Santander Asset Management

State of Play

14 April 2022

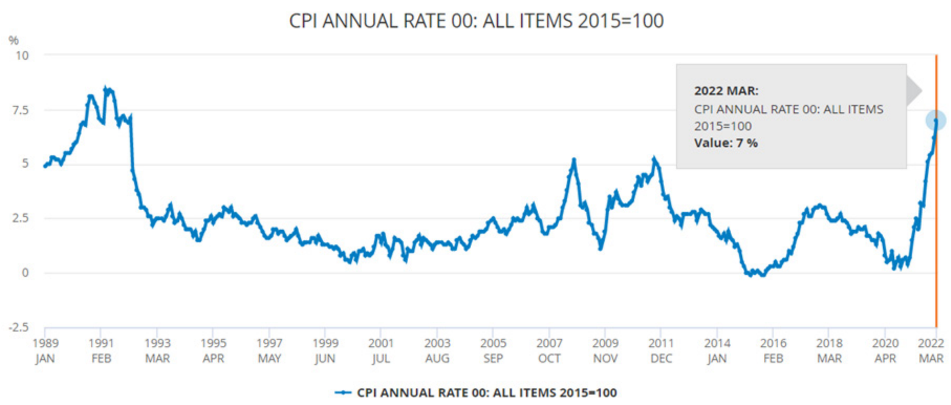
It's been a busy week with important economic and inflation data being released, so how will markets respond to the numbers? Has the cost-of-living crisis and the Ukraine crisis already started to slow the economy, even before interest rate rises have taken effect? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Inflation

Yesterday (13 April) the Office for National Statistics (ONS) released their latest report on UK inflation showing that prices in the 12 months to March grew by 7%, up from 6.2% last month based on Consumer Price Index (CPI), the highest since March 1992.[1] The ONS report points to household energy bills, fuel costs and the price of second-hand cars as the biggest contributors. Despite fuel duty having been cut by five pence in last month's Spring Statement from the Chancellor of the Exchequer, Rishi Sunak, anyone filling up at the petrol station over the last couple of weeks will likely not have noticed much difference. The one small positive is that oil prices appear to have stabilised in the last couple of weeks at just above $100 per barrel.[2] Incidentally, for those old enough to remember the Retail Price Index (RPI), which continues to be measured but no longer used by the ONS, is at 9% in the year to March, the highest since January 1991.[2]

Importantly, despite the price of oil falling from the recent highs last month, the current UK inflation data does not yet account for this month's rise in the energy price cap, which as this update has explained previously, has risen by 54%, affecting 20 million households.[3] Next month's inflation data is being released by the ONS on 18 May, when I expect the rise in prices to reach at least 8% given the influence energy prices hold as a proportion of the inflation basket alongside the other comparisons from April 2021, when as some may remember we were living under restrictions in the midst of the vaccination roll-out. In addition, the recent restrictions put in place in China to tackle another COVID-19 wave has disrupted the supply chain works[4], and will likely not ease the semi-conductor shortage in car manufacturing which has already seen huge rises in used car prices as a consequence[1].

If you need any examples of why inflation has been the dominant driver of markets since the start of the year, the latest data released in the US this week showed inflation grew to a 40-year high at 8.5%, an annual rate last seen in December 1981.[3] Despite the US to some extent being more insulated than say Europe, as they are less reliant on international markets for food and energy, they cannot escape the grip of the energy crisis or the conflict in Ukraine.[5] However, if you delve deeper into the statistics, the 'core measure' of inflation stripping out food and energy costs did reduce from 0.5% in February to 0.3%[1], providing some evidence that there may be light at the end of the inflation tunnel by pointing to inflation cooling in the months ahead.



Source: Office for National Statistics (ONS), 13 April 2022.

Employment and wage growth

According to the latest statistics from the ONS, the unemployment rate for December 2021 to February 2022 decreased by 0.2% to 3.8%. Those unemployed for up to 12 months decreased during the latest period to a record low.[1] Job vacancies rose to a new record high of 1,288,000 with an increase of 492,400 from the pre-COVID-19 pandemic level in January to March 2020.[1] The ONS report goes onto say 'in January to March 2022, quarterly vacancy growth slowed across most industry sectors, and while it remains positive, growth fell to 4.1% from 9.8% in the previous quarter. The growth in vacancies over recent periods, alongside a reduction in the unemployment rate, has seen the ratio of unemployed people to every vacancy reach a record low of 1.0 in December 2021 to February 2022. The rate of annual pay growth for total pay (including bonuses) was 5.4%, and the annual pay growth for regular pay was 4.0% in December 2021 to February 2022. Bonus payments since August 2021 have remained strong, especially in the finance and business services sector'.

Importantly, if you exclude bonuses and factor in the rise in prices, wages fell last month, as they failed to keep pace with inflation.[1] The Office for Budget Responsibility (OBR), the official forecaster for the UK Government, reported in March that take-home pay this year would fall by the largest amount since records began 66 years ago, and real incomes, or the value of earnings after accounting for the impact of inflation, will fall by 2.2% in the 2022-23 financial year. The OBR expects inflation to reach a 40-year high of nearly 9% this winter when the energy price cap increases again.[6] My view is with real wages falling there is a potential silver lining, as the purchasing power of consumers falls this will cool demand therefore bringing inflation down in the months ahead. In addition, some concerns that have been raised by market commentators in recent weeks when trying to compare the stagflation of the 1970's with now, have strong evidence that with wage settlements not keeping pace with surging prices, my opinion is the stagflation cycle will in all probability be avoided.[4]

UK economy

According to the Office for National Statistics (ONS) economic output grew just 0.1% in February down from 0.8% in January, much weaker than forecast. Accommodation and food service activities grew by 8.6% in February 2022 and was the main contributor to February's growth in services, partly reflecting a bounce back following weakness in both January and December because of the impact of the Omicron variant of COVID-19.[1] Also much of the services growth in February 2022 was tourism-related industries with increases in both travel agency, tour operator and other reservation service and related activities (growing 33.1% on the month), and accommodation (growing 23% on the month) as consumer confidence improved as restrictions eased.[1] ONS Director of Economic Statistics, Darren Morgan, said 'the economy was little changed in February with the easing of restrictions for overseas travel and increased confidence in booking holidays in the UK triggering strong growth in travel agencies, tour operators and hotels'. He went on to say 'manufacturing fell notably, with motor manufacturing continuing to struggle to source parts'.

Markets fell earlier this week following the release of the disappointing economic figures[2], in my view, investors recognising that the data was supposed to be the first measure of how the UK economy would respond whilst learning to live with the virus and before the Ukraine conflict became an invasion. In addition, in February whilst inflation continued to rise, investors are probably mindful that it is likely to get much worse before we start to see price rises eventually cool. Already the Bank of England and the Federal Reserve have signposted their more hawkish intentions by warning of further rate rises throughout this year to help tackle rising prices. This has seen sharp rises in volatility throughout the first quarter with the added uncertainty the conflict brings with it.[2]

One aspect of the price rises over the last 12 months has been the dual impact of not just 'demand pull' inflation, where too much demand chases too few goods, but also the 'cost push' inflation impacted by rising wage bills and surges in the cost of raw materials. Whilst the economy is now back above pre-pandemic levels, according to the ONS, the worry now is, has most of the momentum and confidence been lost?

The current wave of Omicron in China, the shortage of metals used to make the components for new cars, and distribution challenges caused by a multitude of factors makes for an environment where the costs of making and supplying goods are much more expensive. Some can pass on these rises to the end consumer, but many are tackling a competitive marketplace and sensitive consumers worried about how much the rises in their household bills will tip them to delay purchases thus cooling economic growth still further. This clearly will have an ongoing impact on both revenues and profits in the short-term, which is why the shares of so many companies have been revalued by investors since the start of the year.[2] If you combine the rise in the cost of making and selling goods, and the rise on the cost of borrowing as base rates are increased and bond yields rise with them, it is understandable why a reassessment of future earnings makes for greater market volatility.

Market update

This week's concentrated data release demonstrates why there is so much uncertainty in the short-term. Markets remain sensitive to the ongoing inflation story and the Ukraine crisis. As central banks seek to normalise interest rates to tackle sustained high inflation, predicting the path of interest rates and economic growth is incredibly challenging. In many respects my observation on investment markets over the last week is they lacked any directional momentum whilst awaiting the latest data. Bonds are the exception to this, as yields continue to grind higher, with UK 10-year Government bond yields now standing at 1.88% (at the time of writing), 0.2% higher than the same time last week, but importantly, 1.2% higher than mid-December.[2] US 10-year Treasury yields have a similar story as they hit a high earlier in the week at 2.88% before falling back slightly to just above 2.75%.[2] Yields in the US have now doubled since mid-December as rising prices, strong wage settlements and a tight labour market driving bond values lower.[2]

I suppose the key question is what next? Clearly, it is impossible to be certain about what lies ahead, but I want to share one observation which may prove to be valuable. As State of Play explained in previous updates, stock market investors look to the future and 'price in' different expected scenarios, with the dominant scenario driving the prices of shares and bonds. The current gloomy outlook influenced by inflation has been underpinned by central banks signposting their expectation on rising rates throughout the remainder of this year. The reason central banks increase rates are to cool demand by making borrowing more expensive, a blunt instrument at best, but normally effective, given sufficient time to work. As the cost-of-living is rising, wage increases are unlikely in most cases to cover the gap, resulting in less money to spend. Energy bills, petrol prices, used cars, food, travel and a whole host of other goods and services we spend our money on have become and are becoming more expensive.

My point is inflation will likely cool demand and it seems markets are just unsure by how much. Also, rising interest rates are less effective on the cost of certain raw materials, as energy supplies do not have any direct correlation to interest rates. Central banks will be very aware that if they increase rates too much, too quickly, they run the risk of tipping economies into recession. So, has the market been overly pessimistic about future rate rises? If inflation cools demand quicker than rate rises, will central banks respond by pausing what has been signposted already? The implications work in reverse of what has happened since the start of the year. Bond yields may fall back as markets realise the path of interest rates is flatter and slower than first thought and share prices will yet again be revalued on the implication of cheaper borrowing costs, albeit, a slower economy usually equates to less sales and less revenue. However, only time will tell what will unfold.

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 13 April 2022.

[1] Office for National Statistics, 13/04/2022
[2] Investing.com, 12/04/2022
[3] OFGEM, 3/02/2022
[4] Financial Times, 24/03/2022 and 13/04/2022
[5] The Times, 13/04/2022
[6] Office for Budget Responsibility, 23/03/2022

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