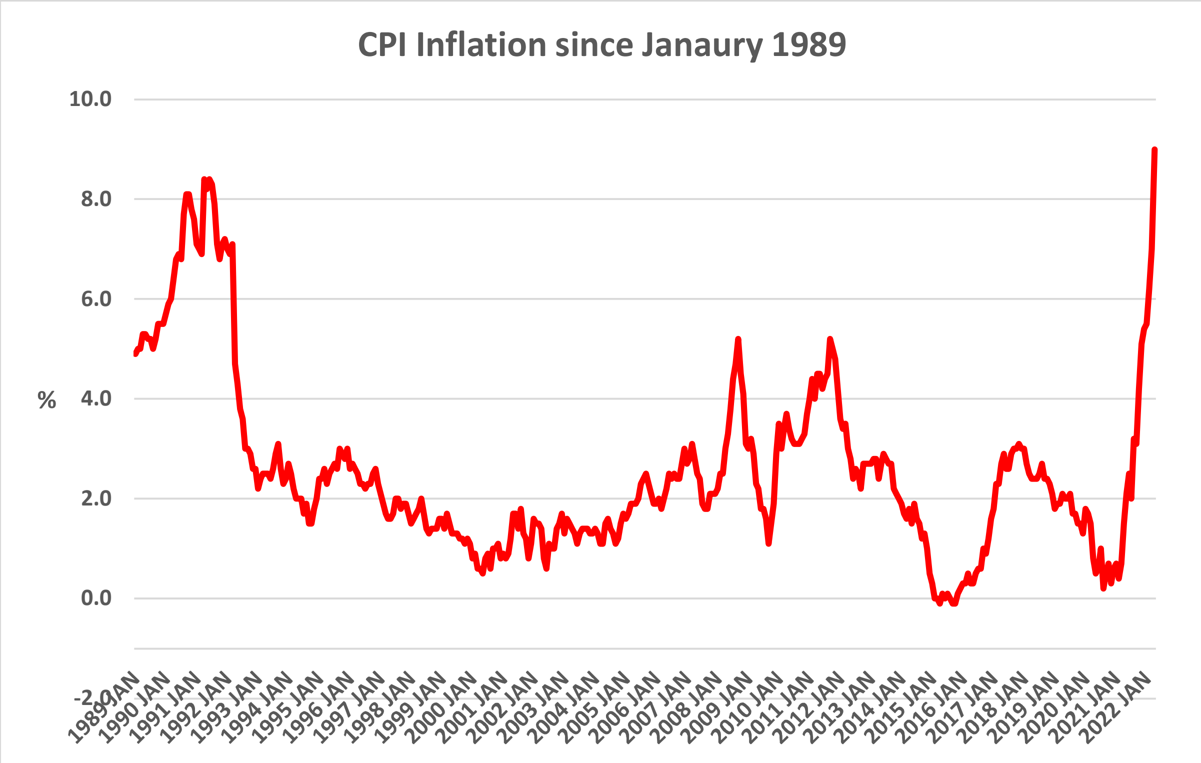
May 2022 Client Newsletter

Inflation: higher than in 1991



Source: National Statistics

Until recently, inflation was one of those regularly published economic measures which went largely ignored. It was always present – give or take a brief dip into negative territory in 2015 – but after the last blip above 5% in 2011, it has not been a concern. Until now. As the graph dramatically illustrates, inflation has surged since the start of 2021, when the CPI measure of annual inflation was just 0.7%. The latest figure (for April 2022) shows the CPI rising by 2.5% - in one month, not a year. The annual CPI rate was 9.0%. For once there are no historical comparisons, as the Office for National Statistics (ONS) data only goes back to January 1989 and shows a 1991 peak of 8.4%.

The UK is not alone in experiencing a sudden bout of inflation. In the USA inflation was running at 8.3% in April, while in the Eurozone, which had been trying to avoid *de*flation not so long ago, the monthly reading was 7.4%.

The consequences

There are many effects from an inflation rate more than three times the 2% target which the Treasury sets the Bank of England. Three of the more significant are:

Interest rates

In recent times the way in which inflation has been tackled has been to raise interest rates. The Bank of England's Monetary Policy Committee has already done so at each of its last four meetings, leaving its base rate still at just 1%. Further rate rises are expected, but the Bank is in a bind which it shares with the central banks in the USA and Eurozone:

- Rates are increasing from a near-zero level, where they have been since March 2009;
- It is far from certain how high rates will have to rise to bring down inflation, especially as some of the main causes, such as rising energy prices, are globally driven; and
- With the backdrop of the war in Ukraine and a slowdown in China prompted by COVID-19 lockdowns, raising rates runs the risk of driving the economy into a recession.

Bank of England base rate increases do not immediately feed through to mortgage costs in the way that they used to, because these days about three quarters of mortgages are fixed rate. However, as the fixed terms end – and many were only fixed for two years – the impact of higher rates will be felt. When rates have been so long, an extra 1% on the rate can translate into mortgage payments rising by over a quarter.

Taxation

In his March 2021 Budget, the Chancellor announced that he would be freezing the income tax personal allowance, the higher rate threshold, the inheritance tax nil rate bands and the capital gains tax annual exempt amount for four years, starting in 2022/23. At the time, the Office for Budget Responsibility (OBR) was projecting the inflation between 2022 and 2025 would average 1.9%. That made the freezes seem a tolerable way of raising extra revenue.

A year later, the Chancellor had not changed his mind on the freezes, but the OBR had altered its thinking on inflation. In March 2022, it expected inflation over the four years to average 3.7%, a figure which is already starting to look like an underestimate. The OBR highlighted the result of the higher inflation assumption in its March 2022 Spring Statement, estimating that:

- The number of people brought into income tax by 2025/26, the final year of the freeze, had risen from 1.34 million, in its March 2021 report, to 2.77 million a year later; and
- The increase in higher rate taxpayer numbers had doubled from its previous projection to 2.0 million, meaning that in 2025/26 nearly one in five income tax payers would suffer higher rate tax. If you are not a higher rate taxpayer today, you may be by 2025.

Personal financial planning

High inflation can rapidly disrupt your financial plans. For example:

- If your life assurance, critical illness cover and income protection are not index-linked, the value of cover you have will be eroded. £1 at the start of 2020 had a buying power of 92.4p by March 2022.

- Investment returns need to be thought of in ‘real’ terms. That means subtracting the inflation rate from the simple return to see whether your capital is keeping pace with inflation. A 5% return will still see the worth of your capital fall by 4% a year if inflation is 9%.
- Pension contributions need to keep up with inflation. If you maintain them at a fixed level, then you are allowing inflation to make your retirement poorer. A corollary is that if you are, or are about to, draw benefits from your pension, you need to build in some provision for inflation protection of your income.
- Cash holdings are generally bad news because interest rates are so far below inflation – back to the issue of real investment returns. Large cash deposits are even harder to justify when their buying power is dropping by 5% or more in a year.

Action

Inflation is a major disruptor and one that is all the worse for its sudden appearance. It will probably mean that you lose more of your income to tax, thanks to the Chancellor’s freezes. It may also mean that you need to review your finances and set new priorities.

Talk to us today about how your financial plans are affected by inflation and what action you need to take.

No fault divorce

A radical change for England and Wales

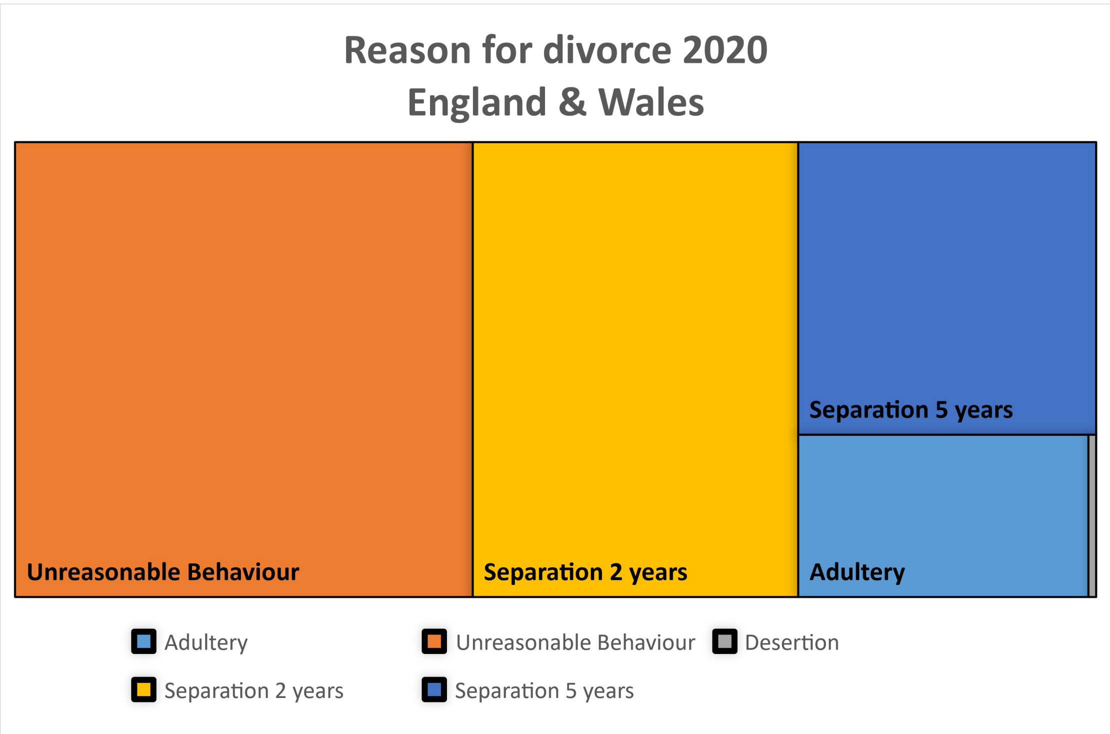
On 6 April 2022, a long-awaited reform to the divorce law took effect in England and Wales. In the eyes of many experts, it was the most radical revamp of the legislation since the introduction of the Matrimonial Causes Act nearly 50 years ago. Proof of the impact of the new regime was that divorce applications jumped by 50% in the first week after the change. However, part of the spike can be blamed on the delay in implementing the new law, which had originally been planned to take effect last autumn.

What has changed?

Before 6 April, In England and Wales one of five 'facts' had to be proven for a court to accept that a marriage had reached the state of irretrievable breakdown:

1. Adultery.
2. Unreasonable behaviour.
3. Desertion for more than two years.
4. Separation for more than two years with mutual consent.
5. Separation for more than two years *without* mutual consent.

The first three meant that one party had to take the blame, which in many situations neither was willing to do, even though it could speed up the process. The alternative was separation, which needed at least five years apart if there was no agreement to divorce. If there was agreement, then the timescale reduced to two years. The graph below shows the breakdown between these five facts in 2020.



Source: ONS

Over two in five divorces were on the grounds of unreasonable behaviour, which was seen as the lesser of the blame-game evils if a two-year wait was to be avoided.

The new regime has replaced the five facts with just one condition: a statement of irretrievable breakdown of the marriage. This can be made jointly or singly, but if it is made by only one party, the other cannot contest it. Despite the headlines that they tended to grab, disputed divorces were rare in practice – less than 2% according to ONS data.

The new rules do not provide an instantaneous divorce. There is a 20-week gap between the start of proceedings and the court granting a provisional decree of divorce (a decree nisi). Six weeks later, the divorce is finalised with the issue of the decree absolute. The initial 20-week gap is there to '…provide a meaningful period of reflection and the chance to turn back, or where divorce is inevitable, it will better enable couples to cooperate and make arrangements for the future', according to the Ministry of Justice.

Note that these new rules also apply to the dissolution of civil partnerships.

What has not changed?

Firstly, nothing has changed in Scotland or Northern Ireland which have their own divorce law – the reform is limited to England and Wales.

Secondly, the new law has only altered the mechanism to obtain a divorce: the surrounding issues of the financial settlement, custody of, and access to children remain as before 6 April. When considering these, professional advice will still be vital in many instances. For example, the treatment of pensions on divorce – sometimes the most valuable matrimonial asset – is one where the three options usually available can be difficult to compare and have differing attractions for each spouse or civil partner.

Tax can also be a trap that needs expert attention when couples are dividing up their wealth. Last November, the Chancellor accepted a recommendation from the Office of Tax Simplification that the interaction of capital gains tax with divorce needed to be amended, but no legislative change is likely until at least Finance Act 2023.

Action

The introduction of no fault divorce brings the process into the 21st century, but it should not be seen as a reason to hasten the agreement financial and family arrangements. These still need time for considered attention.

If you are considering, or are in the process of, a divorce, or the dissolution of a civil partnership, please talk to us in confidence about the financial consequences as soon as possible.

Student finance: the Treasury wants a greater return

The first few months of 2022 produced two important announcements on student finance in England and Wales, both of which were seen as having the Treasury's fingerprints all over them, even if they originated from the Department for Education (DfE).

Students who start(ed) their course between September 2012 and August 2013

Student loan payments operate more as a form of tax than as a conventional loan repayment. The basis has long been that the payment made is 9% of income above a specific threshold – with no upper limit (other than full repayment). The result is that some lowly paid graduates never pay a penny, while the high earners can clear their debt in a decade or less.

The income threshold is a crucial number and had been subject to increases in line with average regular earnings in recent years, after a freeze in 2017/18. However, early in 2022, the DfE 'announced' in a blog that it would be frozen at the 2021/22 level of £27,295 for 2022/23. Subsequently it emerged that the freeze would last for three years, up to and including 2024/25. Thereafter the threshold will rise in line with the RPI rather than earnings (which could be expected to grow faster). Error! Reference source not found.

As a DfE consultation paper noted, the change '…will generate significant savings for the taxpayer', the corollary being that graduates will be making 'significant' extra loan repayments.

Students who start their course from September 2023 Error! Reference source not found.

Shortly after the blog appeared, the DfE revealed that students starting their courses in the 2023/24 academic year or later would be subject to a new set of loan terms:

- The good news was that the maximum interest rate would be reduced to the RPI+0%, compared with the RPI+3% which currently applies during the course and to the highest earners when repayment begins.
- The first slice of bad news was, once again, focussed on the repayment threshold. This will be set at £25,000 and held at that level until April 2027 when, in theory, the first of the graduates from the 2023/24 academic year will start to repay their loans. Probably by coincidence rather than design, £25,000 is the same threshold as applied to the current loan scheme in 2018/19, which gives a good idea of how much of a squeeze is being applied. Increases to the threshold from 2027/28 will be linked to the RPI, which is due to move closer to the CPI three years later.
- The second slice of bad news was the harshest: the loan payment term will be extended from 30 years to 40 years, meaning many graduates will be in their early 60s and nearing retirement before they stop making payments to the Student Loans Company.

The difficult question remains…

Whenever the topic of student loans raises its head, the question of whether to repay early is not far behind. There is only an easy answer if the borrower knows:

- The pattern of their earnings over much or all of their working life;
- What the path of inflation will be over the same period; and
- What changes the current and future governments will make to loan conditions before payments end.

The DfE's own estimates for the entire student population are that even with a 40-year loan term, only about half of borrowers will fully repay their loans. Under the current 30-year regime, the corresponding proportion is just 25%. In either case, there is an obvious risk that making any payments above that statutory 9% will be nothing more than a gift to the government.

Action

The uncertainty about the merits of early loan reduction or full repayment do not mean that the impact of that effective 9% graduate tax can be ignored.

If you are concerned as a parent or grandparent, talk to us about the options for providing assistance. Making capital available for the deposit on a first home may be a better idea than speeding loan repayment.

Footnote: 12% student loan interest?

The RPI measure which is used as a basis for interest on student loans is the annual figure for the March before the start of the academic year. Thus, for the 2022/23 academic year starting on 1 September 2022, what matters is the March 2022 RPI annual rate, which was 9%. Those loans that have a maximum rate of the RPI+3% could therefore face a 12% interest charge later this year, a fact that has grabbed a few headlines. In practice matters are not quite as straightforward.

All the nations of the UK restrict the maximum student loan interest to commercial rates (on differing bases) if these are lower than the RPI-linked basis. Unfortunately, the process for doing so has inbuilt lags, so interest is likely to be overcharged for six months from September – at 12% in this instance - with compensatory undercharging thereafter to reach an overall commercial rate. All of which further complicates any thoughts of repayment…

UK dividends – look beyond the headlines for good news

The latest data on dividend payments from UK companies was published at the end of April by Link Group, a leading firm of share registrars. The headline figure was that total UK dividend payments in the first quarter of 2022 were 25% less than in the same period of 2021. That may sound odd when you think about it, given the history of the pandemic, but the number is both correct… and highly misleading.

In the first three months of 2021 there were a couple of very large dividend payments:

- Tesco made a £5bn special (one-off) dividend payment, distributing the proceeds from the sale of its Asian businesses. That boosted the special dividend total to £6.2bn for January-March 2021. In the first quarter of 2022 total special dividend payments were a more normal £0.93bn.
- BHP, the giant Australian mining company, paid a large interim dividend in March 2021, reflecting profits it had made on iron ore. It handed investors an even bigger dividend in March 2022, but by then the company was no longer listed on the London Stock Exchange, so that payout did not appear in Link's 2022 Q1 UK data. Error! Reference source not found.

If you look only at underlying (regular) dividends and adjust for BHP's absence, then the UK enjoyed year-on-year dividend *growth* in the first quarter of 12.2%. During the pandemic regular dividend payments fell sharply, with many companies suspending all payments. Now those same companies are resuming normal business, with Link noting that all market sectors produced higher payouts in the first quarter of 2022 once calendar effects and other one-offs are allowed for.

Link has also increased its estimate for underlying dividend growth this calendar year, which it says could be 'a very encouraging 15.2%'.

Action

The average dividend yield on UK shares is around 3.2%. If you need income from your capital that has some chance of keeping pace with inflation, this is an area well worth considering

Talk to us today about the range of UK equity income funds available. There is a wide choice, with some funds having a much better track record than others.