State of Play

11 November 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. Earlier this year the Bank of England hinted that they intended to raise the bank base rate as inflation started to rise above their 2% target. Last week they chose to keep it at 0.1% despite inflation reaching 3.2% and admitting it is likely to go higher. State of Play explores the reasons behind their decision, the factors influencing the outlook and why this may be significant for both savers and investors.

Interest rate decisions

In previous State of Play updates, I have explained the history and role of the Bank of England (BoE). As a reminder, they act as the regulator of banks/financial firms, setters of interest rates and monetary policy, and lender of last resort when extreme financial stress strikes. Their primary role is to set appropriate interest rates and monetary policy to enable the economy to grow steadily whilst maintaining an inflation target of 2%. This includes deciding how much money to print, how much government debt to buy and ensuring banks and other financial institutions act appropriately to protect businesses and individuals.

The reason why interest rates have been traditionally used to curb inflation is because there is a direct link between the base interest rate set by the BoE and the amount of money available to individuals and businesses to spend. The higher the cost of borrowing the less money there is available to spend. If the bank base rate is increased this would normally be passed on by banks thus increasing variable mortgage payments and most other types of borrowing. In addition to less money in people's pockets it also tends to stall financial decisions as people put off a purchase until a later date when they have more confidence or if they want to wait and see whether rates eventually fall.

'Demand pull' versus 'cost push' inflation

The BoE have admitted that the rate of recent price rises has caught them by surprise and committed to act if it appeared to be more sustained than the temporary nature they had first presumed. They initially thought the impact of comparing against prices from when we were in lockdown last year (and economic output fell by the most since records began) would reduce in the short term. Although they anticipated plenty of pent-up demand, they argued that this would be transitory and interest rates could be left alone in the short-term to allow the economy to recover as restrictions were lifted and we emerged from the shadow of the pandemic.

However, normally inflation occurs when too much money chases too few goods. This is known as demand-pull inflation when not enough goods are produced to meet the demand triggering prices to rise. Ordinarily one or two interest rate rises would start to cool this type of inflation as borrowing costs increase. This type of move takes time to feed through into the economy and has been described in the past like trying to turn an oil tanker at sea, it takes time to conclude the manoeuvre. If you increase the base rate it may be months before you see clear evidence the decision has had the desired effect on price rises. This is why in modern times central banks have often decided in normal economic conditions to make small increases or decreases, in case they make an error. This is very different say to the 1970's and 1980's when politicians held the responsibility on setting rates and often changed rates by 1% or more.

Cost-push inflation occurs when the cost of manufacturing and producing goods becomes more expensive. Typically, this is caused when wages rise and raw material costs increase. In addition, the cost of transporting, storing, and distributing goods can add to the cost-push dynamic - a rise in oil prices for example. This type of inflation tends to last for a short period because the rise in prices often cools economic activity and purchases cutting off the cost-push dynamic. It can however become more sustained if subsequent higher wage demands drive a cycle of higher prices and further wage demands - not unlike the damaging events played out during the 1970's.

The pandemic ripple effect

Since the announcement of successful vaccines, the world economy reopened gradually as restrictions were lifted and people returned to work having to adjust initially to the additional COVID-19 safe working measures which in turn restricted business capacities to make the same level of goods as pre-pandemic. As the economic engines began to roar and the pent-up demand came into play as many of us went ahead with purchases put on hold during lockdown, a shortage of raw materials saw their costs rise significantly. This surge in demand also saw oil prices rise sharply, going above their pre-pandemic levels by the start of February this year, and now more than 25% above their pre-pandemic price.

As different countries emerged from lockdowns at different times the normally slick 'just-in-time' supply chains began to faulter leaving manufacturers unable to keep pace with demand, disappointing buyers with long and uncertain waiting times for the delivery of their goods. In addition, the pandemic arrived in waves with factories and businesses unable to operate at full capacity during the peak of these waves with large sections of their workforce self-isolating. As covered in previous updates the weather has also played a part in rising prices - a very cold winter in China and the Far East and a lack of wind in Europe has seen energy prices rocket.

Lastly, distributing goods in the world of globalisation means making products abroad and shipping it to a destination market to be sold. A confluence of factors including soaring demand, a shortage of containers, saturated ports, and too few ships and dock workers have contributed to the squeeze on transportation capacity on every freight route around the world. Time reports: 'Transporting a 40-foot steel container of cargo by sea from Shanghai to Rotterdam now costs a record $10,522, a whopping 547% higher than the seasonal average over the last five years'.

A Brussels-based trade group, European Shippers' Council, that represents about 100,000 retailers, wholesalers and manufacturers has noted that at a retail level, vendors are faced with three choices: halt trade, raise prices or absorb the cost to pass it on later, all of which would effectively mean more expensive goods.

Caught between a rock and a hard place

So, the BoE Monetary Policy Committee (MPC) that met to discuss and evaluate the economy, inflation, and review interest rates, faced a tough choice. Whilst they intimated in previous meetings that they intended to raise interest rates if inflation appeared likely to persist for longer, they had concerns about whether raising interest rates in November would slow inflation or not. Remember, if they raise rates too early or too far this could damage confidence and choke off economic growth, which following the pandemic, whilst very strong, is also sensitive to momentum and a change in consumer confidence. If borrowing costs more it doesn't necessarily solve energy price rises or supply side issues like more expensive raw materials.

In addition to the cost-push inflation, we are seeing the BoE also reference the employment market where vacancies are at record highs and the furlough scheme has just concluded at the end of September. There is not enough evidence yet to understand what impact the scheme finishing has had on the employment market, where figures are due out in the next couple of weeks. The most recent wage rises reflected in the Average Earnings Index produced by the Office for National Statistics (ONS) showed wages are rising faster than they have for many years, reflecting a shortage of skilled workers in certain sectors and employers prepared to pay 'top-dollar' to secure the right recruit.

The Governor of the BoE, Andrew Bailey, said; 'Inflation is clearly something that bites on people's household income. I'm sure they're already feeling that in terms of prices that are going up'. But he also said the BoE wanted to see what impact both domestic and global issues were having on the cost of living before deciding on whether to raise rates. Mr Bailey said current conditions were different because inflation was being caused by global 'supply shocks' rather than demand pressure in the UK economy. The MPC meets every six weeks and the BoE did not rule out a rate rise at its next meeting in December.

Impact on asset classes

How have markets reacted leading up to the MPC meeting and after their announcement to maintain rates at 0.1%? Stock markets had a poor end to September with all major markets in negative territory driven by several factors but dominated by inflation concerns. So far this year, technology sectors continue to lead the way, especially in the US. The infrastructure deal agreed eventually by President Joe Biden's administration along with the recent very positive jobs data in the US has helped this momentum as stock markets have recovered over the last few weeks.

Bonds on the other hand in the lead up to the most recent round of central bank interest rate decisions, both here and elsewhere, have seen yields gradually grind higher in the anticipation of higher rates leading to lower bond values in the process. US 10-year Treasury yields dipped at the end of July, reaching a recent low of just under 1.2% in early August, before surging higher throughout September and October, driving yields to just under 1.7%. With UK 10-year Government bonds it is a similar story. Yields dipped in July until a recent low in early August of just above 0.5% but then have gradually ground higher as more and more inflation data pointed to the BoE raising rates before the year-end. UK 10-year Government bond yields went above 1.2% for the first time since early 2019 on 21 October. However, in just the last two weeks yields have fallen away and now stand at 1.46% in the US, a 20% fall, and in the UK Government bond yields have fallen even further by 30% and now stand at 0.85%.

The recent fall in yields is a reflection of many moving parts in the world economy but acknowledgement, in my opinion, that whilst inflation may remain higher than we have become used to, the cost-push effects may only be temporary. The BoE and other central banks continue to walk a tight rope in terms of decision making. Protecting and maintaining the recovery will mean leaving rates lower for longer. However, both the BoE and the Chancellor of the Exchequer, Rishi Sunak, have warned that they expect inflation to stay around 4% for most of next year and could even remain at around 3% throughout 2023 before falling back to the target rate of 2%. Solely raising interest rates will not curb the current cost-push inflation and risks damaging recovery momentum. This is seen as a sign that inflation will be allowed by policymakers to remain above target for some considerable time.

Lastly, where does this leave savers and investors? The current outlook for savers is somewhat of a gloomy one. Those in power are warning of higher prices for probably the next two years including recent energy rises coming to a head in April next year when the next price cap review takes effect. With lower interest rates tolerated by the BoE for longer, the prospect of rate rises, although probable, are unlikely to match anywhere close to the rate of price rises for the foreseeable future leaving hard earned savings at risk of value erosion.

For investors, the current circumstances are a reminder of the key principles of investing. One of the key motivations for most investors is to either grow their wealth over the longer term or at least protect it against the threat of inflation. Whilst the current market sensitivity to any new inflation data means that investors are likely to continue to see volatility in the short-term, the benefits of investing over a longer time horizon allow investors to ride out the peaks and troughs with the goal of achieving an investment return at least better than inflation. Whilst the outcome is not guaranteed, history has shown us that investing in different asset classes provides a better probability of beating inflation.

Interested in the principles of investing?

Investing can feel complex and overwhelming, but our insights can help you cut through the noise. Learn more about the basics **here**.

Note: Data as at 9 November 2021.

Important Information