State of Play

22 July 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. As average earnings soar at the fastest pace since records began in 2000, will rising wages stoke existing inflation concerns for markets?

Employment surge drives wages higher

According to the Office for National Statistics (ONS) the number of employees on UK company payrolls surged by the most since the start of the COVID-19 pandemic, highlighting a roaring jobs market which is likely to stoke fears about growing inflation pressure from rising wages. A day after the Deputy Governor for Markets and Banking at the Bank of England (BoE), Sir Dave Ramsden, said the time for the central bank to think about taking action to head off inflation was approaching sooner than he had thought, tax data showed a 356,000 leap in employment from May to June. The increase was driven by a steep rise in accommodation and food jobs (94,000), both of which were heavily hit by earlier lockdowns, as well as a rise of 72,000 in administration and support services, including temporary staff at recruitment agencies.

The ONS also said that the headline unemployment rate for the three months to May stood at 4.8% when most financial analysts expected the unemployment rate to hold at 4.7% (although the ONS said the population estimates used to calculate the unemployment rate had changed and the figure for the three months to April would have been 4.8% under the new system). Last week's figures showed the fastest headline wage growth in the year to May since records began in 2000, although the comparisons have been skewed by greater job losses among low-paid workers and comparing with depressed wages from a year ago. Average weekly earnings in the three months to the end of May rose by 7.3% compared with a year earlier. The ONS estimated underlying wage growth, excluding distortions caused by the pandemic, was between 3.9% and 5.1% for average weekly earnings. For average earnings excluding bonuses it was between 3.2% and 4.4%.

The pick-up in hiring and in pay support the narrative that Britain's economy is bouncing back from its nearly 10% crash last year. Sir Dave Ramsden also said on Wednesday that the central bank might start to think about reversing its huge monetary stimulus sooner than he previously expected: 'British inflation might rise as high as 4% for a period later this year and the factors driving it up might take some time to ease off'.

Inflation rises above expectations

Consumer price inflation in the UK rose to its highest in almost three years in June, figures from the ONS last week showed. Inflation hit 2.5%, ahead of consensus forecasts of 2.2%. Fuel prices and second-hand car sales were the main drivers but increases were widespread. Prices for clothes, restaurants, accommodation, hairdressers, household appliances and furniture all rose faster than 2.5%. The index has risen above the BoE's 2% target in May and the BoE expects a peak of 3%, something on which the markets disagree. The BoE's Monetary Policy Committee has said it does not intend to tighten policy at least until there is clear evidence of significant progress in eliminating spare capacity and achieving the 2% inflation target sustainably.

The overshoot can be attributed to three key issues. Firstly, surging commodity prices and supply chain disruptions, such as semiconductor shortages that drove second-hand car prices up 4.4% as new car production suffered delays. Also there was a 10% increase in prices for road transport services, where there has been a shortage of lorry drivers, ONS officials said. Higher oil prices caused pump price inflation to rise 20.3%, the biggest rise since May 2010. As inflation is a rolling 12 month measure these rises should pass and settle back down. Secondly, last year's lockdowns caused inflation to drop to only 0.2% in August causing the 'base effect' of a low starting point which exaggerates this year's data. Finally, and critically, are the supply bottlenecks. Demand can rebound faster than supply. It takes longer to increase manufacturing capacity or to hire skilled staff than it does to buy goods online or book a table at a restaurant. These issues may last much longer and provide sustained price rises which is the key worry for investors. These demand-supply mismatches, combined with the £200bn (pound sterling) of lockdown savings in households, are giving businesses the chance to raise prices to cover their higher costs. With input prices still rising at 9.1%, inflationary pressures will remain. The good news is that month-on-month input prices dropped by 0.1% in June, the first fall since August 2020.

If inflation rises above 4% later this year this could trigger the BoE to remove its stimulus earlier than expected. The strength of the recovery and current imbalances caused by the factors outlined earlier may force the BoE to act quicker to cool the economy before inflation becomes more sustained. Initially forecasts were predicting that the UK would only recover to the level of the economy prior to the pandemic in the last quarter. Following the latest data the central bank, many economists and financial experts are suggesting this level could be reached between July and September, three months early, meaning the BoE might be nearing its conditions for scaling back its stimulus. The BoE plans to complete the final £150bn of quantitative easing this year, with £69bn outstanding. Since the pandemic, the only one of the Monetary Policy Committee's nine members to vote in favour of scaling back the BoE's £895bn bond-buying programme has been Andy Haldane, the central bank's Chief Economist, who has since stepped down. The temporarily eight-member committee is due to deliver its latest assessment of the economy and its monetary policy decisions on 5 August. Investors will no doubt watch closely, assessing every word of the response from those in charge of monetary policy and inflation.

Market update

Investors have suffered over the last week as share prices have fallen due to concerns about rising infection rates and the ongoing uncertainty over the path of interest rates caused by rising inflation. The FTSE 100 Index fell 163 basis points on Monday (19 July) alone as market worries overshadowed 'Freedom Day'. The rising infection rates have caused investors to rethink share valuations, against the backdrop of a potential shift in monetary policy by central banks if inflation surges beyond forecasts bringing forward interest rate rises and bringing an end to quantitative easing prematurely.

Ironically enough, markets are somewhat caught in the crossfire of the two competing concerns. Economies reopening and the strength of the economic bounce back have stoked fears about inflation forcing a re-evaluation of share prices, especially in growth and technology stocks, if interest rates rise sooner and faster. However, if rising infection rates cause restrictions or lockdowns to be re-introduced then question marks remain about the strength and sustainability of the recovery which will likely hit value stocks, like energy, travel, and tourism, hard. These two competing anxieties will probably dominate for the next few weeks until either inflation data and central banks next reporting update calms rising interest rate fears, or the current aggressive third wave subsides. As always, it pays to be diversified to help ride out the stormy waters when market conditions get choppy.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi-Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 20 July 2021.

Santander
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Important Information