State of Play

Push or Pull?

20 July 2023

Ever since the pandemic arrived to trigger the first global wide shut down, the ripple effect continues to be felt in our shopping baskets, our savings rates, and our investment portfolios today. Supply disruption, the war in Ukraine and other unintended consequences make the challenge facing policymakers even more complicated. This week the eagerly awaited UK inflation data was released. What did it tell us about the impact of previous rate rises and how might it influence the Bank of England in their next interest rate decision? 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

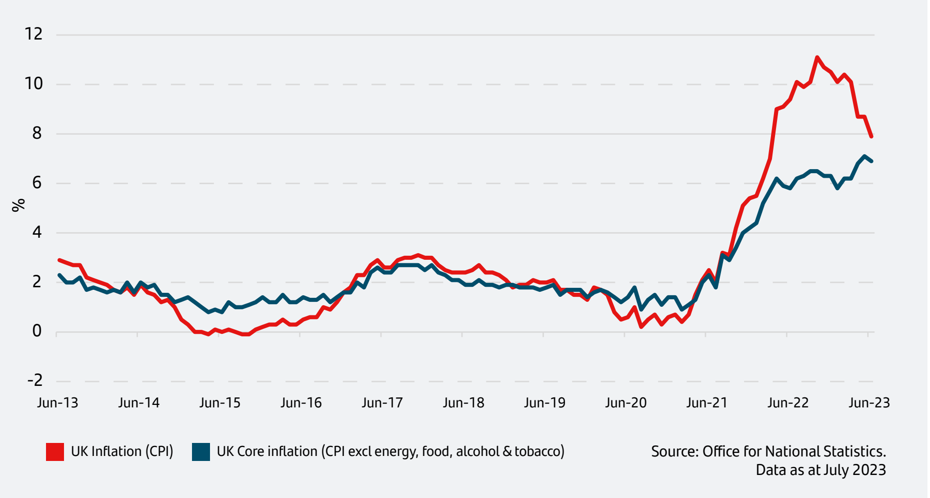
- Latest UK inflation data
- Cost push or demand pull?
- Decision time for the Fed
- Market update

Latest UK inflation

According to the Office for National Statistics (ONS), the Consumer Price Index (CPI) for the 12 months to the end of June rose by 7.9%, down from 8.7% in May and much lower than was forecast. Importantly, Core Inflation, which excludes both food, energy, and tobacco, rose by 6.9% in the 12 months to June, down from 7.1% in May, which was the highest rate since March 1992. The Bank of England Monetary Policy Committee (MPC), which decides interest rates, was forced into a larger increase last month in response. The CPI goods annual rate slowed from 9.7% to 8.5%, while the CPI services annual rate eased from 7.4% to 7.2%.[1]

The ONS report states, 'The easing in the annual inflation rates in June 2023 principally reflected price changes in the transport division, particularly for motor fuels. There were also notable downward effects from food and non-alcoholic beverages, furniture and household goods, and restaurants and hotels. There were no large offsetting upward effects. The CPIH all goods index rose by 8.5% in the 12 months to June 2023, down from 9.7% in May. The slowing in the rate has been caused by a downward contribution to the change from energy, where prices rose by 2.9% in the year to June 2023, down from 8.1% in the year to May. There were other smaller downward effects from non-energy industrial goods (particularly housing goods) and food, alcoholic beverages, and tobacco (particularly non-processed food). The CPIH all services index rose by 6.3% in the 12 months to June 2023, unchanged from May. These rates are the highest since July 1992.'[1]

UK inflation



Source: Office for National Statistics. Data as at July 2023

The other important news that will help ease the pressure on policymakers and shoppers alike is that food manufacturers cut prices for the first time in three years, triggering expectations that record-high grocery inflation will begin to ease soon. Lloyds' monthly UK business tracker for June showed food and drink manufacturers had cut the prices they charged direct customers, which include wholesalers and retailers, for the first time since February 2020.[2] However, this good news is important, but perhaps the causes of inflation will have a greater influence on the Bank of England than just the data itself. Let's explore some of the root causes and why they make a difference in what they decide to do next.

Cost push or demand pull?

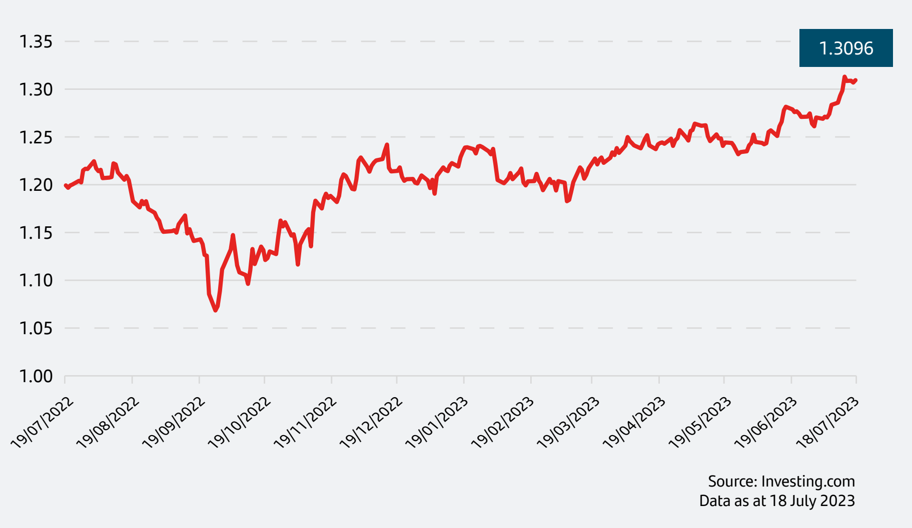
This update has previously tried to explain that in the most recent past, inflation has been at very low levels compared to history. If you look at previous episodes of rising prices over a sustained period, they all look subtly different. Often, the driver of inflation is normally too much money chasing too few goods, causing prices to pull higher. This type of inflation is described as demand pull inflation. This inflation diagnosis tends to prompt policymakers to use a combination of higher interest rates and a lower money supply to reduce disposable income and the capacity of consumers to spend money, thus reducing price rises.

Cost-push inflation
When production costs rise and the producers pass the increase on to consumers.

Demand-pull inflation
When demand for goods increases and exceeds production capacity.

However, this time around, the inflation drivers are complex and very different from what we have seen in recent history. The pandemic has provided an almost perfect example of what is called cost push inflation. This is not triggered by more demand, although the initial economic consequences of lifting restrictions did indeed release a surge in pent-up demand, it is caused by an increase in input prices. The reopening pressure created a spike in commodity prices, which, in addition to supply disruptions, reduced supply and pushed up end prices for consumers. Once the rises in raw materials and distribution costs feed through to companies, they look to pass on as much of the increase in costs as possible to the end price of the goods and services they offer to the end consumer. This situation was exacerbated by both China's zero-COVID policy, meaning they were often in lockdown when the rest of the world wasn't, and the escalation of the conflict in Ukraine, which placed additional pressure on energy prices and the food chain.

The other factors that have made the current challenge facing policymakers more complex have been the strength of the dollar (particularly in 2022) and the secondary effects of wage settlements. The Federal Reserve was arguably the most aggressive and decisive in increasing interest rates, pushing up the value of the dollar against an international basket of currencies. Most of the world's raw materials are priced in dollars, causing what is described as imported inflation. Energy, food and other goods become more expensive for all the reasons explained, but they are even more expensive if the pound is worth less than the dollar. Thankfully, sterling has strengthened in the last 12 months since the mini budget crisis last year, from a low of $1.07 to the pound rising to a most recent high of $1.31.[3] I have covered in previous updates the secondary effects of wage rises. When individuals see more money on the wage slip, rather than saving to cover higher bills, they tend initially to spend the extra pay on more goods and services, making it harder to reduce rising prices.



Market reaction

Last week, stock markets rallied after a tough week. US inflation data being lower than expected saw the prospects for a pause on rates increase, helping share prices soar. In addition, it is the start of a busy earnings season where many companies are reporting their latest results. Many of the big name banks in the US reported strong numbers last week. Directly after the UK inflation numbers were announced by the ONS yesterday, markets digested the bigger fall in CPI as a chance to revaluate the path for future interest rates in advance of the Bank of England meeting on 3 August. UK bond yields fell significantly to below 4.2% (at time of writing) from a recent high of 4.7%.[3] This will be a relief for many low-risk investors who are heavily invested in bonds, and obviously, mortgage borrowers. Those looking to remortgage in the months ahead will be hoping the MPC will not need to go as far with rate rises as first thought. When bond yields fall, bond values increase in line depending on the time the bond has to maturity (a subject covered by State of Play on 1 June – Bond Voyage). In addition to bond yields easing, the FTSE 100 soared nearly 2% after the inflation numbers release and at the time of writing had made another positive start with a further rise of over 50 points taking it to nearly 6,500.[3]

So, what does the UK inflation data tell us about the outlook? Certainly, the MPC will be relieved about the bigger fall in CPI and Core Inflation. This eases the pressure on them to continue increasing interest rates much beyond the next meeting on 3 August. Because core inflation remains stubbornly high, they may be inclined to increase, but perhaps by a smaller amount than originally thought. Wage rises remain an ongoing concern, which will make it harder to reduce price rises faster and may mean rates stay higher for longer. The big question is: are we close to peak rates in the UK? Perhaps the answer is yes, or at least closer to the peak than we thought just a few days ago. It will be fascinating to see what other economic data is released between now and the MPC's next meeting. While it is impossible to predict what they will decide, the latest inflation news is a light at the end of what feels like a very long, dark tunnel.

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 20 July 2023.

[1] Office for National Statistics, 19 July 2023
[2] The Times, 19 July 2023
[3] Investing.com, 19 July 2023

Performance

Index	Value	Change	%	12 Month High	12 Month Low
FTSE 100	7,435	177.63	2.45%	8,014	6,826
FTSE 250	18,567	562.84	3.13%	20,615	16,611
Dow Jones Industry	34,509	774.15	2.29%	34,590	28,726
S&P 500	4,505	106.47	2.42%	4,510	3,577
NASDAQ	15,566	528.75	3.52%	15,572	10,679
Hang Seng	19,414	1048.08	5.71%	22,689	14,687
Nikkei 225	32,391	2.84	0.01%	33,753	25,717
CAC 40	7,375	262.66	3.69%	7,577	5,677
DAX	16,105	501.67	3.22%	16,358	11,976
FTSE Eurofirst 300 Eurozone	2,448	91.36	3.88%	2,547	1,950
S&P TSX Composite Index	20,262	431.03	2.17%	20,767	18,206
Commodity markets*					
Gold	$1,959.25	29.75	1.54%	$2,047.01	$1,628.00
Crude Oil	$79.65	1.25	1.59%	$116.68	$70.96

Source: 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 10 July 2023 to 14 July 2023.

10-year bond yields

Country		Variation	12 Month High	12-Month Low
UK	4.45%		4.67%	1.81%
US	3.82%		4.23%	2.61%
Japan	0.48%		0.51%	0.17%
Euro	2.48%		2.75%	0.76%
Germany	2.48%		2.75%	0.76%
France	3.03%		3.24%	1.35%
Italy	4.18%		4.82%	2.95%
Spain	3.53%		3.79%	1.86%
China	2.69%		2.99%	2.62%

-0.30% -0.10% 0.10%

Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	$1.31	**0.02%**	$1.31	$1.07
Euro	GBP > EUR	€ 1.17	**-0.01%**	€ 1.20	€ 1.11
Yen	GBP > YEN	¥181.69	**-0.72%**	¥183.76	¥154.73

Source: Eikon.

Source Data from the 10 July 2023 to 14 July 2023.

Important Information

For retail distribution.

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