the effectiveness of the scheme is beyond doubt.

The next factor is the make-up of the workforce post pandemic. Whilst thousands of elderly workers have chosen to stop work and have become inactive, the youngest age group, worst affected when the pandemic struck, have been job hunting on a massive scale. The ONS states in its latest summary; 'Our latest Labour Force Survey estimates for July to September 2021 the employment rate increased 0.4% on the quarter, to 75.4%. The quarterly increase in employment was driven by a record high net flow from unemployment to employment. Total job-to-job moves also increased to a record high, largely driven by resignations rather than dismissals, during the July to September 2021 period. The rise is also driven by an increase in part-time work and an increase in the number of people on zero-hour contracts, driven by young people'.

Every age group saw an increase in payrolled employees in the year to October, but those under the age of 25 have seen a staggering 501,000 increase in just 12 months. The UK Government's £2bn kick start scheme launched in September last year targeting support for the younger workers has added 100,000 new roles, but with additional funding for another 150,000 jobs. Take up was initially slow, as COVID-19 restrictions made it difficult for more young people to get started, but participation has picked up as the economy has reopened.

Vacancies hit another record

According to the latest ONS data, vacancies in the UK rose to a new record of 1,172,000 - an increase of 388,000 when compared to the three months January-March 2020 before the pandemic began. Every sector has seen an increase in vacancy numbers, but whilst the rate of increase has slowed, construction and storage sectors saw an increase of over 40% in the latest quarter. Since the pandemic began the biggest rise in vacancies is in the accommodation and food services sector with a 79% increase and 15 out of the 18 industry sectors measured are at record highs. In addition, average total pay increases slowed in the latest data but still remained 5.8% higher in the year to October (including bonuses). Those being paid on the furlough scheme last year inflates the current figure comparing wages being paid at just 80% of their normal level. However, with the scheme ending the impacts on the data are lessening and will eventually drop out of the headline calculation.

The dilemma for the BoE is caused in part by a combination of record job vacancies and high wage settlements that could drive prices higher in the next few months, adding to the cost-push pressures we explored in the State of Play two weeks ago (11 November). At present there are acute shortages in certain sectors forcing companies to offer higher pay packages to attract and secure new recruits. Some are even offering signing-on bonuses for skilled workers in certain roles. This in turn could impact on wage demands from existing employees who discover the 'new recruit' may be being paid more than them and therefore ask for an increase. Indeed workers could, if their demands are not met, look elsewhere for an alternative position, which would leave companies paying out additional costs to replace a trusted long-term employee. Some businesses have already started to raise the price of their goods and services in anticipation of the next round of wage settlements putting further pressure on inflation.

Inflation rises again

The latest data from the ONS measured inflation (Consumer Price Index) at 4.2% for the year to October, more than double the BoE target rate of 2% and much higher than had been forecast. As expected, the recent significant rise in the energy cap pushing up gas prices 28% in the last 12 months and soaring petrol prices have pushed up the rise in the cost of living to the highest since December 2011. In addition to petrol and energy, a shortage of raw materials and components continues to cause supply problems and long waits for consumers.

This 'cost-push' pressure is best demonstrated in the used car market. New cars are now built with computer chips made from various special metals which are in short supply. New car production has been affected, creating not enough supply to meet demand. Car buyers, rather than wait many months for a new car order, have taken to hunting for a nearly new car triggering a ripple effect throughout the used car market. Prices of used cars, especially popular hatchbacks, have risen a staggering 22.3% in just 12 months according to the ONS. This manufacturing price pressure is clearly shown in the latest measure on input prices for manufactured goods, called Producer Price Index (PPI), which hit 13% in October.

After a flat September retail sales grew 0.8% in October as the ONS reported some consumers have started their Christmas shopping earlier than normal in part because shoppers have been shocked in the past by shortages on the shelves and long queues for petrol. Buying early appears to be a changing trend alongside more and more goods being bought online. This additional demand simply amplifies the pressure on the cost of living and experts expect inflation to reach at least 5%, if not higher in the next few months.

Pressure on policymakers and savers

The BoE will know that if they fail to act in response to sustained higher inflation, they face the real prospect of rising prices getting out of control leading to adverse impacts on the post-pandemic economic recovery. Investment markets were surprised and disappointed this month when the BoE Monetary Policy Committee (MPC), who decide on interest rates, chose to keep them unchanged despite previous warnings leading up to the decision. All eyes will now be on their next meeting scheduled for 16 December when they have to assess whether an interest rate rise will be enough to cool the 'demand-pull' influence on rising prices, knowing that it will do little to solve the supply side issues causing 'cost-push' inflation.

For investors and savers this meeting may prove crucial in the likely future path of interest rates. Savers currently face the prospect of higher inflation than we have become used to for a prolonged period, eroding the value of their savings as the savings interest being paid is highly unlikely to keep pace with rising prices. Investors will be watchful as rising interest rates and higher inflation often cause changes in perceived value of risk assets like shares. Bonds as an asset class continue to be under pressure as the prospect of rising rates cause yields to spike and values to fall. The recent rise in yields in response to the latest inflation data is not surprising, as is the cost of borrowing for the government, especially index-linked debt which becomes more expensive as inflation rises. We all wait with keen interest for the outcome of the MPC meeting next month, mindful of the consequences regardless of the decision they make.

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 23 November 2021.

Santander Asset Management

Important Information