

State of Play



10 March 2022

As investors attempt to assess the impact of the conflict in Ukraine, rising oil prices increase inflation concerns as markets try to price in future interest rate rises. Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

The Ukraine crisis, inflation and interest rate rises

According to the Resolution Foundation's annual Living Standards Outlook for 2022, typical household incomes are likely to see the sharpest fall since the mid-1970's as the Ukraine crisis pushes up oil and energy prices therefore lowering living standards by an estimated £1,000 during the coming financial year (April 2022 – March 2023). Adam Corlett, Principal Economist at the Resolution Foundation, said: 'Britain has stepped out of a global pandemic, and straight into a cost-of-living crisis. The tragic Ukraine crisis is likely to further drive up the price of energy and other goods and worsen the squeeze on incomes that families across Britain are facing. Inflation may even exceed the peak seen during the early 1990s, and household incomes are set for falls not seen outside of recessions.'¹

As I have explored in previous editions, the squeeze from rising inflation had already begun to filter into stock market nerves prior to the Ukraine crisis. The key consequence of the invasion by Russia, apart from the tragic humanitarian impacts, is the knock-on effect on commodity prices. Briefly, on Monday of this week, Brent Crude oil touched \$130 per barrel before falling away later in the trading day.² As at the time of writing, the price was trading

consistently above \$125 with stark warnings from the Russian Deputy Prime Minister Alexander Novak who said on state television late on Monday that oil could hit \$300 in the event that the West decided to cut off the use of Russian oil and gas.³ He also said that his country had the right to cut off the Nord Stream 1 gas pipeline between Russia and Germany following the decision by Germany and the European Union to postpone the decision to implement the Nord Stream 2 pipeline⁴ The sharp rise in energy prices is exacerbating the pressure on rising prices⁵, with many inflation forecasts being increased upward following the start of the conflict⁶.

My view is that the record prices at the petrol pump could rise significantly on top of further rises in the energy cap beyond the next increase due in April. It may mean that inflation in April hits 8% to 8.5% which would be the highest since 1991⁷ and importantly could remain at elevated levels for the remainder of this year. Whilst it is expected that price rises will eventually fall, I have observed market concern about how central banks will respond. Seemingly, focus is now on the Federal Open Market Committee's meeting next week when it is expected the first rate rise for some time will be implemented. Given inflation in the US is at its highest since 1982⁸ and the latest economic data suggests a strong economy and labour market⁹, it will not be a complete surprise if they raise the base rate by 0.50% instead of the 0.25% - as hinted by Jeremy Powell last month, the Federal Reserve Chair¹⁰. The Bank of England Monetary Policy Committee is also due to meet next week, again to set the base rate. Following a rate rise in both December and January, the market has been speculating the potential for another small increase.

As State of Play has raised previously, inflation is crucial in understanding the future path for interest rates. The Ukraine crisis has to some extent made forecasting more difficult, in part because the crisis has the potential to unsettle markets and impact future economic growth. If interest rates go higher then borrowing for companies and individuals becomes more expensive which has two knock-on effects. Firstly, it could reduce future company earnings and profits, and importantly investment decisions. Companies who become uncertain about their future are less likely to invest in new machinery, technology and people. If their future earnings are reduced, investors will reprice the value of their shares and react accordingly. Secondly, it could impact consumer buying decisions, delaying purchases or financial decisions, cooling economic growth, and even, if significant, tip an economy into a recession. So, whilst in some ways the crisis may act as an influence in cooling inflation, I suspect the immediate impact on commodities will feed through into higher inflation in the immediate short-term. In summary, central banks are between a 'rock and a hard place'. Too many interest rate rises may equal recession. Too little may mean sustained inflation with the consequences this may entail. Navigating these crucial decisions is therefore not easy to second guess, which helps to explain the market's apprehension.

Market reaction

Understandably with the current uncertainty, we are observing fearful investors and high volatility. A perfect example of this sentiment was this Monday (7 March). UK stock markets opened with the main index, the FTSE 100, which includes the leading companies in the UK stock market by value, nearly 3% down from Friday's closing value as oil prices spiked markedly.¹¹ Then as the price of oil fell investors appeared to breathe a sigh of relief and the index soared back up above the close of Friday, trading 50 points higher before finishing the day, down at 6.959, 51 points lower.¹² For retail investors this example is important for several reasons. Trying to time markets is almost impossible even with the benefit of less uncertain times, but in the current climate, this is even a challenge for investment professionals. History shows that on many occasions in the past either through war or some other unexpected event, markets can become very scared succumbing to the natural emotion which is to sell and wait for calmer waters.¹³

However, time and again shocks happen to markets, but over time typically values recover and continue to rise. Sometimes this recovery can be very quick, thus resulting in those who choose to sell often missing the best days of the bounce back. Although it can also amplify losses by crystallising the immediate fall and then missing the energy of values rising. Therefore, diversification is key. This is demonstrated by the reaction of the bond market to the crisis. Last week, UK 10-year bond yields reduced significantly from the recent high in mid-February of 1.6% falling 50 basis points to 1.1%.¹⁴ This provided portfolios which held UK Government bonds some cushioning as shares fell.¹⁵ In the last couple of days, the yields have risen back up to 1.45%¹⁶, likely in response to the expectations from central bank meetings next week and possibly portfolios rebalancing from bonds to shares after the market sell-off. A combination of different asset classes often enables a smoother journey helping to keep fears at bay and supporting investors to focus on the long-term plan and not be distracted by the day-to-day news.

Find out more!

Listen [here](#) to our latest Market Views from our Head of Systematic Research for TAA and Alpha, Stefano Amato, as he shares his thoughts on the impact of the Ukraine crisis on markets.

Note: Data as at 8 March 2022.

¹ Resolution Foundation, 8/03/2022

² Investing.com, 8/03/2022

³ Market Watch, 8/03/2022

⁴ Reuters, 22/02/2022

⁵ Ofgem, 16/02/2022

⁶ Bloomberg, 25/02/2022

⁷ Office for National Statistics, 8/03/2022

⁸ Bloomberg, 12/01/2022

⁹ US Bureau of Statistics, 24/02/2022

¹⁰ CNBC, 2/03/2022

¹¹ Investing.com, 8/03/2022

¹² Investing.com, 8/03/2022

¹³ Reuters, 18/02/2022

¹⁴ Investing.com, 8/02/2022

¹⁵ Investing.com, 8/02/2022

¹⁶ Investing.com, 8/02/2022

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