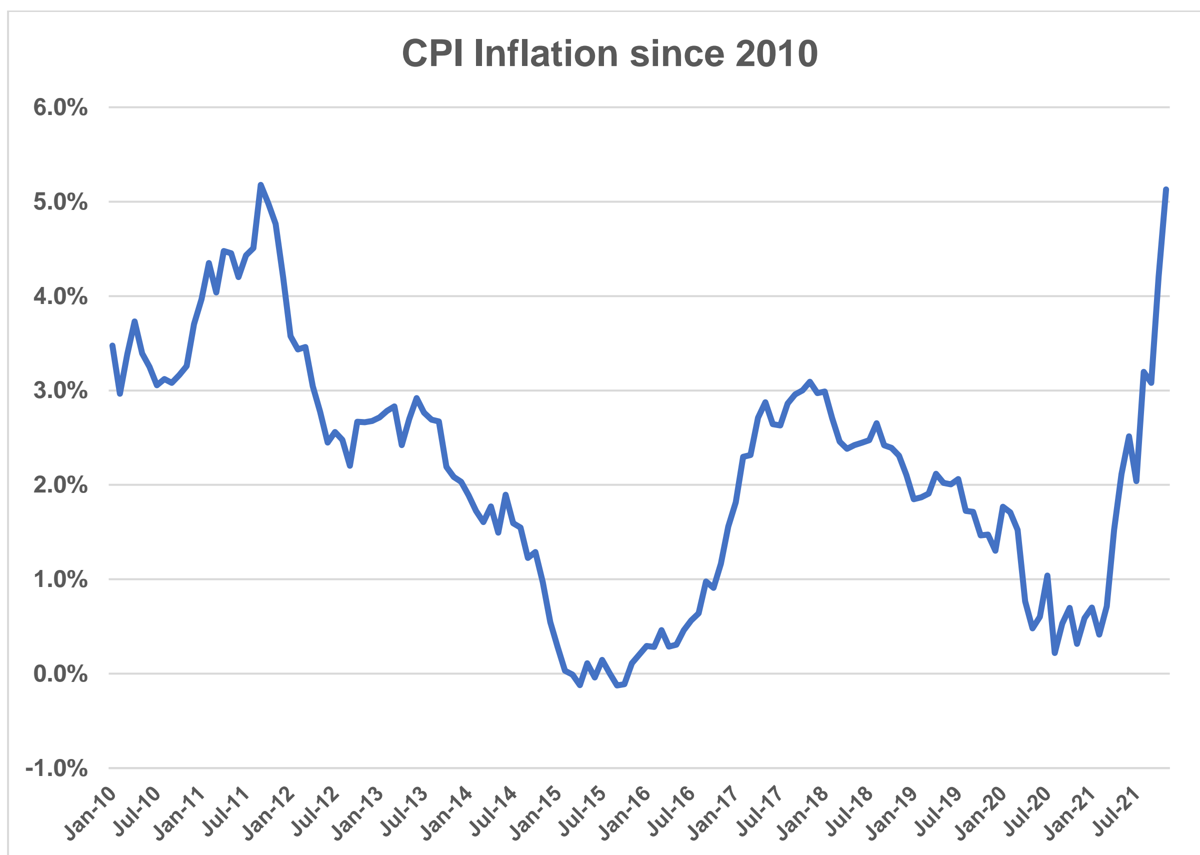
Lessons from rising inflation and interest rates

As 2021 drew to a close, inflation finally forced the Bank of England's hand. What will higher rates mean for you?



Source: ONS.

The November inflation figures, released in mid-December, once again exceeded the Bank of England's (BoE) expectations. At the start of November, the BoE had said that CPI inflation was "expected to peak at around 5% in April 2022". Six weeks later it changed its tune: "Bank staff expect inflation to remain around 5% through the majority of the winter period, and to peak at around 6% in April 2022".

What does that mean to you?

- The effects on your personal spending will fluctuate. Inflation is not constant across all goods and services. For example, November's data showed that while overall inflation was 5.1% a year, in the health category prices rose only 1.4% across the 12 months, while for transport (for example those petrol prices and secondhand cars) the annual increase was 12.5%.
- The buying power of your cash savings is depreciating fast. The Bank responded to the latest jump in inflation by raising Bank Rate from 0.1% to 0.25%. Viewed another way,

over a year a deposit of £1,000 would earn £2.50 (before tax) in interest at Base Rate, while current inflation would erode its buying power by about £50.

- Your next pay rise probably won't cover the erosion of buying power. The Bank's forecast of an April peak for inflation – primarily driven by the next Office of Gas and Electricity Markets (OFGEM) utility price cap rise – will coincide with the increase in National Insurance contributions announced last September. For example, if you earn £40,000 a year and, like many employees, your salary review takes effect in April, you will need a pay rise of 8.2% to maintain the buying power you had a year ago.
- Your insurance cover will need a review. If you have life assurance and/or income protection that is not inflation-proofed, then you will need to increase the level of cover to maintain the real value of your protection. With buildings and contents insurance, that often happens automatically and goes unnoticed.
- Any inheritance tax (IHT) liability on your estate has probably gone up. The current Chancellor has followed in the footsteps of his predecessors by freezing the IHT nil rate band. As inflation drives up asset values, such as your home, that could mean more of your estate is exposed to 40% tax.

2021 investment wrap-up

The world's share markets generally produced solid returns in 2021, but UK stocks and fixed-interest investments suffered. Maintaining an international outlook in your portfolio can help underpin its value.

Index	2021 Change
FTSE 100	+14.3%
FTSE 250	+14.6%
Dow Jones Industrial	+18.7%
Standard & Poor's 500	+26.9%
Nikkei 225	+ 4.9%
Euro Stoxx 50 (€)	+21.2%
Shanghai Composite	+4.8%
MSCI Emerging Markets (£)	-3.7%

2021 was a good year for most investors in share-based funds, particularly those who had holdings linked to the US market.

Despite the optimism around the beginning of Covid-19 vaccine rollouts, there was not an auspicious start. However, once January was out of the way, the US, UK and European markets began to move upwards. The arrival of the Covid-19 Omicron variant in late November prompted a change of direction, but this was reversed before the end of the year.

Overall, the UK stock market lagged the US once again, with the main US indices regularly achieving new highs throughout the year. To no small degree this reflects the growing dominance of technology companies in the States. Of the 500 companies in the S&P 500, the professional's US market index, just half a dozen account for a quarter of its value. All are familiar brand names, although the label given to their holding companies may be less so: Apple, Microsoft, Amazon, Alphabet (aka Google), Tesla and now Meta (aka Facebook). Apple alone has a value of $2,900 billion, which makes it worth more than the entire FTSE 100.

While shares performed well in 2021, it was a poor year for fixed-interest investors. That might seem surprising as the US, European and Japanese central banks all kept rates at around zero throughout 2021, while the Bank of England waited until December to raise its interest rate by just 0.15%.

However, the mood music on interest rates changed as the year progressed, primarily because inflation in Europe and the US rose well above the bankers' targets of around 2%. An increase in US rates – the first since December 2018 – could come as early as March.

There are a few lessons to draw from 2021:

- Without the benefit of hindsight, it is virtually impossible to hit the perfect timing for investment. January 2021's lockdown was a good time to invest, but it did not feel like it back then.
- Inflation, and with it the prospect of rising interest rates, has become a concern for bond investors but not – at least, not yet – for equity investors.
- International diversification remains valuable for UK-based investors. The UK now accounts for only about 3.5% of the world's stock markets by value.

The Investment COACH

Uncertainties removed on two key personal taxes

The future of two important personal taxes – inheritance and capital gains – has finally been clarified, simplifying aspects of year-end planning. The extended wait highlights the difficulty of changing useful revenue-raising measures in uncertain times.

Four years ago, in January 2018, when there seemed to be both appetite and scope for reformation of the tax system, the then Chancellor, Philip Hammond, asked the Office of Tax Simplification (OTS) to review inheritance tax (IHT). Of two reports submitted in November 2018 and July 2019, the second was the more interesting, making several proposals to reform and simplify the tax, including restructuring some of the current exemptions and scrapping the relief for lifetime gifts made within seven years of death.

Reaction to the reports' recommendations were expected in the Autumn 2019 Budget. However, by the time November 2019 arrived, Sajid Javid was Chancellor and an imminent general election meant that the Budget was postponed to the following spring. When March 2020 arrived, along with Covid-19, Mr Javid had been replaced by Rishi Sunak and his first, Covid-focused Budget made no comment on the OTS's proposals. Four months later, Mr Sunak asked the OTS to review another tax on capital – capital gains tax (CGT).

Once again, the OTS laboured away and produced two more reports, the first in November 2020 and the second in May 2021. This time it was the first report that was the more radical, suggesting that CGT rates should be aligned (i.e. increased) to income tax rates. The OTS also suggested a reduction to the annual exemption by around two thirds (currently £12,300). For those trying to plan their capital disposals, the possibility of such radical change and uncertainty around timing were, to say the least, unhelpful.

The Spring 2021 Budget passed by with no mention of reform of CGT and just one administrative tweak to IHT rules. Surely, the Autumn 2021 Budget would end the wait for a formal response to the OTS's quartet of reports…

Yet, we had to wait several weeks after the Budget, until 30 November, when the Treasury had its Tax Administration and Maintenance Day. Among the raft of largely technical documents was a five-page letter to the OTS on its IHT and CGT reports. Replying on the IHT recommendations, the Treasury highlighted that "IHT still makes an important contribution to the public finances and it is forecast to raise £6 billion in 2021–22 to help fund public services." Similarly, commenting on the proposals for reforming CGT: "…these reforms would involve a number of wider policy trade-offs and so careful thought must be given to the impact that they would have on taxpayers, as well as any additional administrative burden on HMRC."

The reply was not quite "Thanks, but no thanks" – five administrative improvements to CGT were accepted – but the message was clear enough: no major changes would be made to either tax.

So with two swords of Damocles now removed, you now have no excuse to delay estate and CGT planning.

Focus on tax year-end planning

With Christmas and New Year behind us, tax year-end planning should now be on your radar.

The 2021/22 tax year will end on Tuesday 5 April. This year there is no Spring Budget and Easter arrives on 15 April, so no obstacles stand in the way of year-end tax planning. Nevertheless, the sooner you start the better, as some decisions cannot be made quickly. Among the areas to consider on this occasion are:

Pensions

Making pension contributions is one of the few ways that you can receive full income tax relief *and* reduce your taxable income. The second benefit matters in a world where your level of taxable income can determine whether you suffer the High Income Child Benefit tax charge or retain entitlement to a full personal allowance. The end of the tax year is a good time to assess how much you can contribute as you should have a good idea of your income for the year.

Inheritance tax

Now that we know the Chancellor does not have any plans for major reform of Inheritance Tax (IHT), there is a stable framework on which to plan. As ever, first on the list to consider is use of your annual exemptions, such as the £3,000 annual gifts exemption. With the nil rate bands currently frozen until April 2026, it is more important than ever not to let these go to waste.

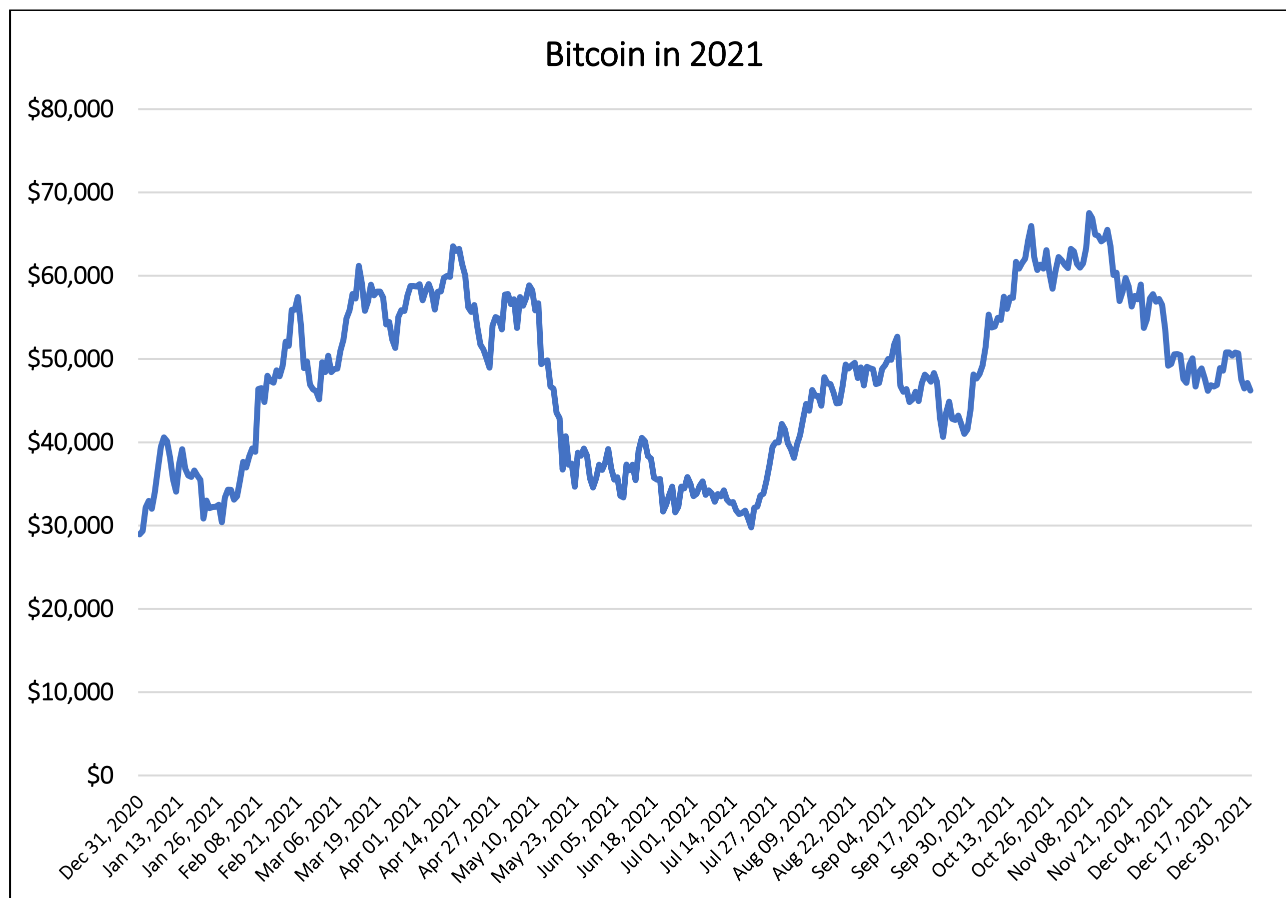
Capital gains tax

As with IHT, the Chancellor has recently clarified his plans for Capital Gains Tax (CGT). The annual exemption, which currently allows you to realise CGT-free gains of up to £12,300 each tax year, will not be slashed, nor will the tax rates be raised to income tax levels. That has simplified the year-end planning process, as there is now no point in realising gains above your annual exemption in case there would be more tax to pay in the near future.

If you think your personal finances could benefit from year-end planning, do not wait until the last moment to seek advice. Calculations will often need data that can take time to collect, particularly on the pensions front.

Crypto – investment or gamble?

Cryptocurrencies are regularly in the headlines and growing in popularity, but are they really investments?



Source: Investing.com

Cryptocurrencies, of which Bitcoin is the most famous (or notorious, depending on your viewpoint), are not currencies in any practical sense of the word. Think of the pound in your pocket:

- It has the backing of a state-owned central bank;
- Its value is stable, give or take the longer-term impact of inflation; and
- It can be easily used in any financial transaction as a method of payment.

According to the Financial Conduct Authority (FCA), in the UK, 2.3 million people own some form of cryptocurrency, with an average holding of about £300 – meaning that cryptocurrencies account for about 0.1% of UK household wealth. Other research shows ownership to be concentrated largely among Generation Z – 45% of 18–29-year-olds have placed some money in cryptocurrencies and half of those have gone into debt doing so. However, 10% of cryptocurrency holders in the UK are over 55, with potential inheritance tax and legacy issues for their estates.

Many of these new investors may believe these virtual currencies are socially as well as personally beneficial. But with the huge amounts of energy required in cryptocurrency mining just one area of controversy, they may not be simply a benign option for those seeking to sidestep traditional investing.

HMRC has recently entered the fray, seeking to contact holders of crypto assets to remind them that they would owe tax on any profit from disposal of cryptocurrencies, whether from sale, exchange or where used for goods or services in the limited areas available.

Some cryptocurrencies called stablecoins, such as Tether, aim to have a fixed value (often linked, ironically, to a traditional currency). However, most cryptocurrencies have anything but a stable value, as none have central bank backing and it can be difficult or near impossible to buy anything with them.

Despite these factors the cryptocurrency market has grown at a breakneck pace: over the last five years to November 2021, its value has increased from USD $16 billion to USD $2,600 billion.

The FCA does not directly regulate cryptocurrencies. However, UK cryptocurrency businesses are required to register with the FCA and comply with money laundering rules. The regulator makes clear in its consumer guidance (see fca.org.uk/consumers/cryptoassets) that:

- Cryptocurrencies are regarded as “very high risk, speculative investments”;
- Purchasers are unlikely to be covered by the main investor protection schemes; and
- If you choose cryptocurrencies, “you should be prepared to lose all your money”.

Scams, particularly using social media and involving offshore companies, are another high risk of the cryptocurrency market. One international scheme, the subject of an in-depth podcast investigation, operated in over 175 countries to the tune of $4 billion but turned out to be a complex scam with the founder still apparently unaccounted for.

As the Bitcoin graph shows, it is possible to make – and lose – large amounts in cryptocurrencies. With the development and growing popularity of app platforms making ‘trading’ and tracking more accessible and convenient, you may be tempted to join in. But be warned – other, less exotic, and better regulated investments could well be a wiser choice.