Santander Asset Management

State of Play

28 October 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. The story dominating investment markets throughout 2021 has been rising inflation. In this week's State of Play we look at how it is measured and why it is so important for consumers, savers and investors alike.

Origins of inflation

The definition of inflation is the rate at which the prices of the goods and services we consume rise over a given period. Measuring price rises began in the mid-19th century, triggered by individuals and social researchers investigating the extent of poverty by collecting and tracking the price of certain goods over time. The first official measure in the UK, the Working-Class Cost of Living Index, started in 1914 and was used to adjust the wages of essential workers supporting the war effort. This limited measure was extended after the Second World War and became the Index of Retail Prices in 1956. In 1970, the Retail Prices Index (RPI) was produced by the Department of Employment before it transferred to the Central Statistical Office in 1989 which was absorbed into the newly formed Office for National Statistics (ONS) in 1996. A European measure, the Harmonised Index of Consumer Prices was introduced in 1996, aiming to establish a comparable measure at the European level. The UK version was named the Consumer Prices Index (CPI) which became the UK measure for monetary purposes in 2003.

What's in the basket?

Everyone will choose to spend their money in different ways and to be able to accurately track over 60 million people would be complex, expensive, and difficult to achieve. To measure how prices rise or fall over time statisticians prefer to use sample methods in which a 'basket of goods' is established, and the methodology is reviewed and adapted over time. The 'basket' of items used in compiling the various measures of consumer price inflation are reviewed each year. Some items are taken out of the baskets and some are brought in to make sure the measures are up-to-date and representative of consumer spending patterns and changing trends. For example, in 2021, the Consumer Prices Index including owner occupiers' housing costs (CPIH) basket had 17 items added and 10 removed.

Currently, around 180,000 separate price quotations are collected every month in order to compile the indices, which cover over 720 representative consumer goods and services from around 140 locations across the UK. In addition, around 300,000 quotes are used in measuring owner occupiers' housing costs each month.

Importantly the basket of goods is a 'weighted' index to ensure the influence of price changes is reflected based on the importance to the household budget. So, bread, milk and eggs are used daily in most cases and petrol perhaps weekly. But items we buy less frequently, like mobile phones, clothes or house improvements are occasional purchases.

Although kept constant within the year, the contents of the consumer price inflation basket of goods and services and their associated expenditure weights are updated annually. This is important in helping to avoid potential biases that might otherwise develop over time. This could be because of the development of entirely new goods and services, or the tendency for consumers to move away from buying goods and services whose prices have risen relatively rapidly to goods and services whose prices have fallen. For example, if the price of tea rose dramatically during the year, consumers might switch their spending towards coffee, making it necessary to adjust the expenditure weights accordingly in the following year.

Who measures inflation?

The ONS produces and publishes a wide range of the information about the UK that can be used for social and economic policy makers as well as painting a portrait of the country as its population evolves over time. As last week's update explained the Bank of England (BoE) relies on inflation data to help decide at what level to set base interest rates. Other data the ONS produces is formatted in ways that make comparison with other societies and economies possible. Its publications, and analysis by other users based on its published data, are reported, and discussed daily in the media as the basis for the public understanding of the country in which we live.

Is inflation good or bad?

Currently the UK Government have set a target inflation rate of 2% (CPI). Why not set the target at 0% or say, 5%? Most central banks around the world have concluded that 2% represents an ideal target for several reasons.

If inflation is too high companies are normally reluctant to invest because of concerns about future prices making it difficult to plan and execute a business idea commercially. If price rises were rapid enough there may be a shortage of goods as consumers begin hoarding out of concern that prices will increase in the future, thus skewing the sensitive supply and demand relationship. This has been demonstrated in recent times when supermarket shelves were empty at the start of the first national lockdowns in 2020 and a few weeks ago when people queued for petrol draining the pumps dry. If the UK's inflation rate was much higher than other countries, there would be far reaching international impacts as our exports would become less competitive leading to lower exports and depreciation in exchange rate. Lastly, economists believe that if you have very high inflation for a sustained period the boom will almost certainly be followed by a bust, so low inflation enables stable and steady growth.

The opposite of inflation is deflation. This is where prices start to fall over time. The first reaction of consumers may be, great – cheaper prices, means more money for me to spend on other things. The reality is very different. Deflation can be as dangerous as inflation for different reasons. When prices are falling consumers delay purchasing goods because they believe they will be cheaper in the future. This delay in spending can cause a fall in demand - again skewing the supply and demand balance. This compounds itself as prices drop further in response to decreasing demand. In addition, deflation inflates the real value of debt for governments, companies and individuals normally leading to lower growth or recession. Unemployment rises and wages decline as demand drops and companies struggle to make a profit. The best example of deflation in modern times was in Japan between 1991 and 2001 often referred to as the 'lost decade'. Japan experienced a period of economic stagnation and price deflation, and whilst the Japanese economy outgrew this period, it did so at a much slower pace than other industrialised nations.

Why is inflation so important to savers and investors?

Inflation for savers is probably the number one enemy. When inflation is high, or higher than the rate of interest they receive on their savings, the real value of their capital falls. Since the financial crisis in 2008 interest rates have been at record lows whilst inflation, albeit lower than the historic average, has been much higher than savings interest rates. It means that in the future what their cash can buy will diminish. If say £100 today bought a nice pair of leather shoes, but in 12 months' time the price of the shoes had risen to £105, unless their savings had earned 5% interest, they would have to look for cheaper shoes. When this impact is compounded over time the erosion of a saver's capital can be stark. The CPI has risen by nearly 19% in the last 10 years but the savings rates have been at rock bottom. The Moneyfacts 90-day Savings Index which monitors the best 90-day account rate savers can achieve on £10,000 in an account paid only 8.2% over the same period. The reality is that savers would therefore lose over 10% of the purchasing value of their savings.

Investors have a slightly different reason to be mindful of inflation. As last week's State of Play explored, there is a relationship between inflation, interest rates and asset prices. If inflation is higher than expected and central banks increase interest rates, then asset prices are repriced. Bond yields tend to rise thus reducing the value of bonds. Share prices are re-evaluated as future company earnings are expected to be lower and the risk return expectation from investors changes. As bond yields rise and their price falls investors may think that the additional risk of holding shares needs to be compensated and the gap between the two can influence investors to switch to less risky assets like bonds therefore causing shares to fall in value.

Regardless of whether you are interested in inflation or not, it affects everybody. Our future wealth, health and well-being are reliant on a stable economic environment in which we can work, rest and play. If policy makers interpret inflation and other data incorrectly the decisions they take to manage our economy can have lasting and damaging impacts unless they broadly make the right calls. Inflation has never been more important than right now, which is reflected in the sensitivity of markets to the latest data and economic trends. Inflation has dominated the story in 2021 and will no doubt continue to play a pivotal role in investment markets for the foreseeable future.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Multi-Asset Solutions Stefano Amato looks at how key themes impacted markets in September.

Note: Data as at 26 October 2021.

Important Information