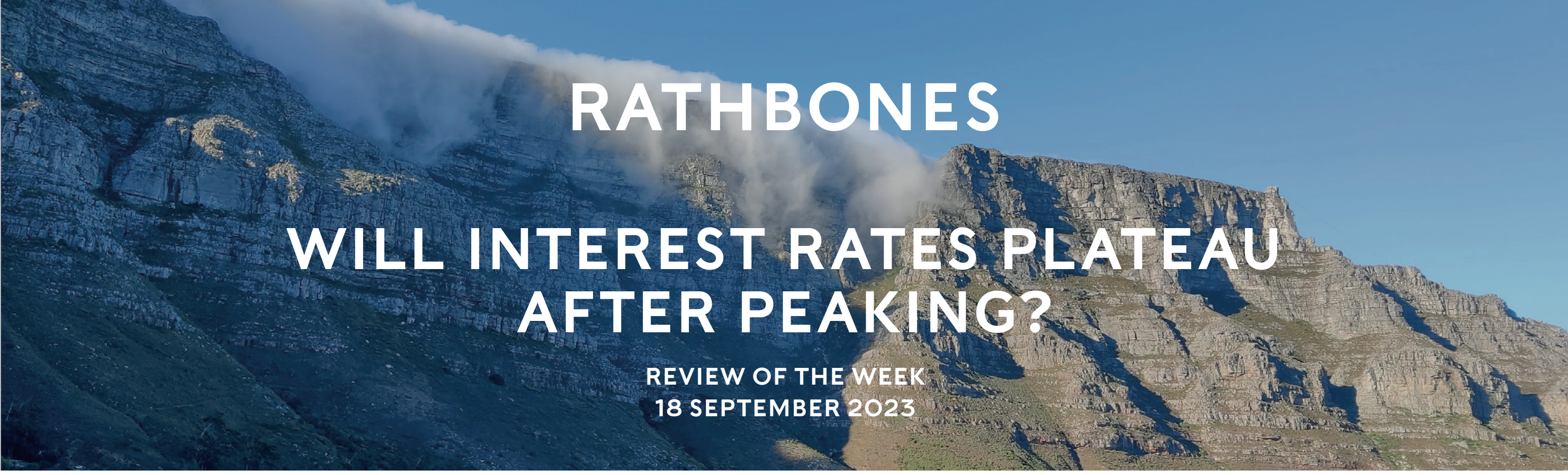

RATHBONES

WILL INTEREST RATES PLATEAU AFTER PEAKING?

REVIEW OF THE WEEK
18 SEPTEMBER 2023

WILL THE BIG CENTRAL BANKS MAKING SIGNIFICANT INTEREST RATE ANNOUNCEMENTS THIS WEEK FOLLOW THE ECB'S LEAD AND SIGNAL THAT RATES HAVE NOW PEAKED? AND WHERE MIGHT RATES SETTLE LONGER TERM?

The US Federal Reserve (Fed), Bank of England (BoE), and Bank of Japan (BoJ) will all be delivering their latest interest rate announcements this week amid a new ratcheting up of inflation worries. Rate decisions are also due from the central banks of Norway, Sweden, and Switzerland.

The Fed is widely expected to keep rates on hold at 5.5% on Wednesday. There's less certainty about whether it will pause on hiking again at meetings later in the year amid concerns that spiking energy prices could drive a nasty upward lurch in inflation. When the US inflation rate in August came in higher than expected (headline consumer prices rose at an annual rate of 3.7%, up from July's 3.2%), more than half the monthly increase seemed to have been driven by higher petrol prices. The news on core inflation, which excludes volatile energy and food prices, was more encouraging: it fell to 4.3% in August, down from 4.7% the month before. Even if the Fed hikes maybe once more time this year, investors are hoping it's gradually transitioning to a 'rates on hold' phase that eventually clears the way for rate cuts.

Meanwhile, despite growing signs that the UK's economy could be veering towards a recession (though we think a mild one would be most likely), the BoE is widely expected to deliver its 15th consecutive rate increase when it meets on Thursday, bringing rates to 5.5%. That could change if August's inflation figures, due the day before, show that inflation has dropped significantly. But that seems pretty unlikely. The way the energy market works in the UK will probably shield us from some of the rise in energy prices, but economists recently polled by Reuters are predicting that the headline rate of inflation will have accelerated last month to around 7%. They expect core inflation to stay at June's level of 6.8%.

Could rates get stuck on top of Table Mountain?

Will a BoE hike on Thursday mark the peak in the bank's current rate-hiking cycle? That's still not clear, though BoE Governor Andrew Bailey has said that UK rates are now "much nearer" that peak. When the European Central Bank (ECB) hiked rates by a further quarter percentage point last week, it signalled that this was likely to be its last hike for now. But it also said that it expects its battle to tame inflation will be successful only if it maintains higher rates "for a sufficiently long duration" – in other words, it isn't contemplating cutting rates any time soon and favours keeping them higher for longer.

Keeping interest rates like a "Table Mountain," as BoE Chief Economist Huw Pill described it in a speech at the end of August, is fast becoming the mantra of all the big central banks as they keep warning that the rate-hiking of the last couple of years isn't going to be reversed swiftly. Pill outlined two routes to taming inflation and getting it decisively down to central banks' target of around 2%. One is a Matterhorn model, named after the vertiginous mountain in the Alps, and involves rates soaring quickly and then falling sharply. The second, which he favours, looks more like Cape Town's flat-topped Table Mountain and involves rates peaking at a lower level and then plateauing at a high altitude for a considerable period.

Ambling around the top of Table Mountain sounds a lot less frenetic than trying to scale the Matterhorn. But financial markets have been far from sedate in recent months as stock and bond prices have swung wildly in response to conflicting signals from GDP data, indicators on the health of the jobs market and the inflation rate and so on. The more vibrant economies look, the more nervous investors become about inflation reaccelerating and central bankers hiking interest rates further. The more economies appear to be fading, the more prevailing bond yields (which run in the opposite direction to prices) drop back and the more relaxed investors become about owning stocks.

All this is driving a lot of short-term volatility while investors stay fixated on trying to guess when rates will peak. Moreover, they aren't yet reconciled to the idea that rates could get stuck at high levels for quite a while. They're still pricing in rate cuts in the US in the first half of 2024 and expecting them in both the UK and in Europe later in the year. Financial markets could stay feverish until investors stop focusing so intently on the prospect of rates hitting a Matterhorn peak and then falling fast and start getting behind central banks' Table Mountain mindset.

The new (old) normal?

Of course, there are clear risks that central banks may have already pushed rates so high that things are nearing breaking point and they could be forced to cut them fast to try to prevent economies from tanking. These risks are most acute in the UK and Europe, which seem closer to heading for the kind of economic downturn that the US has swerved so far.

The US economy is slowing a bit, but it's still defying the doomsters and powering ahead like a Duracell bunny (albeit one whose battery might be losing some juice). By contrast, Europe tipped into recession (two successive quarters of shrinking GDP) earlier this year. And while the UK economy has been holding up better, it shrank by 0.5% in July – much more than expected - as strikes hit productivity and miserable weather kept people at home rather than out-and-about and spending.

But even if we do get a recession, rates may stay quite a bit higher than we've been used to over the last 15 years or so. It's important to remember that recent interest rate policy has been very, very unusual. Today's rates, while painfully high compared with the last decade and a half, are only just creeping up to the very low end of a 'normal' rate compared with previous decades.

Before the pandemic hit, central banks were edging away from the ultra-low rates of the post-Global Financial Crisis years. Look back to 2017 and 2018 when central banks, led by the Fed, tentatively began to raise rates from their extreme lows. This marked the start of a process of 'normalising' rates that was, of course, halted abruptly when the pandemic struck.

We may well now be looking at a period when rates plateau for quite a while after they hit their peak. This will involve getting used to a 'new normal' in which higher rates are here to stay. This will have important implications for the investment returns likely to be generated by stocks, bonds, cash and a wide range of 'alternative' asset classes.

We'll be exploring some of these implications in depth in our next Investment Insights publication, which will be available in early October.

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