State of Play

9 June 2022

After mounting pressure, the UK Government responds to the cost of living crisis by imposing a levy on energy company profits. Are the measures enough to support families struggling with rising bills or is this a failed attempt to put the inflation genie back in the bottle? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Cost of living measures

On 24 May the Chief Executive of The Office of Gas and Electricity Markets (Ofgem) wrote a letter to both Rishi Sunak, the Chancellor of the Exchequer, and Kwasi Kwarteng, Secretary of State for Business, Energy and Industrial Strategy,[1] in which he explains about possible energy price increases expected to be announced in August and possibly to take effect in October. He explained: 'as we have indicated previously, we are expecting another significant increase in the level of the price cap. As I explained to the Business, Energy, and Industrial Strategy Committee today, based on our current forecasts, we expect that the price cap is likely to increase from its current level of £1,971 to approximately £2,800 in October 2022. This estimate is for a consumer with average consumption and paying by direct debit. As with the increase to the level of the price cap that took effect in April 2022, the increase is driven primarily by the rise in global gas prices. In particular, conditions have worsened considerably in the international gas market since Russia's invasion of Ukraine.'

He goes onto urge that regulators and the UK Government work together to help consumers: 'Ofgem will continue to do all it can to protect the interests of consumers – but, as I know you will appreciate, the affordability challenge that many people will face is not something that either Ofgem or the industry can tackle alone. It will therefore be very important that Ofgem, the industry, government and other stakeholders continue to work together to address the difficulties facing consumers, especially for the most vulnerable.'[1]

Under mounting pressure from all sides, Chancellor Rishi Sunak subsequently announced on 24 May a set of measures designed to cushion the blow for consumers from rising energy prices.[2] In his statement to the House of Commons the Chancellor explained that every household would be given a £400 rebate off their energy bills this winter with a further eight million people on means tested benefits receiving an extra £650 in direct payments.[2] The disabled will receive an extra £150 and pensioners who qualify for the winter fuel payment will get an extra £300, bringing the total for the poorest households to more than £1,000 in support.[2] All of this is possible after a significant U-turn by Chancellor Rishi Sunak and the UK Government imposing a £5 billion windfall tax on the profits of oil and gas companies who have benefited from the sharp rise in commodity prices making near record profits in the process.[3] Whilst these steps will provide some much-needed relief for families struggling to cope with the sharp rise in their energy bills, petrol prices, and the weekly shop, is it enough to prevent prolonged financial pain to UK households as real incomes come under their greatest threat in a generation? Given the other factors like the ongoing war in Ukraine, supply chain disruptions and sky-high commodity prices, it is hard to see inflation falling back to central bank targets anytime soon.

Pandemic ripple affect

Apart from the obvious tragic loss of life and serious health consequences caused by the COVID-19 global pandemic, I believe the long-term impacts on society, working trends and the UK employment market should not be underestimated. I want to explore some of the evidence which suggests that the UK may face bigger challenges when compared to other international economies and what this may mean for investors in the future. Firstly, last month the Office for National Statistics released data showing that for the first time since records began job vacancies are higher than those registered as unemployed and seeking work.[4] One of the many reasons cited for causing this anomaly is the huge rise in the number of people who have chosen to become economically inactive since the lockdowns began. Initially, a large proportion of these were young people in part time or low paid jobs, but latterly, this has centred on those over the age of 50. The UK numbers are different from most other major economies as according to OECD (Organisation for Economic Co-operation and Development) data,[5] with only Italy seeing a bigger drop in the share of those aged 15-64 active in its workforce. Inactivity among the working-age population has increased in the UK by a higher margin than any of its peers.[5]

The ONS report[6] stated: 'Overall economic inactivity has increased by 522,000 in October to December 2021 compared with before the pandemic (October to December 2019). Most of the increase was because of those aged 50 years and over, contributing 94.4% (493,000) to the overall change.' To understand more closely the reasons behind this significant change the ONS conducted an 'Over 50's Lifestyle Study', which was conducted between 8 February and 13 February this year talking to those aged 50-70 who had previously told the ONS they had left work when responding to the 'Opinions and Lifestyle Survey' in 2021.

The ONS said, 'Just over six in 10 (63%) adults aged 50 to 70 years said they had left work sooner than expected. Those in their 50's were more likely to say this (77%) than those aged 60 years and over (57%). Leaving work to retire was the most commonly reported reason (47%), with the vast majority saying it was their choice to leave. However, 6% said they had lost their job and subsequently retired, suggesting that their exit from the labour market was involuntary. 75% said it was their choice to leave their previous job. 5% said they had lost their job, and 10% had been furloughed and then lost their job. Just over half (53%) provided reasons besides retirement for leaving work. However, when asked to provide reasons for not returning to work, a larger proportion said it was because they had retired (62%). This could suggest that while the initial intention for some may have been to return to work, they may have later decided to retire.'[6]

Whilst it is impossible to explain every individual circumstance triggering this change, the huge social experiment implementing restrictions to slow the spread of COVID-19 forced many older workers to stay at home to shield from the increased health risks of testing positive with the virus. In my view, many who adjusted to lockdown were provided graphic evidence that life is short as daily statistics showed how fragile life can be, coupled with getting used to either no additional income or lower wages for those placed on furlough. When the economy reopened, they simply chose not to re-enter the workforce. The consequences for the UK economy are very important. Employers are now struggling to fill vacancies in part because of this drop in the workforce and due to another important reason – Brexit.

Brexit affect

Britain made the decision to leave the European Union (EU) following the Referendum in 2016, and after many years of negotiation, the departure was sealed at 11pm (GMT) on 31 January 2020, just weeks before the pandemic began. Whilst many rules and regulations remained in the short-term during the transition period which ended in December 2020, one of the many reasons given in the decision to leave was to control immigration. Over the last two years the number of EU nationals has fallen by 211,000, whilst the rules for hiring foreign workers has become more challenging as most now need a visa to work in the UK.

Many businesses struggle to fill vacancies, especially for the right skills and have also been hit with rising costs due to increased form filling and delays in receiving goods and raw materials from the EU.[7] In the past lots of businesses, especially agriculture and hospitality sectors have looked to the EU to hire workers to carry out jobs many UK jobseekers are simply unwilling to do. The consequence is higher costs for businesses having to increase pay offers to attract enough staff locally thus causing higher prices for consumers in the process. The combination of the pandemic and Brexit has made the task of tackling inflation for the Bank of England arguably even harder than their peers.

Bank of England concerns about persistent inflation

Whilst the UK economy has now regained its pre-COVID-19 size in the last quarter of 2021[8], the Bank of England worries about the tight employment market limiting the ability of the UK economy to grow. In addition, fears exist about wage settlements in the future if demands from the UK workforce to keep pace with rising prices simply triggers more inflation. As State of Play explained a few weeks ago, comparing now with the stagflation of the 1970's, when union membership was much higher than now and wage rises spiralled higher, is not the best example of what might happen in the short-term.

However, if employers are unable to recruit new skilled employees and compete with competitors through increased pay deals for new employees, this could have a significant impact on the battle to bring down inflation to the central bank's target of 2%, especially in the short-term. If economy stalls or falls into recession, we may be faced with the worst-case scenario of stagnant or little growth and sustained high inflation. Whilst unemployment is near record lows, if the UK were to suffer a short bout of stagflation, it is expected that unemployment would rise sharply, exacerbating the financial pain. The Bank of England has been very clear, it is not sure how quickly any of these factors will change in its latest forecasts and sees further falls in the workforce over the coming years.

In summary, the potential impact on the UK investment market is a complex one with all these factors affecting the value of the pound versus other international currencies, the path of interest rates and the likelihood of recession. Whilst raising interest rates should eventually cool inflation, in the short-term supply-side pressures coupled with a shortage of applicants for certain job sectors may sustain higher inflation regardless. Even if many show wage rise restraint simply because some employers will have no choice but to offer higher packages to secure the right recruit, wages may rise faster and higher than the Bank of England would prefer. This in turn may sustain higher inflation for longer at precisely when the UK economy starts to stall.

Market update

After a very volatile month, most stock market indices recovered towards the end of May apart from the NASDAQ index which closed 1.9%.[9] Despite finishing the month strongly investors have been subjected to a rough ride with sharp falls and then subsequent bounce backs centred around the news on inflation, the language used by central banks and any fresh news on the economic outlook. The change in outlook for inflation and interest rates have affected certain markets more acutely than others especially where growth stocks dominate and investors reprice company shares which have in the past benefited from low interest rates and low inflation driving their share price ever higher.

Bonds had a mixed month with UK Government bonds continuing their poor performance with a fall, including income received, of nearly 3% for May. The rise in UK Government yields has seen the capital value fall 13% since the start of the year based on the Bank of America UK All Gilt Index.[10] This in line with the rise in yields as markets price in what they expect interest rates to rise to over the next 12-18 months. The challenge for investors, especially those in low-risk solutions which hold most of their assets in bonds is that bonds have fallen in value at the same time as shares have slumped. Over the long-term, bonds normally provide diversification to allow portfolios to be constructed matching both risk and time horizons. Very rarely do we see prolonged periods when both shares and bonds either fall or rise at the same time, so hopefully investors will find their experience in 2022 a rare one.

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 31 May 2022.

[1] The Office of Gas and Electricity Markets (OFGEM), 24 May 2022
[2] Times Newspaper, 26 May 2022
[3] Insider.com, 3 May 2022
[4] Office for National Statistics, 17 May 2022
[5] Reuters, 27 May 2022
[6] Office for National Statistics , 14 March 2022
[7] Reuters, 27 May 2022
[8] Office for National Statistics , 26 May 2022
[9] FE Fund Info , 31 May 2022
[10] FE Fund Info, 31 May 2022