WEALTH MANAGEMENT

Déjà Vu

The world looked on in awe back in the Spring of 2021, when US Consumer Price Inflation stood at 4.2%. Newspaper stands were flooded with alarming headlines, with the Financial Times stating in May, 'US consumer prices rise at fastest pace since 2008'[1]. Here in the UK, things seemed a little more stable, with Consumer Price Inflation rising 1.6% in the same 12 months to April 2021[2]. Almost as if the US was 6 months ahead of the UK, we are now coincidently seeing the same headlines – the BBC's opening paragraph to a recent inflation article reads 'New figures published on Wednesday reveal the cost of living rose by 4.2% in October, its highest rate in almost 10 years'[3].

What Is Inflation?

To digest these figures it is important to understand exactly what is inflation. In short, it is a term used to describe the rate at which the prices of goods and services are rising. The UK aims to keep annual price rises at 2%[4]. Why would the government want prices to rise I hear you ask? Whilst prices decreasing or remaining the same sounds good to us, the consumer, reduced spending could lead to company profits decreasing and people losing their jobs – generally speaking, a little inflation is a good thing, but too much is bad.

If inflation moves more than 1% in either direction, the Governor of the Bank of England is required to send an open letter to the Chancellor explaining the reasons behind the missed target and what the Bank intends to do to get back on track. This may mean increasing interest rates, but the Bank must be conscious that anyone who has borrowed money may see their monthly repayments increase, which could be significant when debt is high, for example, on mortgages. The principle is that if borrowing becomes more expensive people will have to spend/buy less which will lead to prices decreasing in response.

Why Are Prices Rising?

We believe that an unfortunate combination of the pandemic and, in part, Brexit, seem to be the main sources of the UK inflation surge.

Several UK energy suppliers are going bust after the pandemic saw the country's gas and electricity use fall. With excess oil and gas being produced, this led to prices falling sharply. This saw small energy companies lowering their prices to make costs more appealing to new customers. With the pandemic worsening, the government placed a ban on disconnecting customers so utility companies were obliged to continue to supply energy regardless of customers' ability to pay. What would have usually been a profitable period turned into an unprofitable period. Now demand is recovering, gas supply is falling, which has resulted in a surge in prices. Suppliers cannot increase their prices in line with the higher gas costs, as Ofgem, the electricity and natural gas regulator, has a cap on energy price increases, so suppliers have had to continue business on unprofitable terms, which is why so many energy companies are failing.

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The surge in gas costs has made oil a more cost-efficient alternative for power generation, which has increased demand and in turn the price. At the end of September, oil prices surpassed $80 a barrel for the first time in three years [5] - bad news for UK motorists. In April 2020, petrol was hovering around 108p a litre [6]. In November of this year, prices hit 146.89p [7] a litre – a new all-time high [8].

The rise in commodity prices has been partly responsible for the rise in the price of goods, along with a global shift in demand from services to goods as the nation closed for various lockdowns to curb the spread of the virus.

Supply bottlenecks have also contributed to a rise in global shipping costs which have led to companies passing on these costs to the consumers. Specifically, semi-conductor shortages have led to a disruption in the production of new cars resulting in used car prices increasing by 18% over the twelve months to August 2021.

Lastly, the UK government was forced to issue temporary visas for 5,000 EU lorry drivers after the Road Haulage Association (RHA) cited a shortage of over 100,000 qualified drivers in the UK in the summer of 2021. This has led to wage inflation, which increases the costs of both goods and services.

What Can I Do?

In terms of controlling the price of goods and services there is very little we can do, but the OECD believes inflation will remain higher for the next two years [9]. For reference, if you have $1,000,000 in your bank account today and inflation continues at 4% for the next two years, that $1,000,000 will purchase ~$924,556 worth of goods/services in two years, assuming you are earning 0% interest in your bank account. With banks offering interest rates well below current inflation figures, keeping cash over and above your required expenditure and emergency expenditure pots in the sanctuary of a bank account guarantees a negative real rate of return.

Investing in the capital markets may hypothetically give you a better chance of a positive return in real terms, above inflation, although this is not guaranteed because risk and reward are correlated. Historically, value stocks have outperformed growth stocks in the short-term when inflation has been high because they have an intrinsic value higher than the price they are currently trading at and generally have a good cash flow, which is why our portfolios are built to target the value premia, inflation aside.

When investing your hard-earned cash in the capital markets you are essentially passing on the increasing costs of goods and services to consumers over time. It is important to understand when you will need various pots of cash because a longer time horizon generally dictates a higher allocation to growth assets and a short-term time horizon may render capital market investment unsuitable, as the funds won't have time to ride out any short-term dips which will inevitably come with the volatility associated with investing – especially as markets are generally more volatile during periods of higher inflation.

Whether the current level of inflation is transitory or here to stay, it is one of the many

unfortunate ramifications of the pandemic. We are far from the dizzying UK inflationary highs of the 70s, where inflation peaked at 24.21% in 1975 [10], but given the average UK inflation rate of the last 20 years has been around 2.49%, we are well above the norm. If you would like to understand the potential impact of inflation on your individual circumstances, you should speak to a Wealth Manager to determine your needs.

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MASECO has helped hundreds of High Net Worth US citizens residing in the UK with their finances since its inception in 2008, and we would be delighted to have a complementary initial call to see if we can add value to your situation.

All investments involve risk and may lose value. The value of investments can go down depending upon market conditions and you may not get back the original amount invested. Your capital is always at risk. Currency exchange rates may cause the value of an investment and/or a portfolio to go up or down.

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