

# State of Play

## Financial MOT – part one



**5 October 2023**

As we move into the first few days of the last quarter of 2023, the change in our financial world appears to be entering a new phase. Policymakers trying to navigate this transition have come under immense scrutiny as they responded to higher inflation. It feels like a prudent time to take stock and assess the recent journey, checking whether UK Plc would pass a financial MOT. Given the current uncertainty and the challenges we face, do you think it would pass this test? If it failed, what would be the list of advisories necessary to meet the required standard for a roadworthy pass certificate? This week is part one of a two-part series covering the MOT test. State of Play takes a break next week, look out for part two when it returns. Simon Durling, from Santander Asset Management, shares his thoughts in this week's State of Play.

### Key highlights from this week's State of Play

- MOT test
- Advisory notes – part one - Inflation
- Market update

## UK Plc – MOT Test

During the 1950's, post-war economic boom, car ownership grew rapidly, creating a large second-hand market. However, there were no regulations in place in terms of servicing and maintaining your vehicle, leaving a significant portion of cars in dangerous condition, especially those that had been manufactured and sold before 1940.<sup>1</sup> In response, the then Minister of Transport Ernest Marples, introduced the Ministry of Transport (MOT) test as part of the 1960 Road Traffic Act.<sup>1</sup> At the time of its introduction, the test was mandatory for cars of 10 years of age or older, requiring an annual check of their brakes, steering and lights. Given the failure rate in the first year MOTs took place, the limit was reduced to 7 years, just 12 months after the test was brought in. Remarkably, the rules today requiring a test for cars that are 3 years of age or older were changed way back in 1967.<sup>1</sup>

So, why use the MOT as a format to measure economics or financial decision-making? I suppose to many, financial markets and economics are just a blur of long words and detailed explanations, which often make no sense. Using an everyday example provides a framework to explain the 'State of Play'. Given this approach, what would be the equivalent 'car tests' like brakes, steering and lights? To keep things simple, let's pick the big data we all recognise, otherwise, the effectiveness of this update would immediately fail the translation test! This week we tackle the biggest element of the key tests, which is inflation and interest rates. In part two we will explore economic growth and employment.



## Advisory notes

**So, let's start with part one - Inflation – standard required to pass - target of 2%**

Given the recent changes in our financial circumstances that has been triggered by the return of rising prices, it seems like an obvious place to begin. The long-term target the Bank of England agrees with the government is 2%. If you look at the chart below, you can see that over the last 26 years (ever since Gordon Brown shifted the responsibility for setting interest rates to the Bank in May 1997) the Bank of England has maintained price rises very close to the target, with only occasional periods where price rises were either

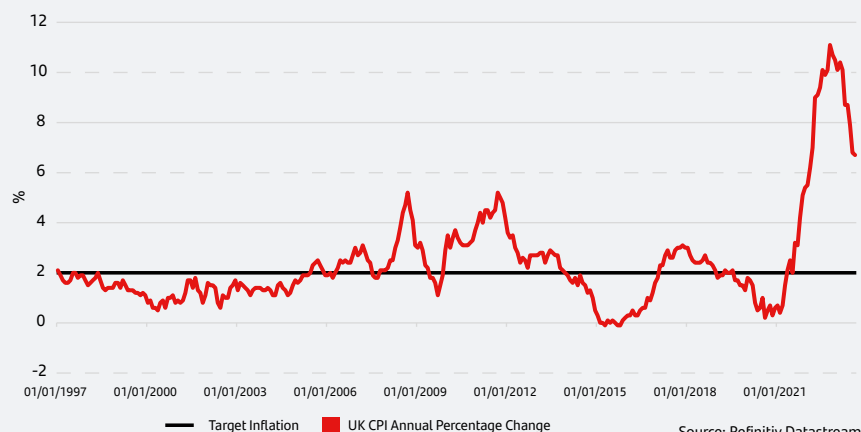
higher or lower than the target.<sup>2</sup> If you compare their track record to the US or the EU, you could argue the level of control in and around the target is better.

However, when restrictions from the pandemic ended, the pent-up demand chasing a limited supply of goods started to push up prices. Russia invading Ukraine in February last year exacerbated rising commodity prices, which meant higher energy bills for consumers. The Bank of England was slow to respond, claiming higher inflation would be temporary. Furthermore, when they recognised the need to act and raise interest rates, they were much more cautious about rate rises than the Federal Reserve in the US. The consequence of failing to keep pace with a more aggressive approach by their US counterparts was the strength of the dollar. Nearly all raw materials and commodities are priced in dollars. If your pound sterling buys less because of the drop in value when compared to the US dollar, all essentials for food, energy and manufacturing goods become even more expensive, making the price rise even higher.

UK inflation (Consumer Price Index - CPI) hit a high in October last year of 11.1%, the highest rising price measure since 1981.<sup>3</sup> The Bank of England's Monetary Policy Committee (MPC) which meets eight times a year to decide on interest rates, raised them in 14 consecutive meetings (a record), from December 2021 until pausing for breath last month.<sup>2</sup> When their first increase occurred, the base rate was 0.15%, and they lifted rates by just 0.1%. The last increase came at their meeting on 3 August, taking the base rate to 5.25%, the highest since 2008.<sup>2</sup> Although policymakers were late to respond to inflation, following such a rapid normalisation of interest rates, how are they progressing on this primary advisory note within our MOT test?

Since October last year inflation has fallen significantly, much slower than the bank would have preferred, but the increase in interest rates is starting to have an impact. There are several reasons why inflation has been slow to fall and why increasing interest rates alone is not necessarily the one silver bullet to solve the inflation challenge. Whilst the initial trigger for a rise in inflation can be traced back to too much demand chasing too few goods and therefore pushing up prices, the sustained nature of price rises can be more closely linked to an increase in the price of raw materials and higher wages.

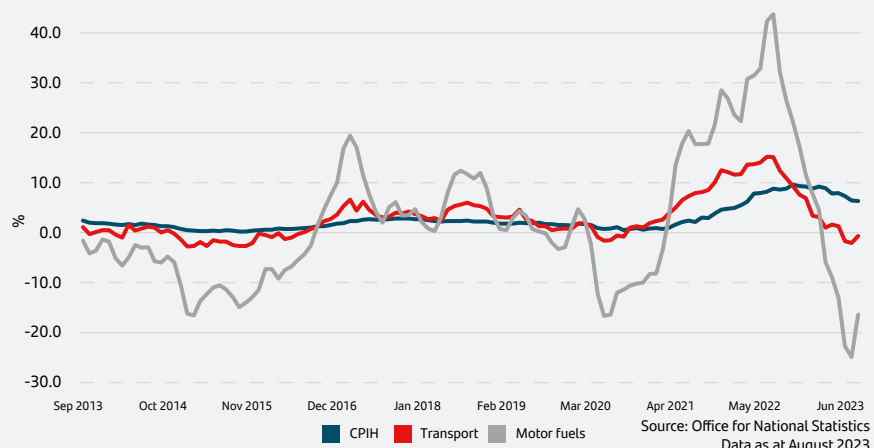
## Consumer price inflation



A further worry for policymakers has been what is referred to as 'second round effects'. In essence, this is when workers negotiate higher wages to compensate for higher prices, and in turn, trigger the employer to pass on this higher wage bill to higher-end prices. This spiral can have devastating consequences, as witnessed in the 1970's through stagflation. Very high inflation and either stagnant economic growth or, worse, a deep recession. Once embedded, it is very difficult to escape.

You could also argue another factor called the 'base effect' has had more impact on inflation beginning to fall than rising interest rates and that is the fall in value of the basket of goods which is used to measure price rises. When prices rise sharply, such as when the price of oil increased last summer and we paid more at the petrol pump, the impact on the inflation basket is profound. However, this can work in reverse. Fast forward 12 months to this summer; the average cost at the petrol pump for unleaded had fallen from £1.91 per litre to £1.43 per litre. That is a 25% fall in the price of filling up.<sup>4</sup> Since then, oil prices have begun to rise again, and the average price today (at time of writing) is £1.57 per litre, an increase of 10% in just 3 months.<sup>5</sup>

### CPIH, transport and motor fuels annual inflation rates, UK, August 2013 to August 2023



The key question then is: If inflation is falling and eventually reaches the 2% target, when is this expected to happen? It would make sense to leave the last word to the policymakers who's responsibility it is to make the key decisions. Here is the latest statement from the Bank of England – directly from their website following last month's decision to pause interest rates for the first time since December 2021.

'Inflation has started to fall. It was over 11% in October last year and it was just under 7% in August this year. We expect it to fall further to around 5% by the end of this year. Although the prices of some food products are likely to rise faster than this. An important reason we expect inflation to keep falling this year is because energy bills should come down more as gas prices have fallen a lot recently. Higher interest rates will also help to bring inflation down further. That's because they will reduce the amount of overall spending in the economy. We expect inflation to keep on falling in 2024 and reach our 2% target in the first half of 2025. That means prices would still be rising, but they would be only rising gradually.'<sup>6</sup>

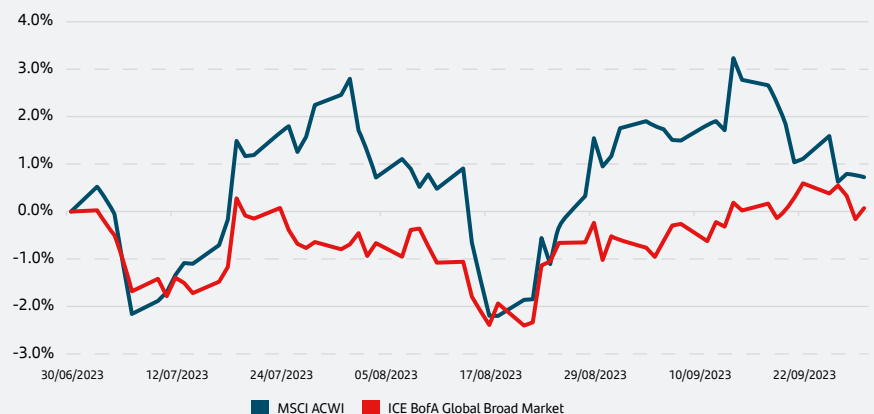
## MOT - fail Much work to be done

As much as the MOT test we have used on inflation is a clear fail, progress has been made. Having been late to respond to the return of rising prices, policymakers have made unprecedented steps in trying to tame inflation since the end of 2021. This time round the causes have been both complex and triggered by an unusual economic and political backdrop. In terms of trying to protect financial stability, policymakers have taken some tough decisions, and although inflation remains above their preferred target, there is light at the end of this bumpy tunnel.

## Market update

Markets remain nervous as stock markets fell during the latter half of September and bond values have started to fall in the last week in response to yields rising sharply. Investors appear to be reflecting the change in narrative from the Federal Reserve's path for interest rates, as higher rates for longer begins to be reflected in market activity. Given how long the investment markets lived with very low interest rates and historically low bond yields, meaning for many there were limited alternatives to investing in shares, the new environment is in stark contrast. Higher cash rates mean the compensation for investing in bonds seems limited unless you look at high-yield bonds, which carry more risk of default. Shares, which have had a strong run since the start of the year, again, struggle with the cash rate comparison in the short term. Given that central banks have pressed the pause button on rate rises, attention turns to when they might cut rates and at what point next year this might happen. Market participants are likely to be focused on the next round of company earnings (especially in the US) and any new economic data to gain a sense of the immediate economic direction of travel. We wait to see what unfolds in the weeks ahead.

### Global shares and bond market performance



## The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

**Learn more!**

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing [here](#).

Note: Data as at 5 October 2023.

<sup>1</sup> Arnold Clark, 13 February 2018

<sup>2</sup> Bank of England 3 October 2023, 20 September 2023

<sup>3</sup> Office for National Statistics (ONS), 20 September 2023

<sup>4</sup> RAC Fuel Watch, 3 October 2023









<sup>5</sup> RAC Foundation, 3 October 2023

<sup>6</sup> Bank of England, 20 September 2023





## Performance

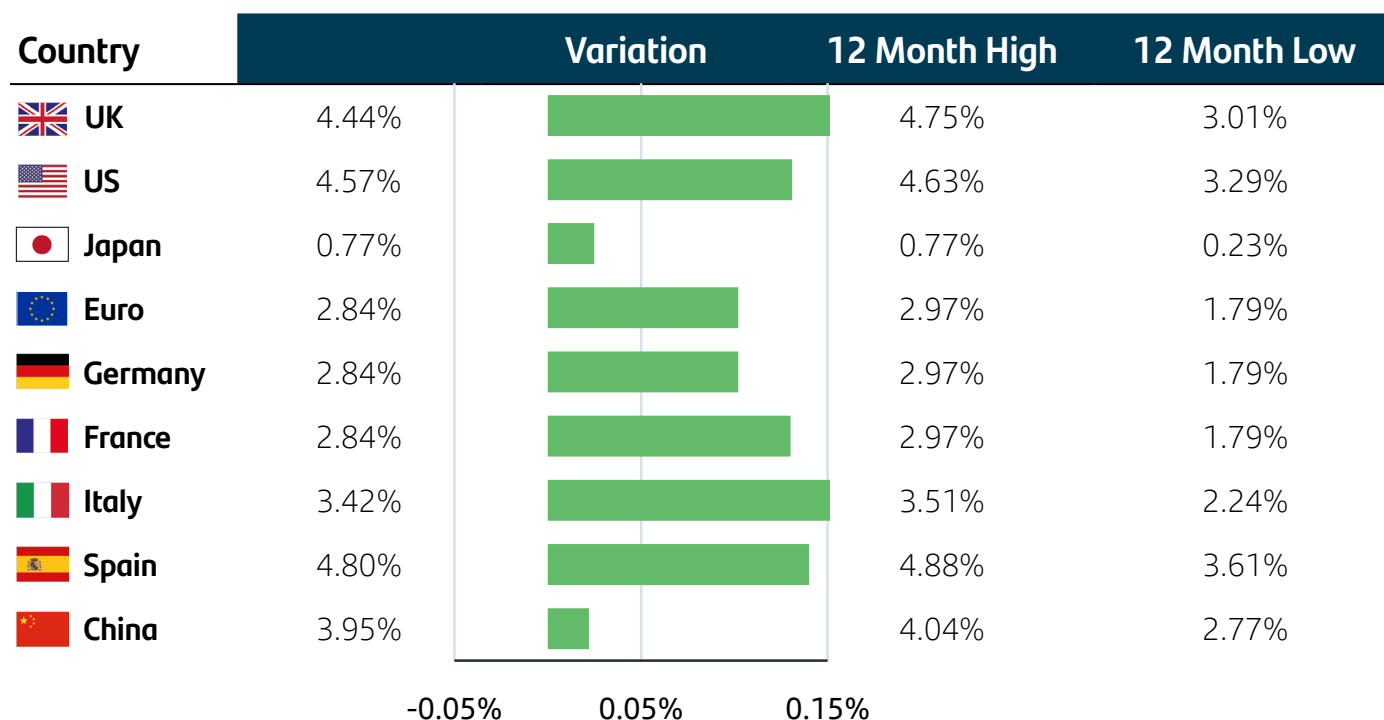
Index	Value	Change	%	12 Month High	12 Month Low
					
<b>FTSE 100</b>	7,608	-76	-0.99%	8,014	6,826
<b>FTSE 250</b>	18,279	-327	-1.76%	20,615	16,611
					
<b>Dow Jones Industry</b>	33,508	-456	-1.34%	35,631	28,726
<b>S&amp;P 500</b>	4,288	-32	-0.74%	4,589	3,577
<b>NASDAQ</b>	14,715	14	0.10%	15,841	10,679
					
<b>Hang Seng</b>	17,810	-248	-1.37%	22,689	14,687
					
<b>Nikkei 225</b>	31,858	-545	-1.68%	33,753	25,717
					
<b>CAC 40</b>	7,135	-50	-0.69%	7,577	5,677
					
<b>DAX</b>	15,387	-171	-1.10%	16,470	11,976
					
<b>FTSE Eurofirst 300</b>					
<b>Eurozone</b>	2,360	-29	-1.22%	2,547	1,950
					
<b>S&amp;P TSX Composite Index</b>	19,541	-239	-1.21%	20,767	18,206
<b>Commodity markets*</b>					
<b>Gold</b>	19,541	-239	-1.21%	20,767	18206
<b>Crude Oil</b>	\$94.55	-1.29	-1.35%	\$99.93	\$70.96

Source: Refinitiv Eikon, prices displayed in the local currency.

\*Gold Bullion London Bullion Market \$ Per Metric Tonne Ounce Delay & Brent Forties and Oseberg Dated Free on Board Northsea Crude used for commodity performance.

Source Data from the 25 September 2023 to 29 September 2023.

## 10-year bond yields



## Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	\$1.22	0.00%	\$1.31	\$1.10
Euro	GBP > EUR	€ 1.15	0.01%	€ 1.17	€ 1.12
Yen	GBP > YEN	¥182.20	0.59%	¥186.51	¥156.32

Source: Refinitiv Eikon.

Source Data from the 25 September 2023 to 29 September 2023.

### Important Information

For retail distribution.

This document has been approved and issued by Santander Asset Management UK Limited (SAM UK). This document is for information purposes only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Opinions expressed within this document, if any, are current opinions as of the date stated and do not constitute investment or any other advice; the views are subject to change and do not necessarily reflect the views of Santander Asset Management as a whole or any part thereof. While we try and take every care over the information in this document, we cannot accept any responsibility for mistakes and missing information that may be presented.

All information is sourced, issued, and approved by Santander Asset Management UK Limited (Company Registration No. SC106669). Registered in Scotland at 287 St Vincent Street, Glasgow G2 5NB, United Kingdom. Authorised and regulated by the FCA. FCA registered number 122491. You can check this on the Financial Services Register by visiting the FCA's website [www.fca.org.uk/register](http://www.fca.org.uk/register).

Santander and the flame logo are registered trademarks. [www.santanderassetmanagement.co.uk](http://www.santanderassetmanagement.co.uk).