State of Play

19 May 2022

As inflation reaches 9%, the highest level for 40 years, and the UK economy stalls, some may be tempted to wonder whether we are heading for stagflation 2.0. How realistic are the comparisons between the 1970's and today? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Latest inflation update

According to the Office for National Statistics (ONS)[1], UK inflation which is measured by the Consumer Price Index (also referred to as CPI) rose 9% in the year to April 2022, the highest for 40 years. This is based on a modelling of the calculation as the current data series was introduced in 1989. As expected, the largest contribution comes from the rise in the Office of Gas and Electricity Markets (Ofgem) energy price cap as electricity prices increase 53.5% and gas prices increase 95.5% in just 12 months.[1] Seven of the 12 sectors measured in the inflation basket increased, with petrol prices at a record average price of £1.61 per litre (up from £1.25 a year earlier) and diesel at £1.76, taking the 12-month rate for motor fuels and lubricants to 31.4%, the highest since before the start of the current data series in January 1989.[1] Other significant contributions came from second-hand cars, hotel costs and rising food prices.[1]

Unemployment data and wages

Based on the latest data from the ONS[1], for the first time since records began in the UK the total number of vacancies is greater than those registered as unemployed. The unemployment rate for January to March 2022 fell by 0.3% on the quarter to 3.7%.[1] The number of vacancies now stands at a new record of 1,295,000, compared to 1,257,000 registered as unemployed.[1] Whilst the number of people employed increased slightly by 0.1% to 75.7% it still remains just below pre-pandemic levels.[1] One striking statistic during the first quarter was 994,000 people moved from one job to another mainly driven by resignations, not dismissals.[1]

In my view this shows many people are looking to improve their pay by moving companies to combat the rise in the cost of living, confident in the knowledge of high vacancy levels, especially in specific skilled jobs where a lack of applicants forces employers to offer better packages to attract the right candidates. This improvement in packages is also demonstrated in the latest nominal earning figures which increased by 4.2% in the year to March 2022, but if you include bonuses 7%, which likely indicates that employers may be paying bigger bonuses to try and retain key staff.[1] Importantly, if you factor inflation into the calculation, real wages fell by 1.2% as increases failed to keep pace with rising prices.

A key concern of the central banks is if wage increases are sustained for a long period it may make it even harder to combat inflation, as higher incomes feed into consumer demand thus slowing the pace at which price rises start to cool. One aspect which may provide some comfort for policymakers is that some of the current wage rise can be linked to a lower wage being paid for the same period last year due to furlough still being in place, therefore reducing four million incomes by 20%. I am sure policymakers will be keen to see the data for April 2022 to gain a clearer picture without the influence of the furlough scheme. At the start of 2021 some five million people were supported on the scheme, falling by around a million by April 2021 gradually subsiding to just over one million when it finished at the end of September 2021.[2] The fall in furlough usage directly corresponds to the easing of restrictions and the economy gradually reopening in spring last year.

Stagflation

Prime Minister Edward Heath won a surprising general election victory in the summer of 1970.[3] Two days after asking the Queen to form the next government, he appointed fellow Conservative MP, Iain Macleod, to become his Chancellor of the Exchequer.[3] Tragically Macleod was soon rushed into hospital with suspected appendicitis and later discharged, but then suffered a cardiac arrest at 11 Downing Street on 20 July 1970, dying just 30 days after being appointed at the tender age of 56.[3] His tenure at the helm of the nation's finance's is the shortest in our history, but he will arguably be most remembered for a phrase he coined five years before his sad demise.

Speaking in the House of Commons on 17 November 1965 he said 'We now have the worst of both worlds – not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation. Thus history, in modern terms, is indeed being made.'[4] The phrase is built from two words: stagnation, where the economy exhibits little or no growth; and inflation, the rise in the price of the goods and services we consume. Normally when these two factors combine the knock-on consequences can be severe, long lasting and difficult to rectify.

Until more recently, the expression has rarely been referred to outside of an educational setting since the dark economic period in the 1970s when governments, both in the UK and elsewhere, struggled to resolve a damaging continuous economic cycle. Typically, in addition to stagnant growth and high inflation, these economic conditions combined with high unemployment further exacerbate the economic impacts and make the return to economic growth even more difficult. So, are the concerns of stagflation re-emerging realistic given the current economic climate when compared to the 1970s? Let's take a look.

Economic comparisons - 1970s

Firstly, economic data for the decade began with steady growth with just two negative quarters in the first two years until the economy plunged into recession in 1973, which was prompted by Organisation of Arab Petroleum Exporting Countries (OPEC) implementing an oil embargo for any country seen to be supporting Israel in the Yom Kippur war triggering an oil crisis.[1/5] The consequences of the embargo meant that countries like the US and UK could no longer import oil from the Middle East creating a severe supply shock and sending oil prices soaring by 300%.[5] Even though the embargo was lifted in March 1974 the ripple effects remained throughout the remainder of the 1970s with the UK being forced to ration vital oil supplies and electricity, numerous power cuts and an enforced three-day working week.[5] Strict speed limits were even introduced on their roads to improve fuel efficiency often with long queues at the petrol pump.[5] Economic growth was then inconsistent from 1974 with growth followed by an occasional contraction, albeit with small falls, until a significant fall of 2.3% in the third quarter of 1979.[5]

Inflation began the decade, measured by the old calculation which used the Retail Price Index (RPI), at a modest by historical standards 5% but well above the current targets used by the Bank of England.[1] Following the oil crisis prices started to rocket, peaking in September 1975 at an extraordinary 26.6% and remaining elevated all the way until the end of the decade when inflation still stood at 17.2% in December 1979.[1] Interest rates began the decade at 8% before falling gradually to 5% by early 1972.[1] Once the price of oil started to rocket the UK Government response was to increase rates rapidly over the following 18 months, reaching over 12% by the start

of 1974. Interest rates remained above 8% before rising further at the beginning of 1976 to reach 15%.[6] Margaret Thatcher was elected in 1979 and immediately increased interest rates to 17% in a direct attempt to tackle inflation but with severe wider economic ramifications.

Because of the economic shocks, rising prices and interest rates, and knock-on impact for the wider economy unemployment doubled from 4% to 8% over the 10-year period. Incidentally, the wider UK stock market endured its worst bear market from 1972-1974 when the UK stock market fell -73% in 32 months (yes, that is correct – nearly three quarters drop in value!) more than the financial shock from both world wars, the great depression of 1930's or the recent global pandemic.[7]

Is this stagflation 2.0?

Given the inflation numbers released yesterday by the ONS[1] are the highest for 40 years it is understandable why many will refer to the 1970s in part because of the emotional scar left on the national psyche during such a difficult period. One of the motivations to move the setting of interest rates across to an independent Bank of England by Chancellor Gordon Brown in May 1997, was the recognition that to avoid boom and bust in the economy it is vital to maintain price stability for stable economic growth to be achieved.[8] There is a fine balance to be struck between setting monetary policy which incentivises investment into new businesses, new jobs and better public services, and the prospect of an overheating economy which has great short-term benefits but longer-term consequences.

It would be easy to link the current economic signs to stagflation 2.0, in part because much of the current inflation is caused by supply-side shock, combined with shortages of raw materials exacerbated by a global shortage of gas supplies and the Ukraine conflict as sanctions on Russia push up the price of oil. Already, this comparison looks strikingly familiar. Lockdowns in China continue to cause supply chain disruption which will take time to ease. The UK economy in March shrank by 0.1% evidencing that rising prices have already started to impact demand.[1] In March, the Office for Budget Responsibility (OBR) warned that UK households will be hit by the biggest fall in real incomes since records began back in 1956, with a fall of over 2.2% through 2022. This hit to the UK public pocket will reduce demand further as although wages are rising above recent averages, they remain well below rising prices. Slowing economic growth, a fall in real incomes and rising prices sounds like an echo of the past.

However, in some ways this is where the comparisons end. Unemployment fell in the recent ONS data[1] to near record lows at just 3.7% with vacancies above unemployment for the first time since records began. Whilst wages have been elevated there is no evidence yet that this will be sustained, with many moving jobs to secure better pay rather than negotiating with their current employer. The Bank of England have increased rates for three

consecutive meetings in a row, for the first time since they were appointed to set rates in 1997, with a further rise expected at their next meeting on 16 June, likely bringing rates to just 1.25% assuming the next rise is 0.25%.[8] The Bank of England Governor, Andrew Bailey, this week warned that inflation would breach 10% before taking at least two years to fall closer to their 2% target, hinting that further rate rises are inevitable.[8]

This intent, alongside the same commitment from the US Federal Reserve, should be noted. Economic experts probably agree that a short sharp recession to tackle inflation is the lesser of two evils when compared to a repeat of the damaging 1970s economic disaster. It does mean investors are in for a bumpy ride as the major central banks monetary tightening brings slowing growth or even a potential recession to ensure inflation is brought down to their targets. This year's volatility will probably remain until the bad news starts to ease and investors can look beyond the current shock to the system. Already there seems to be more clarity as markets over the last week have recovered in part because share price falls this year for some have provided a buying opportunity, although it is not for the faint hearted. My observations are that we are some way from entering a period of stagflation, but it is clear that policymakers and central banks are very clear of the dangers, being prepared to do whatever it takes to avoid a 1970s repeat.

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 18 May 2022.

[1] Office for National Statistics, 17 and 18 May 2022
[2] UK Government, 16 December 2021
[3] Yorkshire Post, 20 July 2020
[4] Hansard - Economic Affairs, 17 November 1965
[5] The Times, 18 May 2022
[6] Refinitiv Eikon, 18 May 2022
[7] Monevator.com, 7 July 2020
[8] Bank of England, 14 March 2022

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