RATHBONES

WHICH PATH ARE WE ON?

REVIEW OF THE WEEK
13 NOVEMBER 2023

UPDATES ON INFLATION AND UNEMPLOYMENT ARRIVE THIS WEEK. WILL THEY GIVE INVESTORS MORE CLARITY ABOUT THE PATHS OF INTEREST RATES?

American inflation popped slightly higher over the summer – from 3.1% to 3.7% in August where it stayed in September – mainly driven by a sharp jump in the price of petrol. The cost of housing, whether rents or mortgage payments, has also kept inflation elevated. The next US reading is released this week. Most economists expect headline CPI inflation to fall significantly to 3.3%. If so (or if it sinks even more), investors will rejoice and stock and bond markets will probably pop higher. Signs that inflation is moving strongly back towards the 2% target of the US Federal Reserve would mean less pressure on the central bank to increase interest rates further and a greater chance that they may even start to reduce rates sometime next year.

Generally, lower rates make for higher stock and bond prices because these assets are simply rights to receive money in the future, whether coupons and your money back from bonds or a share in the profits of a stock. If prevailing rates in the economy fall over the time between now and when you get your money back, then it means your rights to those future pounds would become more valuable. You bought those assets when general rates of return were higher, and now investors are faced with generally lower rates of return.

Of course, there's also the other possibility: you buy an asset for a given return and then interest rates move higher. In that situation, the return you've invested at is now lower than the generally available level. That means the price of your investment will fall, all other things equal.

At root, this bifurcating question is what's driving today's erratic markets. Investors are hoping that interest rates have peaked and will then fade over the coming years. Some are even more hopeful – expecting central banks to start cutting rates much faster. Other investors are concerned that central banks may need to raise rates yet further if they are to drag inflation back below 2%. Some are concerned that they may have to go much further than most forecast.

The tug-of-war between these two sides has caused big moves in the prices of stocks and bonds as people try to assess the most likely paths of inflation and interest rates over the coming years and how they will affect the prices of investments. As new data points for inflation, household spending, business surveys, profit calls and economic growth drift down like leaves from the trees, investors are constantly reassessing their beliefs and trading. Sometimes, that means buying or selling stocks almost indiscriminately, sometimes it means buying only certain industries and selling others. It can mean selling all types of bonds, or perhaps only those issued by governments or buying only those that mature very far in the future. It depends on the flavour of the data and how it makes you feel.

Looking ahead

As 2023 winds down, many people, it seems, are feeling jittery and cautious about the future. Consumer confidence surveys aren't fantastically reliable these days, after seismic shifts from the pandemic and changes to people's behaviour. Yet they are trending downward again in the US, UK and Europe after a positive summer. As we've already highlighted, investors seem twitchy too. Many businesses have been cagey about the future as well, with most big American companies reducing their guidance for profits in the final quarter.

Household spending has continued despite the glum mood, however. And that then flows through to company profits which means people stay employed which helps keep economies ticking over. When cracks start to appear in the jobs market, that's when a downturn is likely to materialise. Here in the UK, it's slightly complicated because the Office for National Statistics is introducing a new unemployment measure. The new, experimental data says the rate is 4.2% while the old data says it's 4.3% (it was 3.7% at the start of the year). The latest number will be released this week. The British economy didn't grow at all in the third quarter, but it was a better result than an expected 0.1% fall. UK wage growth moderated slightly over the summer, but it's still very high at 8.1% (although the experimental data say it has already started to fall quite sharply). If inflation can continue to fall, that should give real wages a long-overdue bump and deliver some cheer to Brits. UK inflation is forecast to drop from 6.7% to 4.8% when it's reported this week.

On the other side of the Atlantic, the number of Americans signing up for jobless benefits fell slightly last week. **The most recent update of the unemployment rate ticked up slightly from 3.8% to 3.9%.** Some members of the

Fed have noted “important cooling” in the labour market, yet Fed Chair Jay Powell noted again last week that he believed the war against inflation is far from over and that there’s a ‘long way to go’ to get inflation to its 2% target. Whether that necessarily means that more rate hikes are required is unclear though. Some investors think so, yet we still firmly believe that the massive rise in borrowing costs (in all major economies) will continue to squeeze businesses and households in the coming months. It takes a long time for these monetary policy changes to truly bite and we think past medicine is still working its way through the system.

If you have any questions or comments, or if there’s anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We’d love to hear from you.