State of Play

24 March 2022

Yesterday saw two key announcements. Firstly, the Chancellor of the Exchequer, Rishi Sunak, faced a difficult task of navigating competing priorities as the cost-of-living crisis, caused by rising energy and commodity prices, forced his hand in the 2022 Spring Statement. Secondly, the Office for National Statistics (ONS) announced the latest inflation data for February, showing prices rising at their highest for 30 years.[1] Our Investment Specialist, Simon Durling, shares his thoughts on these announcements in this week's State of Play.

Spring Statement

Rishi Sunak, the Chancellor of the Exchequer, delivered his Spring Statement to the House of Commons yesterday (23 March). The Office for Budget Responsibility (OBR) has forecast that the UK's gross domestic product will expand 3.8% in 2022 (not 5.4% as originally predicted) and 1.8% in 2023, with inflation expected to average 7.4% this year.[2] In light of the squeeze on household income the Chancellor announced that the UK Government would lift the National Insurance threshold by £3,000 to £12,570 in what he called the 'largest single personal tax cut in a decade - a tax cut for employees worth over £330 a year'.[3] In addition, he announced a 5p cut in fuel duty which came into effect yesterday (23 March) and is set to last for 12 months.[3] Turning to energy, he said any purchases of energy saving material and home installations such as heat pumps or solar panels would now be offered VAT (value added tax) free.[3] Lastly, in a hint of future plans, he announced a cut in the basic rate of income tax to 19% by the end of the current parliament in 2024.[3]

The UK's economic performance over the last 12 months has beaten expectations and provided some much-needed head room for the Chancellor against the cost-of-living and Ukraine crises.[3] However, since the Spring Statement, some politicians have stated the Chancellor didn't go far enough, even within his own political party, who wanted as a minimum to shelve the planned rise in National Insurance.[3] He said he wanted to take prudent steps given the increase in borrowing costs for the UK Government as interest rates and bond yields rise, especially given £500 billion of the UK Government debt is borrowed on inflation linked contracts.[4] This means that as inflation rises, the cost of borrowing on these bonds increases with them, combine this with the rise in bond yields for new issued debt and the interest payments on UK Government debt is likely to soar.

Prices rising at their highest for 30 years[1]

The stark reality facing consumers whether this be at the petrol pumps, the supermarket checkout or glancing at their latest energy bill, I am sure will testify that the latest inflation data showing price rises are now at their highest for 30 years[1] won't be a surprise. According to the ONS the latest year-on-year rise in prices, based on the Consumer Price Index (CPI), hit 6.2% in February, higher than market expectations.[1] To contextualise, this is more than three times higher than the 2% target set by the Bank of England, which is used as their benchmark to maintain a healthy growing economy and stable prices.[5] As expected, the largest contributions to the rise in cost of the inflation basket came from housing and household services (including electricity and gas) and transport (principally from motor fuels and second-hand cars).[1]

It is important to remember that inflation measures are a rolling 12-month snapshot which compare prices from the previous year. This can distort comparisons either up or down depending on specific events in our recent history, for example when COVID-19 lockdowns brought economic activity to a crawl this led to less demand for goods and services during 2020, translating into much lower oil prices and consequently lower fuel costs.[1] As oil prices recovered in late 2020 and continued into last year, comparing last summer with the lockdown sunshine of the previous year saw inflation pick up but against what the ONS and experts label 'the base effect'.[6] As time moves on these rises 'drop-off' the calculation and inflation can be viewed as temporary. This is the stance initially taken by central banks when inflation picked up, with policymakers explaining that although inflation may rise slightly above their target, it would be transitory.[5]

However, the pandemic triggered inflation pressure beyond the normal 'demand pull' (too much demand pushing up prices) as the global economy roared back to life after the easing of restrictions.[6] A shortage of raw materials, supply chain disruptions stoked by a lack of distribution capacity and slower to market manufacturing, as vast swathes of the work force were at home isolating at certain periods, caused 'cost push inflation' pressure. This is when raw materials and labour costs increase the cost of manufacturing goods. In part, this is what we are now witnessing as a combination of factors limit the supply of oil, gas, and other raw materials. This pressure existed before the Ukraine crisis began, but with the added complication of sanctions and Europe's dependency on

Russian oil and gas, both prices have soared with oil reaching $122 per barrel[6] at the time of writing and UK natural gas prices having risen nearly tenfold in just 12 months.[7]

The squeeze on household incomes is set to become even more acute as the expectation is that inflation could exceed 8% in April according to the Bank of England as the energy price cap increase is implemented.[5] Also, the current inflation data measures the difference between petrol prices in February last year which were £1.20 per litre for unleaded petrol and £1.47 per litre last month.[1] As you will have noticed when you last filled up, prices for unleaded petrol are now on average £1.66 per litre for unleaded and £1.78 per litre for diesel according to the RAC Fuel Watch.[8] With Russia again threatening to disrupt their contribution to global oil supplies[3], consumers and investors will watch with interest and apprehension as oil prices remain volatile. Whilst it is expected that inflation pressure will ease later this year[1], for now the impact on households is the reality of a complex range of influences and factors placing pressure on budgets and potentially affecting future economic growth forecasts.

Market update

Investors in large part have been holding their nerve over the last week. In fact, the leading companies within the UK stock market, the FTSE 100 Index, have been grinding higher since 7 March when for a brief moment the index fell below the psychological barrier of 7,000.[6] The index was just shy of 7,500on 23 March, representing a rise of just over 7%.[6] Many other indices, like the NASDAQ and S&P 500 have seen similar performances, and whilst volatility remains, some investors have seen the current uncertainty as an opportunity.[6] Bond yields at the start of the Ukraine crisis fell providing multi asset portfolios with some protection against share price falls.[6] However, following the latest inflation data and the rate rises implemented by both the Federal Reserve and Bank of England last week, bond yields have risen sharply over the last couple of weeks.[6] 10-year bond yields for the UK and US are now at 1.6% and 2.3% respectively.[6] In my opinion, the key information for savers and investors to digest in these announcements is inflation is at a 30-year high and is likely to get much worse before it gets better, which can be echoed by the OBR's prediction for 2022. They expect inflation to average 7.4% during 2022.[2] At that rate, if sustained, the purchasing power of your money excluding any interest paid will halve in just nine years.

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 recent volatility within investment markets.

Note: Data as at 23 March 2022.

[1] Office for National Statistics, 23/03/2022
[2] Office for Budget Responsibility, 23/03/2022
[3] BBC News, 23/03/2022
[4] Financial TImes, 23/03/2022
[5] Bank of England, 23/03/2022
[6] Investing.com, 23/03/2022
[7] OFGEM, 3/02/2022
[8] RAC, 22/03/2022