TIME TO CUT?

REVIEW OF THE WEEK
29 JULY 2024

AFTER MONTHS OF WAITING, THERE'S A STRONG CHANCE THAT INTEREST RATES MAY FALL IN THE UK THIS WEEK. ACROSS THE ATLANTIC, THE LONGED-FOR CUTS WON'T BE TILL THE AUTUMN, IF MARKETS ARE CORRECT.

The Bank of England's (BoE) interest-rate-setting committee meets on Thursday – it will be the second time this summer that it will have done so with inflation meeting its 2% target. According to markets for future interest rates, there's a roughly 60% chance of a quarter-percentage-point cut to 5.0%.

While headline inflation is back to normal, it obscures a more complicated picture. Goods prices are falling swiftly, while prices for services (like bars, restaurants, hairdressers and mechanics) are still rising by a stubbornly high 5.7%. Services prices tend to be more sensitive to wage increases – indeed, salaries are rising at 5.7% as well.

While we think wage pressures should be easing, there are some risks that they could reaccelerate. A few commentators are concerned about the government's soon-to-be announced decision on pay rises for almost 2 million NHS workers and teachers (around 6% of the workforce). Independent review boards have recommended 5.5% hikes for the current year. The government's current budget assumes 3% increases. But a 5.5% pay rise would add only around 0.1% to national salary growth – hardly an inflationary shock. If this were extended to another 4 million public servants (police, prison officers, the armed forces and other civil servants) we're talking about a more meaningful number, which would also come with the risk of private sector workers demanding greater pay rises as their bargaining behaviour is influenced by such highly publicised deals.

As we write, the Labour government has just agreed, with the British Medical Association, a pay deal for junior doctors in England worth 22% on average over two years – more than the Conservative government had offered but less than the 35% sought by the union.

This pay increase and others that come will strain government finances that are already incredibly taut. To pay for them will require cuts elsewhere, higher taxes, more borrowing or a combination of these. New Chancellor Rachel Reeves kicked off the week briefing journalists that the financial situation is even more dire than what has been reported to the Office for Budget Responsibility, something that is strenuously denied by former Chancellor Jeremy Hunt. The BBC reports that Reeves is due to release a Treasury report outlining a £20 billion deficit between tax revenues and forecast spending. Several investment projects are apparently due to be axed while the government paves the way for tax hikes in the first Budget in the autumn. **We've outlined some areas of personal taxation, pensions and investment where Labour could raise taxes**, if you're interested. Enacting these would provide some disinflationary offsets.

The BoE committee's calculus is made even tougher by unexpectedly high GDP growth of 0.7% in the first quarter, or 2.8% annualised, as the UK bounced back from a mild recession in the second half of the year. While this is only one quarter, it's tied with the US as the strongest growth in the G7, a group of the largest advanced economies. If demand in the economy continues to expand at near that pace and businesses can't keep up, it could soon lead to higher prices and reaccelerating inflation as more money chases the inadequate supply. To prevent this from happening and allow domestic production and trade from abroad to deliver what our society needs, various things would help: structural reform programmes that improve infrastructure, smoother processes with our largest trading partners, more homes and better transport networks. But these things don't happen overnight – and most cost a lot of money.

Yet interest rates at the highest in decades can dissuade governments and businesses from investing in these areas (news that the government is looking to cut back on investment is a disappointing and apt example). The BoE must get the balance right between preventing a resurgence in household spending from reheating inflation, and easing pressure on indebted households and making the environment more attractive to investment to bolster the economy's long-term capacity.

While personal finance decisions are less grand than central bank decrees, they are no less fraught and momentous for the people making them. This is especially true for young people who often find it hard to know where to start. We think it's crucial that people learn how finance works early so they can use it to their advantage, which is why we hold regular **financial awareness courses for 16 to 25-year-olds**. If you or anyone you know think this would be useful, the **next one is on 8 August**.

American rate cuts not yet ripe

The US Federal Reserve (Fed) will also decide whether to cut rates this week. Like the UK, it's dealing with very high services inflation and a shock improvement in GDP growth (Q2 expansion was revised up from 2.0% to 2.8% annualised last week). But unlike the UK, its headline CPI inflation (which is the measure most comparable to other nations' inflation) is at 3.0%

The Fed prefers a different inflation metric, though. PCE inflation is also above the 2% target, but it's much closer, at 2.5%. On this measure, housing costs are finally moderating noticeably after a very long wait, which would be a boon for the central bank. Still, this good news is likely to bear the fruit of lower rates in September, not at this Wednesday's meeting.

While the US is still running hot, there are growing signs that it is not as healthy as aggregates and averages may suggest. The nation's unemployment rate has risen year to date, from 3.7% to 4.1%, and hiring and wage growth have slowed as the once-in-a-generation boom that followed the pandemic starts to fade.

While the looming US election on 5 November sounds like a complication – independent central banks try their utmost to remain politically neutral – it's actually unlikely to affect interest rate decisions west of the Atlantic. It's a case of cultural differences. Whereas the BoE shows its neutrality by studiously keeping rates as they are in the months ahead of an election, the Fed takes a more brash approach: it just carries on as if nothing is happening!

Since 1980, it has changed rates ahead of every election bar 2012, when rates were already at zero (it plumped instead for restarting quantitative easing, another form of monetary loosening, that year instead). With that track record, it would be weird if the Fed *didn't* cut rates if conditions warranted it. In contrast, in the seven elections since the BoE was granted independence it changed rates ahead of an election only once. It cut them by 50bps ahead of the 2001 election when inflation was falling to close to zero, the fallout from the burst dotcom bubble was spreading and foot in mouth disease was plaguing the country. In short, when the sky appeared to be falling.

When the Fed does start to cut rates, it will usher in the next phase of a financial cycle that has been starkly different to the one that came before. We think that investors will need to take a different approach to what was successful in the past decade. **With rates and inflation likely to remain higher, the lessons of the past could become extremely valuable**.

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.

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