RATHBONES

CENTRAL BANKS PAUSE FOR THOUGHT

REVIEW OF THE WEEK
25 SEPTEMBER 2023

LAST WEEK'S ROUND OF CENTRAL BANK MEETINGS SENT A MAINLY CONSISTENT MESSAGE. MOST HELD INTEREST RATES ON HOLD AND SUGGESTED RATES ARE NOW AT (OR VERY NEAR) THEIR PEAKS.

By and large, most of the world's biggest central banks seem united in the hope that interest rates have now peaked at levels where they can plateau for some time. Last Thursday, the Bank of England (BoE) unexpectedly followed the lead set by the Federal Reserve (Fed) and opted to keep rates on hold rather than raising them again. Switzerland's central bank paused too. Sweden's Riksbank went for another hike, but strongly hinted that it was near halting its run of rate rises. The one exception to the pausing rates 'higher for longer' message came from the Bank of Japan which, yet again, opted to stick with negative interest rates for now. This wasn't much of a shock as it's been clinging to negative rates for the last seven years.

The BoE had been widely expected to raise again until headline consumer price inflation data, released on Wednesday, showed its annual rate had dropped to 6.7%, down from 6.8% in July.

That too came as a surprise: it had been anticipated that the recent rally in oil prices would drive CPI up a bit. Even more significantly, 'core' price inflation, which excludes volatile food and energy, fell sharply to 5.9%, down from 6.4% in July. Recent producer price data suggest that significant further falls in food and goods inflation are likely. The global shocks to these prices from the war in Ukraine and the pandemic have largely unwound. And already-announced changes in Ofgem's energy price cap mean that utility bills will further push headline inflation down in the UK later this year too.

It's true that annual wage growth in the UK remains way above levels consistent with the BoE's 2% inflation target, with growth in regular pay recently accelerating to 7.8%.

The Monetary Policy Committee meeting notes that followed the BoE's rate decision pointed out that a lot of the data it's been looking at have proved "erratic". In particular, it noted that the widely followed average weekly earnings figures have been stronger than other measures of pay growth (including experimental payroll data from the tax office, which we've been tracking recently and think could provide a more reliable guide to what's really going on). In addition, the blowout in pay inflation has been buoyed up recently by one-offs, like a large increase in the National Living Wage and a bonus paid to NHS staff.

Meanwhile, there's evidence that the UK labour market, though very tight, has begun to loosen. The unemployment rate has risen from last year's multi-decade lows, while the rate of unfilled job vacancies has fallen. Surveys show that firms have reined in their hiring plans, even as it has become easier to find qualified candidates. The labour market is likely to loosen even further in time and this is likely to cause wage growth to fall. We've already seen this beginning to happen elsewhere, including in the US, even if it hasn't taken place as quickly as central bankers would have liked.

Are recession risks rising in the UK?

There's more general evidence of the UK economy losing its momentum. The monthly GDP numbers can be volatile, but the 0.5% month-on-month drop in GDP in July really stood out. Since then, more timely business survey data released on Friday (which the BoE had seen and factored into its decision to keep rates on hold) fell to its weakest level since the pandemic lockdown in January 2021. In addition, house prices are dropping at their fastest rate since the Global Financial Crisis (GFC) and consumers tend to be cautious when house prices fall. That's all consistent with an environment of weakening domestic price pressures, reinforcing our view that a disinflationary economic downturn is the most likely outcome for the UK over the next 12 months.

Nevertheless, rate cuts aren't likely just yet. **As we outlined last week, BoE Chief Economist Huw Pill has been arguing for a phase in which the path of rates looks more like the flat-topped Table Mountain than the super-steep Matterhorn.** It would be tricky for the BoE to justify rate cuts when inflation is still so far above its target, but rate cuts could plausibly come on to the agenda in mid-2024.

By then, our analysis suggests inflation in the UK could be back in the low single digits. Historically, the median gap between the last rate hike of a raising cycle and the first subsequent cut has been seven and a half months in the UK so a mid-year cut wouldn't be unusually quick. There have been gaps that have lasted well over a year, but not many

(only two in the last 16 major UK rates cycles). In addition, rates have historically nearly always fallen in the years after house prices have started to drop.

In our view, all this adds to the tactical appeal of longer-dated UK government bonds (gilts). In past cycles, longer-dated gilts have performed strongly between the end of rate increases and the start of rate cuts.

We'll be giving a more detailed outlook on where we think financial markets are headed, and where we see the greatest risks and opportunities, in our next *Quarterly Investment Update* which will be available later this week.

Can the Fed pull off a super-soft landing?

Fed Chair Jerome Powell unveiled new economic forecasts after keeping the central bank's benchmark interest rate on hold at a range of between 5.25% and 5.5% on Wednesday. These suggest that the American economy is proving more robust than the Fed itself had expected. GDP is now expected to be higher, while the unemployment rate is expected to be lower and inflation is expected to continue slowing towards the Fed's target.

So far, the Fed seems to have managed to pull off very significant policy tightening with much less fallout for growth and employment compared with previous US inflation battles. That's led US equity markets to price in an economic 'soft landing' that's helped prop up stock prices for much of this year. The key question is: can this continue?

Some significant near-term headwinds, including the big auto-workers' strike, higher energy prices, the resumption of student loan payments after a pause of more than three years, and a possible government shutdown, are looming. All this, together with the cumulative effect of the last couple of years of very big rate rises, could ending up sapping the strength of the so-far resilient US economy.

A prolonged period of very tight monetary policy has historically very rarely (if ever) ended in anything other than rising unemployment and economic contraction. A super-soft landing for the US economy is certainly *possible*, but we continue to question whether it's *probable*.

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.

The content contained in this document is for information purposes only and does not constitute as a recommendation to purchase any product or service, you should always take appropriate advice from a professional, who has made an evaluation at the point of investing. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested. Tax treatments depend on the individual circumstances of each client and may be subject to change in the future. Cashflow planning is based on assumptions and can only give an indication as to what may happen. They are not guarantees.

Important information. The content contained in this document is for information purposes only and does not constitute as a recommendation to purchase any product or service, you should always take appropriate advice from a professional, who has made an evaluation at the point of investing. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested. Tax treatments depend on the individual circumstances of each client and may be subject to change in the future. Cashflow planning is based on assumptions and can only give an indication as to what may happen. They are not guarantees.

Rathbones and Rathbone Financial Planning are trading names of Rathbones Investment Management Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. Registered in England No. 01448919. Rathbones Trust Company Limited is authorised and regulated by the Solicitors Regulation Authority. It should be noted that any services provided by Rathbones Trust Company and some services from Rathbones Financial Planning are not regulated by either the Financial Conduct Authority nor the Prudential Regulation Authority. Registered office: 8 Finsbury Circus, London EC2M 7AZ. Registered in England No. 01688. Copyright ©2023 Rathbones Group Plc.