State of Play

25 February 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update.

UK exit strategy

Monday 22 February saw Prime Minister Boris Johnson announce in the House of Commons, and later that day in a TV address to the nation, a detailed roadmap which outlined the framework of dates triggering the gradual releasing of restrictions between now and the summer. This exit strategy is conditional, focusing on 'data not dates', and is subject to improving data and the continued success of the vaccine programme to avoid having to return to some form of lockdown in the future. A cautionary message was given reminding everyone that sticking to the current rules was essential to protecting the public and the NHS, with no guarantees given. The experts also warned that some measures, like wearing masks in certain situations, may continue into next winter in a sign that despite the success of the vaccine programme thus far, like the flu, COVID-19 is able to mutate to survive. Following the announcement, travel companies and airlines have reported a huge surge in bookings as holidaymakers decided to take the plunge now that they can see light at the end of the tunnel.

Unemployment continues to rise as businesses lobby ahead of next week's Budget

According to the Office for National Statistics (ONS) unemployment has risen to the highest level in nearly five years as the jobless rate reached 5.1% in the three months to December. It is only when you look at the data in more detail that a more accurate story can be told as almost 60% of those now unemployed since the pandemic began are under the age of 25. The number of people on company payrolls is 726,000 lower than before the pandemic, although a more promising 83,000 were added during January. This significant change in the make-up of the labour market also impacted on the latest average pay data from December showing a rise to 4.7% including bonuses. Some of this rise can be explained by the proportion of people made unemployed being at the lower end of the pay scale with the ONS describing this as a 'statistical quirk' and the 'real' wage rise number is thought to be closer to 3%.

Chancellor of the Exchequer Rishi Sunak is preparing for next Wednesday's (3 March) Budget, stating: 'I know how incredibly tough the past year has been for everyone, and every job lost is a personal tragedy. At the Budget next week I will set out the next stage of our Plan for Jobs, and the support we'll provide through the remainder of the pandemic and our recovery'. Many sectors have approached the Chancellor directly asking for targeted help to prevent some businesses from going under.

Why future inflation rises may create uncertainty

According to the Bank of England UK inflation has averaged 2.9% over the last 30 years - which is well below the previous 30 years when it averaged 8%. Whilst 1960 through to 1990 was a difficult economic period for the UK, the longer-term average over the whole of the twentieth century was still 4.4%. The reality for savers and investors is inflation can represent a significant risk to the value of their money especially when it exceeds savings rates for a sustained period. Every individual saver or investor will have their own 'inflation rate' depending on how they spend their income and how they conduct their lives. If they are in retirement they may eat out and travel more often as they are able to do so but will not commute into an office or drive every day. Also a retired individual or couple will spend more on heating in the winter as they are at home more often. So each investor or saver will be affected by rises in prices in different ways so whilst the official inflation data is helpful it is simply a guide.

The other important impact of the rate of inflation is how investment markets adjust their outlook and the valuation of different asset classes. Any investment return needs to be adjusted to understand the 'real' return achieved given that inflation will have eroded the purchasing power of this money over time. If asset valuations are based on a lower inflation expectation and priced accordingly, when inflation spikes unexpectedly, or investment markets estimate that inflation will rise upwards for a sustained period, then the current valuation may be adjusted downwards to factor this rise into account.

Jargon buster - inflation

The definition of inflation is the rise in the price of goods and services in the economy. It is measured through a 'basket of goods' each month with everyday items such as bread, milk and petrol carrying a greater influence on this change in prices when compared to 'occasional' purchases such as mobile phones or laptops. According to the ONS 722 items are currently measured in this inflation basket. The data is sourced from around 180,000 separate price quotations every month in compiling the indices, in around 140 locations across the UK, from the internet and over the phone. In addition, around 300,000 quotes are used in measuring owner occupiers' housing costs each month. In 2020, 16 items have been added to the basket and 14 items have been removed.

A major change in the 'dynamics' of the relationship between interest rates, money supply and economic/consumer demand was seen immediately following the financial crisis of 2008. When the wider financial system was under threat central banks like the Bank of England (BoE) stepped in to help support the system. They lowered interest rates dramatically and instigated a programme called 'quantitative easing', when money was printed by the bank to buy back loans held on high street bank balance sheets so this cash could be 'lent' to the wider economy. The longer-term effect of this intervention caused asset prices, like Shares to increase in value, in part because investors were forced to take more risk as safer assets like cash and Bonds no longer offered an attractive return.

Since the pandemic struck, economies both in the UK and around the world had to shut down most of the normal economic activity to suppress the spread of the virus. Yet again central banks were forced, combined with government intervention, to step in to support the financial market place, lowering interest rates and printing yet more money. The speed of the interventions last year was extraordinary and helped to pay peoples wages and keep businesses afloat along with an injection of confidence to markets, knowing central banks offered this 'safety net'. It has also helped to support a rebound in Share prices, especially companies whose product or service benefited from lockdowns.

Market update

The reason for providing context on inflation and why it is important to both investment markets and investors is that since my last update markets appear to be in conflict between 'optimism' and 'realism'. The incredible success of the vaccine roll-out, especially in the UK, is cause for markets to be optimistic as the eventual opening of the economy provides reasons to be hopeful. Share prices in companies and sectors worst affected by lockdowns have rebounded strongly and news about a sudden dramatic rush to book this year's summer holiday provide immediate evidence that the rise in Share price for these and other sectors is well supported.

However, markets also are starting to price in the impact of rising inflation later this year. As I explained earlier, higher inflation prospects prompt revaluations of different assets. So, some technology companies Share prices have fallen significantly in the last couple of weeks with the NASDAQ-100 Index falling 5.5% in just over a week. In contrast, the FTSE 100 is made up of less than 2% technology companies and dominated by cyclical and value companies, which are likely to benefit the most from the easing of restrictions, has risen slightly over the same period.

In a sign of further repricing, Bond yields continue to grind higher, driven by the same inflation expectation. 10-year UK Government Bond yields are now up from a low of 0.1% to reach 0.7% (as at 23 February). Yields on US 10-year Treasuries have reached 1.3% from a low of 0.5%. Consumers have saved record amounts over the last 12 months as they have been prevented from spending on travel, leisure, hospitality and other day-to-day social pleasures. This mountain of cash, once released, is likely to drive prices higher for a sustained period eventually forcing central banks to increase interest rates. Whilst they have built in flexibility to tolerate higher inflation over a longer period, when compared to normal economic conditions, markets know that they cannot afford for inflation to spiral out of control given the lessons learned from the past.

As Bond yields drive higher, the value of these loans fall to reflect this. The biggest challenge for investment managers, especially those managing Multi Asset portfolios, is when different assets used to diversify portfolios, like Bonds and Shares, both fall at the same time it can dilute the diversification benefits. Navigating uncertain markets requires expertise, skill and a sound investment decision making process. Given the backdrop of rising inflation, investment professionals over the next few months will have to find the right blend to ensure client portfolios remain on track to achieve their long-term goals.

Find out more

Listen to our latest **Market Views** from our Portfolio Manager, John Mullins, as he shares his thoughts on the main themes dominating markets in February **here**.

Note: Data as at 23 February 2021.

Important Information