FINANCE UPDATES

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THE EFFECTS OF RISING INFLATION IN 2022

Understanding your options to beat soaring prices.

If there's one thing we know isn't going away this year it's the problem of rising inflation. It's not just the UK who has to cope with rising inflation; it's a growing issue across much of the developed world.

Put simply, COVID-19 is to blame as the economic recovery from the pandemic sparks energy, labour and material shortages ranging from semiconductors to cement and several things in between.

What that means is prices for goods are rising as manufacturers compete for the items that are in the shortest supply. They end up paying more and passing those costs onto consumers.

In recent months, wholesale gas prices have reached unprecedented levels. Over Christmas, they hit a new record of 450p per therm, which experts think could take average annual gas bills to about £2,000 this year.

Consumers have been largely protected from the full spike in wholesale costs by the price cap, a limit on domestic rises set by the regulator Ofgem.

The cap is set every six months and is next due to change in April 2022, prompting the energy sector to warn of eye-watering increases to electricity and gas bills.

Average pay rises are failing to keep up with the increase in the cost of living, too. While wages rose in the year to November 2021, they did not rise as fast as prices over the same period.

RESPONDING TO INFLATION

Inflation is a pain in the backside for the Bank of England, which is tasked with keeping the UK's rate – as measured by the Consumer Prices Index (CPI) – at or under its 2% target to help UK GDP bounce back from the pandemic.

For policymakers at the central bank, it's a balancing act between using interest rates – inflation's main control – and the risk of stifling the UK's economic recovery.

For consumers, there are other asset classes which can offer better protection against inflation, although it is important to understand there are no guarantees.

Shares are one such asset – company share prices can often outperform inflation. Gold and property are other asset classes people have turned to. These all come with risks and rewards.

Asides from the central bank, who else is inflation a problem for and what could it positively or negatively affect this year?

SAVINGS & EMPLOYEES

High inflation rates is a big issue for anyone on a fixed income and for savers, many of whom will find the value of their savings is rapidly eroded this year.

In December 2021, interest rates rose for the first time in three years. The increase from the record low of 0.1% to 0.25% was in response to prices surging at their fastest pace for a decade.

Further incremental increases are expected throughout 2022. While savers stand to benefit, the increases will be small, such as the most recent 0.15% rise, and they won't be enough to compensate for high inflation.

If ever there was a time for the rainy-day fund to come into play, this year is probably it as households feel the squeeze from surging living costs. As ever, low-income families and young people will feel the pinch the most.

You should ideally have at least three and six months' worth of necessary living expenses to fall back on. Inflation, however, threatens to drain that faster than you might expect.

This has the potential to drive down living standards, although workers could respond by increasing their wage demands to soften the blow from a period of high inflation.

BORROWING

If you're planning to buy a home this year or remortgaging an existing property, any increases to the base rate of interest will be reflected by lenders increasing their borrowing costs.

This will result in mixed fortunes for all types of borrowers, whether they are taking out a new mortgage or another type of loan, depending on the arrangement.

For example, borrowers who took out fixed-term mortgages over the last three years when the base rate was at its lowest will be repaying less in real terms than they borrowed.

Conversely, if you have a loan at a variable rate of interest, then any rise in the central bank's base rate of interest would push up the cost of your repayments.

The headline student loan interest rate – for those from England and Wales who started university in or after 2012 – increased to 4.4% last month.

It's to go up again next month, possibly to 4.5%, in line with the current Retail Prices Index and the temporary prevailing market rate cap. This rate is higher than most mortgages.

PENSIONS

Whether you're retirement saving or drawing down in retirement, pensions are not immune from the effects of inflation.

In normal times, pensions grow faster than the rate of inflation. They are invested on the stock market, so inflation's no issue.

However, high rates of inflation can erode the value of your pension in real terms. For instance, if your pot grew in value by 7% during 2021 but inflation averaged at 5%, your pension will have grown by just 2% in real terms.

Many benefits and the state pension are linked to inflation, but the 2022 rates were set before prices started to spiral out of control. That means the state pension will rise by 3.1% in April 2022 – half the expected increase in living costs.

The Department for Work and Pensions removed average earnings growth from the triple-lock last autumn, which would have seen the state pension rise by 8.3% from April 2022.

Chancellor Rishi Sunak could yet boost the state pension before April to help retirees cope with rising living costs over the course of the year. Time will tell.

HOUSE PRICES

The costs involved with buying a house soared during COVID-19, largely due to the stamp duty holiday. Months have passed since that tax break ended and house prices remain at record highs.

That suggests the real factor behind house prices was the low cost of taking out a mortgage. Those deals would evaporate should interest rates continue to rise to try and contain inflation.

House prices might not collapse but should the base rate of interest increase several times in 2022, it could mean that buying a home becomes less affordable.

That could cause the property market to slow down, with the potential for some buyers to slip into financial difficulty if they overstretched themselves during the stamp duty holiday.

As such, the prices of some houses with overly inflated prices could begin to fall due to pressures caused by high inflation.

WE HAVE SOLUTIONS

If you are buying a new home, we can help you secure fixed-rate repayments to utilise the current low rates of interest. They should only continue to rise this year so talk to us now.

We can help people start investing, using shares, funds or bonds to prevent inflation from eating into your cash holdings.

For pension savers and retirees, we can help build your wealth by finding solutions to make your pension pot work harder.

Talk to us for expert financial advice.

IMPORTANT INFORMATION

The way in which tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to future change. ISA eligibility depends on individual circumstances.

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