State of Play

Price rises finally begin to slow

16 February 2023

Inflation has dominated the financial news over the last 18 months. The latest data released shows rising prices are beginning to slow. However, with inflation still in double digits, it remains the biggest threat to savers wealth. In this week's update, we go back to basics on inflation, explaining why it remains so important to savers' and investors. Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

- Inflation: Back to basics
- The basket of goods explained
- Why inflation remains the biggest threat to maintaining wealth
- Latest inflation data shows price rises continue to slow

Inflation: Back to basics

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.[1]

How is the basket of goods measured?

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. While steps are in progress at the ONS to transition to live digital price capturing, at present, 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 is reviewed each year. Some items are taken out of the basket, 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 when compiling 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 their 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 compared to those that 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.[2]

Currently, the UK Government has set a target inflation rate of 2% (CPI). Why not set the target at 0% or 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 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 a depreciation in the 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.

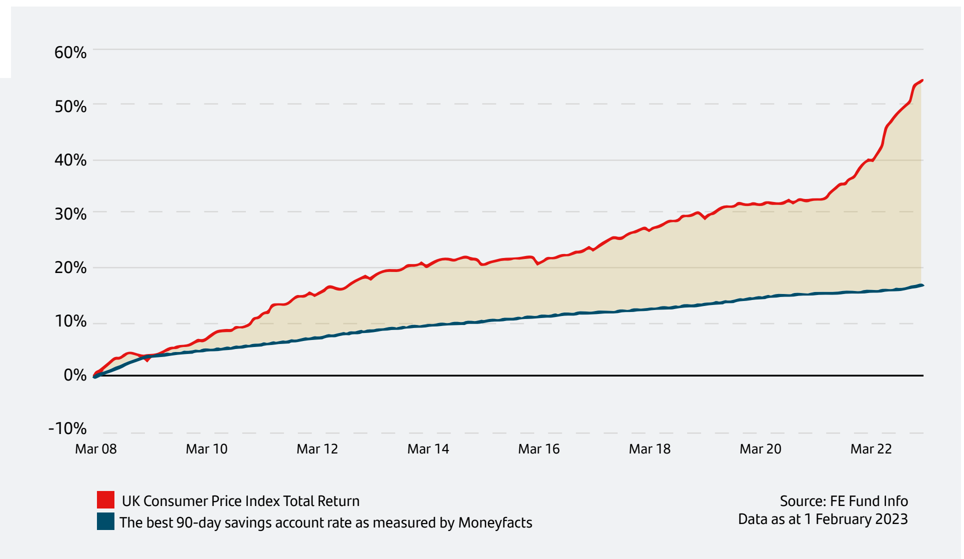
Deflation

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 and 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 while the Japanese economy outgrew this period, it did so at a much slower pace than other industrialised nations.[3]

Why does inflation matter to savers and investors?

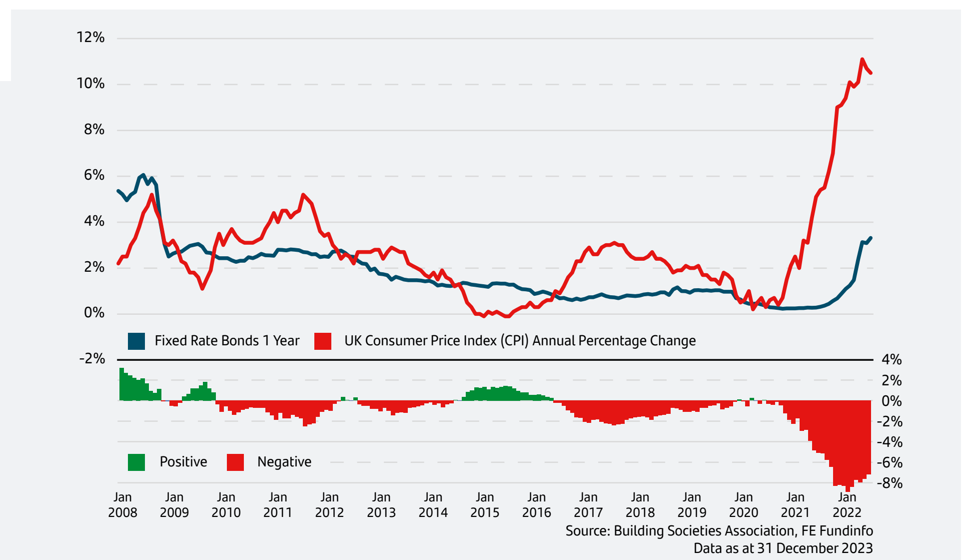
Inflation for savers is probably the number one enemy. When inflation is high or higher than the rate of interest they receive on their savings, the real value of their capital falls. Since the financial crisis in 2008, interest rates have been at record lows while inflation, albeit lower than the historic average, has been higher than savings interest rates (See chart). It means that in the future, what their cash can buy will diminish. If £100 today bought a nice pair of leather shoes, but in 12 months' time the price of the shoes had risen to £110, unless their savings had earned 10% 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.

Cumulative savings erosion over time



As you can see from the chart tracking the Consumer Price Index over the last 15 years compared to the best 90-day savings account rate as measured by Moneyfacts, prices have risen 54% while a 90-day savings account has delivered just over 17% in interest. The value of savings in this scenario has fallen by over a third. So, translated, if you had £10,000 in your savings account for this prolonged period, you have lost £3,700 of the purchasing power of this money.

The erosion gap



Some may argue that during this period, interest rates remained at record lows. However, inflation also remained below the historical average. Now that interest rates are much higher following several rate hikes last year – are savers now better off? Unfortunately, as this update explored last month, the erosion gap has widened. As you can see from the erosion chart, the gap between a one-year fixed rate savings bond (data from the Building Society Association) is now close to 8%. The reality is that if this gap remained, your savings would halve in value in just 9 years. Yes, let me repeat, your £10,000 would only buy £5,000 worth of goods just 9 years later.

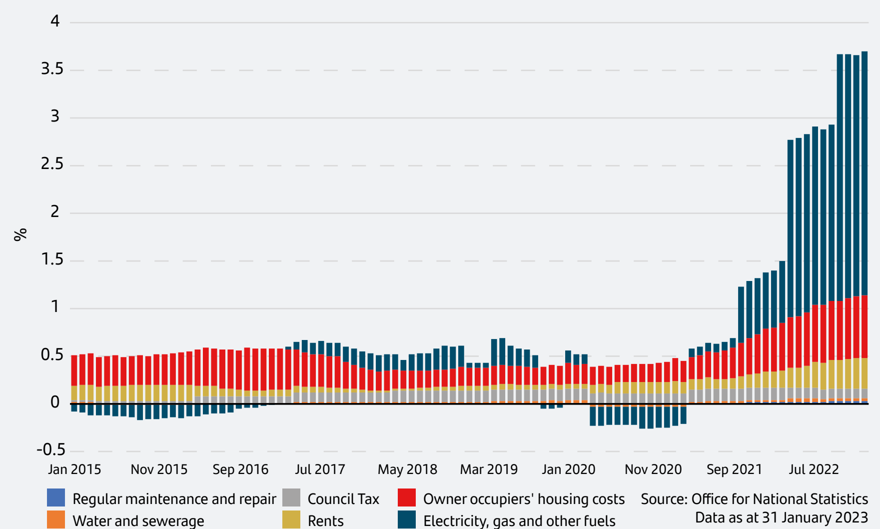
Impact of inflation for investors

Investors are generally less concerned about inflation. One of the primary reasons to invest over the long-term rather than remain in savings is that history shows that investing ordinarily provides a better return than savings, provided you invest for long enough. In the last 18 months, the impact of inflation has been more pronounced for investors, as previous State of Play's 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 of 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, causing shares to fall further 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 generally 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 over the last 18 months and will no doubt continue to play a pivotal role in investment markets for the foreseeable future.

Latest inflation data

Contributions of housing components to the annual CPIH inflation rate, UK, January 2016 to January 2023



This week saw the latest inflation data from both the US and the UK, showing inflation continuing to fall. Importantly, investors have been keeping a close eye on core inflation, trying to evaluate whether the increases in interest rates by both the Federal Reserve and the Bank of England are beginning to help slow economic consumption and hence price pressures. US inflation continued to fall, with rising prices now at 6.4% compared to 6.5% in December, lower but higher than forecast.[4] Core inflation also fell slightly but will have disappointed market participants as it is falling more slowly than predicted. The Federal Reserve emphasised in their last update that the job is not yet done, and rates would continue to rise until they are satisfied price rises are finally under control and heading towards the long-term target rate of 2%.

In the UK however, core inflation, which strips out volatile food, tobacco, energy, and alcohol, fell 5.8% in January, much lower than the 6.2% that had been forecast.[5] This represents a potential dilemma for the Bank of England at their next meeting in March to review interest rates. Some signs in data released by the Office for National Statistics (ONS) are a cause for celebration as wholesale gas prices have fallen substantially, mainly due to a much milder winter in Europe. However, some of the falls are caused by what is known as the 'base effect', where sharp rises from 12 months ago drop off the calculation, potentially skewing the reality facing the consumer. In addition, the Monetary Policy Committee at the bank, whose nine members must navigate and assess a wide range of factors before making a decision about whether to increase rates and by how much, will have to consider the most appropriate point to pause and review.

Interest rate rises are somewhat of a blunt instrument to use in controlling inflation. Increasing the rate of borrowing takes time to filter into the wider economy as it doesn't affect all consumers and businesses at the same time. If they continue to raise rates beyond the point which consumption is already falling enough to cool future price rises, they could tip the economy into a much deeper recession and slowdown than was necessary to tackle price pressures. Given the impact the cost-of-living crisis is already having on the average household, their responsibilities must be a heavy burden to carry and one which I do not envy.

Asset Management

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

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 15 February 2023.

[1] Office for National Statistics (ONS), 24 November 2017
[2] International Monetary Fund (IMF), 13 February 2003
[3] Financial Times, 15 February 2023
[4] Investing.com, 15 February 2023

Important Information

For retail distribution.

This document has been approved and issued by Santander Asset Management UK Limited (SAM UK). This document is for information purposes only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Opinions expressed within this document, if any, are current opinions as of the date stated and do not constitute investment or any other advice; the views are subject to change and do not necessarily reflect the views of Santander Asset Management as a whole or any part thereof. While we try and take every care over the information in this document, we cannot accept any responsibility for mistakes and missing information that may be presented.

The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. Past performance is not a guide to future performance.

All information is sourced, issued, and approved by Santander Asset Management UK Limited (Company Registration No. SC106669). Registered in Scotland at 287 St Vincent Street, Glasgow G2 5NB, United Kingdom. Authorised and regulated by the FCA. FCA registered number 122491. You can check this on the Financial Services Register by visiting the FCA's website www.fca.org.uk/register.

Santander and the flame logo are registered trademarks. www.santanderassetmanagement.co.uk.