RATHBONES

SHOPPERS ON STRIKE?

REVIEW OF THE WEEK
22 JANUARY 2024

UK RETAIL SALES SLUMPED IN DECEMBER WHILE INFLATION WENT IN THE OTHER DIRECTION. IS THE UK NOW IN RECESSION, ALBEIT THE MILDEST OF THE MILD?

It was the UK's turn to disappoint on inflation last week, **following the unexpected uptick in US inflation** earlier this month. UK inflation accelerated from 3.9% in November to 4.0% in December; it had been forecast to slow to 3.8%.

The main sources of the upward surprise were services costs and alcohol and tobacco prices. But the details weren't as bad as the headline suggests because food and energy inflation continued to edge lower. Economic research business Capital Economics believes that the headline rate should be close to the 2% target by April as past large price rises pass through the annual numbers like an elephant through a snake.

Regardless of Capital Economics' reasonable take (which we broadly agree with), the inflation release sent stock and bond markets tumbling as traders re-evaluated just how much and how fast the Bank of England (BoE) will cut interest rates this year. The 10-year UK Treasury bond yield rose from 3.8% a week earlier to roughly 4%. Around Christmas it had traded around 3.5%.

Interestingly, this inflation miss was followed by an even bigger disappointment in British retail sales. They were dreadful. December sales volumes fell 3.2% from November; economists had forecast a drop of just 0.5%. Excluding fuel, the fall was slightly larger, at 3.3%. UK retail sales volumes are now at their lowest level since May 2020 when the economy was under its first set of COVID-19 lockdowns. Sales fell in every one of the seven subsectors. The biggest fall came from non-food stores which dropped 3.9%. A partial explanation could be that some Christmas shopping was frontloaded in November, when there were some heavy and lengthy discounting periods around Black Friday, a trend we've imported from the US. However, the size of this December fall outweighs the (upwardly revised) 1.4% month-on-month rise in November's sales volumes.

The BoE's credit conditions report also gave little reason for optimism. Although, it didn't suggest things were necessarily getting any worse. It showed that it was slightly easier for households to get loans secured on houses and cars after a run of tightening standards, yet banks expected no further improvements in the next couple of months. The modest easing could be due to the large fall in borrowing costs over the tail end of the fourth quarter as bond yields plummeted. Added to that, demand among households for secured loans diminished over the month, which would also encourage banks to offer better terms in order to entice customers. Default rates on these sorts of loans to households increased, and losses from such defaults rose as well.

In one bright spot, OpenTable restaurant bookings were 3% higher than last December, suggesting that at least some of the weakness was due to an ongoing recovery in service sector spending. But, in sum, the retail sales release significantly increases the chance that our economy may have ended 2023 in the mildest of mild recessions. Either way, the UK economy hasn't grown since spring 2022.

Consumer confidence coming up Trumps

We're all sick of inflation and of talking about inflation. Yet it's extremely important for lots of areas of the market. The biggest effect of falling inflation is how it should encourage central banks to lower interest rates, thereby boosting stock and bond prices and reducing the strain of increased costs on indebted households and businesses (and governments). However, even before that, it can have a big effect on the people's mood. Since the pandemic, consumer confidence measures have remained substantially below where they had been, especially considering how economies have fared (i.e. no recessions).

This has been particularly acute in the US. The country has boomed in the past few years, yet households have remained very gloomy indeed. Now, in January, while inflation has popped higher and frightened investors, the longer-term, fairly swift downward trend in inflation has done wonders for consumers' optimism. The first University of Michigan Consumer Sentiment release of 2024 soared more than nine index points to 78.8 – far and away the highest level since 2021. Taking January and December together, consumer sentiment climbed 29%, the largest two-month increase since 1991 when a recession ended. Still, that only brings the index back to a fairly middling level of confidence. It also brings the University of Michigan survey back into line with the Conference Board's gauge of consumer confidence, which is influenced less by consumers' perception of prices. In other words, it might be more noise than signal.

While a fall in inflation seems the likeliest and most by-the-book economic argument for the surge in consumer sentiment, there is another possible driver: Trump fever. US confidence measures have bifurcated massively along political lines since President Joe Biden moved into the White House. Republicans have been catatonic, Democrats have been exultant and undecideds/independents have been roughly in the middle. However, the Republicans' hustings for November's presidential candidate are well under way and former President Donald Trump has blasted out of the traps with an overwhelming lead. While the optimism of people has increased dramatically over the past couple of months, regardless of their political affiliation, Republicans' measure rose by far the most, closely followed by independents.

Since 2020, the University of Michigan survey has been a very poor guide to actual consumer spending, breaking from a strong track record before that. The Conference Board's measure has fared better, but it hasn't been as useful as it was previously either (we'll be watching the next release of that data next Tuesday). That said, this time, the University of Michigan survey's bounce was backed up by American retail sales. December sales rose 0.6% month-on-month and followed a healthy 0.3% rise in November. The month's trading outstripped retailers' own forecasts and posted a 5.6% rise on a year earlier. The annual comparison is enlightening, as it shows that Americans spent about 7% less on petrol, helped by lower oil prices, and splurged more than 10% extra on going out to restaurants and bars, buying electronics and appliances, health and personal care for themselves and on fixing up their cars.

There's a bit of time for people to ponder what this means for the path of American interest rates. The next US Federal Reserve (Fed) meeting and press conference aren't until 30 and 31 January. In the meantime, there's a blizzard of economic releases on the way, along with the bulk of fourth-quarter earnings reports. The first estimate of US Q4 GDP is expected to show the annualised growth rate more than halving to around 2% from 4.9% in Q3. US PCE inflation data (which is favoured by the Fed) is forecast to stay flat at 2.6%, and American personal income growth is expected to fade slightly to 0.3% in December from 0.4% in November. On Tuesday, the Bank of Japan meets as commentators increasingly call its negative interest rate unsustainable. Then, on Thursday, the European Central Bank meets to discuss monetary policy and most likely leave its interest rate unchanged.

Finally, if you missed last week's webinar where our co-chief investment officer Ed Smith and head of equities Sanjiv Tumkur discussed the key questions facing investors in 2024, **you can watch the recording here.**

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.