Santander Asset Management

State of Play

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As expected last week's inflation data was the highest since March 1992.[1] What does this mean for savers and investors, and how might this shape the investment outlook? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Cost of living rises at fastest rate in 30 years[1]

Housing and household services were the largest contributor to the price rise, which were driven by a steep rise in the energy cap imposed by the Office of Gas and Electricity Markets (Ofgem) in October last year. This energy cap, designed to limit the price energy suppliers can charge, is adjusted every six months based on the cost of supplying energy. It is calculated a few weeks before the adjustment takes effect and affects around 22 million households.[2] The latest adjustment is due to start on 1 April and will increase the cap from £1,277 to £1,971, a rise of 52%.[2] Many market commentators are expecting this to push inflation to at least 7%, but perhaps as high as 8%, when the cost of living is measured in April (figures released in May).

The impact of the pandemic over the last two years has affected many parts of our lives, not least of which our car buying habits. A severe shortage of semi-conductors causes by limited availability of raw materials dramatically reduced the number of new cars being produced during the last two years forcing buyers to seek nearly new cars. This has had a dramatic effect on the used car market with prices rising by 28.7%[1] in just 12 months. In my view, this trend may continue for some time as the shortage of new cars being built means a very limited supply of one year old cars available, the extension of lease contracts and fewer part exchanges. Additionally, as many have embraced working from home, and more recently a hybrid working pattern, more people are travelling locally in their cars rather than relying on commuting into cities, which has seemingly created more demand for second-hand cars at precisely a time when supply is limited.

Inflation impact for savers

When it comes to inflation it can sometimes be hard to relate the statistics published each month against the reality of your own personal circumstances. When news channels cover inflation they try to provide a sense of what the figures mean and report on some of the practical application but given the collection of data is a 'representative sample' there is always going to be a disconnect between the percentage announced and what your own personal inflation rate will be. How we spend our money will directly impact the way rising prices will ultimately erode our wealth over any given time frame. The Office for National Statistics have announced they are evolving the way they collect pricing data in the future to help identify the effects on different age groups and different levels of household income. In some ways this would point to a revised inflation calculator allowing individuals to input how they spend their money and providing a 'personal rate' that is more meaningful.

For those that have built a lump sum over time and simply kept the money in a bank account or a savings account, the next few years carry greater risk from value erosion when compared to the last few years. As an example, if you keep all of your savings in your bank account with no interest paid, based on current price rises at say the Consumer Price Index rate of 5.5%[3], then your savings will halve in value in just over 12 years. If you had £50,000 kept in an account, it would buy £25,000 of goods if left in this account for over 12 years and price rises were sustained for all of these 12 years. Inflation is not expected to stay at current levels for all this time, but you can see the threat price rises pose to savings with low or no returns even if elevated for a short period.

Ever since the financial crisis in 2008 interest rates have been kept artificially low at near zero for most of this time, thus hurting savers. The only comfort has been very low inflation for much of this period, as explained in last week's update, helped by innovation, technology, and cheap wages in the developing world. The dilemma now is that inflation has become an immediate threat whilst interest rates, although likely to rise throughout the rest of this year and into next, are unlikely to rise at a pace that is enough to protect against rapid value erosion.

How does inflation impact different types of investments?

Bonds

One of the consequences of the outbreak of COVID-19 was the financial response from central banks to lower rates to all-time lows. When investors hold bond assets, often as a diversifier for a multi-asset portfolio, they seek an asset class that will behave differently to shares. In times of financial stress or uncertainty, like we saw in the first few weeks of the crisis, bond assets delivered this diversification as bond yields plummeted, thus increasing the value of bonds and helping to protect portfolios against some of the stock market sell-off. However, with rates at record lows and inflation rates elevated for longer, the pressure on central banks to respond to the inflation threat places bond assets under increasing pressure as yields start to rise in response. We saw this in December and last month when the Bank of England raised rates in consecutive months for the first time since the financial crisis.

When central bank's language becomes more hawkish (their desire to tackle inflation grows) then bond yields will likely grind higher, reducing the value of bonds themselves, and in turn hurting portfolio values. As State of Play has explained in previous updates, bond assets struggle when inflation remains higher than bank targets, especially if it is sustained. The problem for investors is once inflation is factored in, the 'real' return on bonds is negative unless you are willing to invest in higher risk debt which carries much higher volatility. This means multi-asset portfolios may not provide the total returns investors have become used to in recent times as bonds remain under pressure from raising yields and high inflation therefore making the job of portfolio managers much harder.

Shares

The rise of share prices since the sell-off in the first quarter of 2020[4] has made many investors nervous about share valuations and whether these can be sustained. We have already witnessed significant volatility since the start of the year as the market attempts to predict what will happen against a backdrop of increasing uncertainty. It is important to remind ourselves that investors always face a trade-off between risk and return. In part, this is one of the reasons for the continued rise in share prices investors facing the threat of much higher inflation may choose to embrace more risk to overcome this threat. With bonds likely offering very little real return over the next few years, many have moved some or all of their investments into shares, driving valuations ever higher.

The record-breaking financial support offered by banks with loose monetary policy and governments backing employers and employees with furlough schemes, have enabled company earnings to grow substantially. Whilst this support will be gradually removed and monetary policy will tighten, this does not necessarily mean that earnings will fall sharply. As we shift from policy support to more organic growth, earnings may slow, although pent up demand should support this in the short-term. If inflation remains higher and is not as temporary as investors thought it would be, companies with less pricing power would be more negatively affected. Markets are likely to remain very sensitive waiting in anticipation of key decisions due in March from the key central banks.

Latest on the Ukraine political crisis

Financial markets have suffered a rocky start to the year, not helped by Russia's actions in Ukraine, and likely response from the US and European governments, which have added to investors' worries, especially as the conflict raises the prospect of higher oil and European natural gas prices which would further fuel inflation. Nevertheless, while 2022 was always likely to disappoint after the stellar returns of 2021, where we have seen the MSCI World Index deliver total investment return just shy of 23%[4], there are good reasons in my opinion to think the year can be still be a good one for investors who hold their nerve during the bouts of market turbulence that will be a feature as the world economic cycle matures and translates from expansion to its latter stages.

First and foremost, while markets are understandably nervous about events in Ukraine, if we reflect on previous similar geopolitical episodes, like the outbreak of the Gulf War or the civil war in the former Yugoslavia, any initial market falls have often been followed by a quick recovery in share prices as investors have come to realise that the global implications are not as bad as they had first feared.[5] Second, whilst inflation is its highest for over 20 years, it is expected to fall over the remainder of the year as supply bottlenecks ease even without central bankers raising interest rates. Moreover, COVID-19, which has created those bottlenecks in the first place is diminishing as a cause for concern thanks to the rollout of vaccines. And lastly, whilst financial markets typically enjoy their best returns early in the economic cycle following recession, stock markets can also deliver good returns later in the cycle even as policymakers raise interest rates. Afterall, the reason central banks will be raising interest rates this year is because they think growth is too strong.

In my opinion, market sentiment indicators arguably have become overly pessimistic as investors wait for more positive news to act as a catalyst to improve the market mood. Globally, economic growth this year is likely to be weaker than last year's, but still higher than the historical average, which ought to provide a positive environment for financial markets. Nevertheless, markets are likely to remain nervous for now, which for some may provide investment opportunities. For the average retail investor, it remains vital that they regularly review their portfolio ensuring that their investments are aligned to a combination of their individual long-term goals and risk appetite. Maintaining a diversified portfolio matched to these factors can typically help to ride out short-term market volatility, helping to reach those goals.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Systematic Research for TAA and Alpha, Stefano Amato, looks at how key themes impacted markets in January.

Note: Data as at 22 February 2022.

[1] Office for National Statistics, 16/02/2022
[2] Office of Gas and Electricty Markets, 3/02/2022
[3] Office for National Statistics, 16/02/2022
[4] FE Analytics, 31/12/2021
[5] Reuters, 31/12/2021