Santander Asset Management

State of Play

Pause for thought?

27 July 2023

Last month, the Federal Reserve decided to pause rate rises following an aggressive approach to monetary tightening, where they have raised rates at every meeting since March 2022. Finally, after many months of high inflation, rising prices appear to be cooling, therefore vindicating their approach. However, policymakers made a promise to investors at their last meeting to continue raising rates until the battle with inflation is won. Will this week's Federal Open Market Committee Meeting (FOMC) make them pause for thought? Simon Durling from Santander Asset Management shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

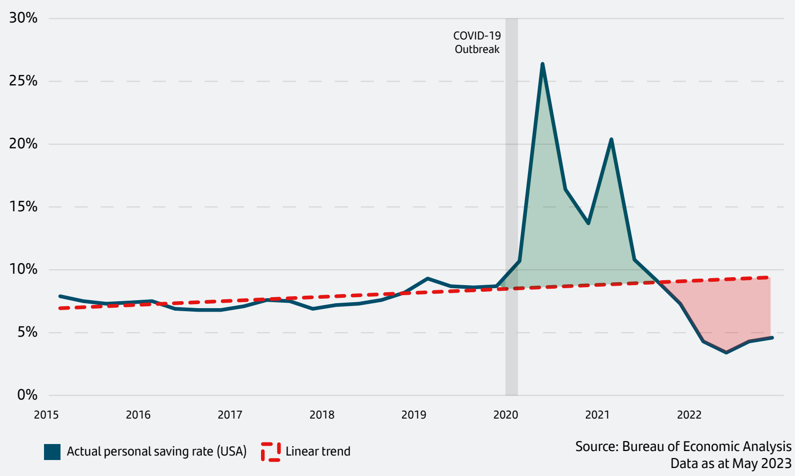
- Is it time to hold tight?
- Fed decision on interest rates
- Market update

Is it time to hold tight?

Last month saw the Federal Reserve (Fed) pause interest rate rises for the first time since March 2022. Over the last year and a half, the Fed has tightened at a breath-taking pace with one single objective in mind: taming high inflation. The dilemma now facing the Federal Open Market Committee (FOMC) is the balance between protecting their credibility and missing the opportunity to be pragmatic. At their last meeting, they informed market participants of their intention to raise rates at this week's meeting. This mindset triggers a scenario I once had described to me: When you hold a hammer in your hand, all you see is nails. The relentless and unwavering focus on tackling rising prices has the potential to blind pragmatic thinking when some obvious signs allow them the option to actively 'do nothing'. Let me explain in more detail what decision-makers face before we reflect on the choices they make.

Whatever decision the FOMC makes this week, if they were marking their own homework, I suspect secretly they would grade their approach over the last 18 months as a 'D-minus' at the beginning (for being late to react and wrong in their initial assessment of inflation) before reaching at least an 'A-minus' in recent weeks. The Federal Reserve should feel vindicated in its decision to be aggressive in rate rises since they embarked on their challenge. Last month, the latest data showed US inflation is finally starting to cool significantly. The consumer price index (CPI) rose a mere 3% in the twelve months to June, down sharply from a peak of 9.1% in June 2022, with producer price increases slowing even faster.[1] Even with such a rapid rise in rates, the US economy remains robust, with unemployment at just 3.6% and a further 200,000 new jobs created in June alone.

Aggregate personal savings versus the pre-pandemic trend

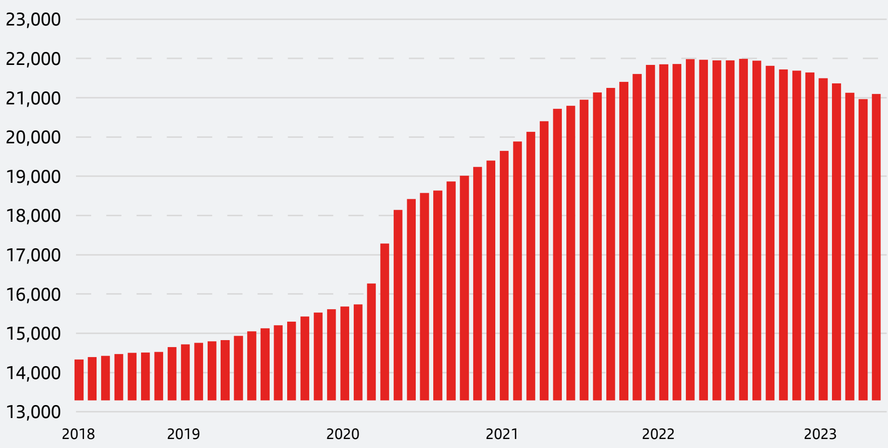


Source: Bureau of Economic Analysis
Data as at May 2023

So, what signals could help persuade the FED to extend their time pressing the pause button? Firstly, data measuring the money supply in the US fell by 4.6% over the previous 12 months, which is the first decrease since the Fed started measuring this in 1959.[2] The US economy needs time to adjust to the new normal. Interest rate rises, like in the UK, take time to impact disposable incomes and cool consumer spending. Individuals and businesses have relied more on fixed-rate financing for their homes and businesses in recent years, so inevitably there will be a lag in the impact. Additionally, one aspect that remains important is disposable household savings. Typically, this had been growing at a very stable rate for many years until the pandemic emerged. When restrictions were imposed in the US (and elsewhere in the world), individuals had to work from home, they were unable to access many goods and services and spent less money travelling and commuting, confined to their homes with family. During this period, individuals saved more disposable income than in the preceding 20 years, which in the US, was an enormous $2.6 trillion.[3]

So, why is this important? When restrictions ended, while there was the expected surge in demand for things unavailable during lockdown, which triggered the initial reappearance of inflation, much of these savings took time to be used, supporting demand in the economy long after price rises began rocketing. If you look at the chart, since then, the build-up of savings has started to be spent, reducing this pot of wealth in the US by $1.6 trillion.[3] Clearly, this disposable savings is not the sole reason for the slow pace at which inflation began to ease. Higher wage settlements fuel greater consumer demand and higher costs for raw materials (although down from last year's peak) remain baked into the price of many goods and services. Only energy costs (which are outside of the core calculation) have returned to pre-pandemic levels. What the savings insights and money supply data tell us is, even with rising mortgage payments from the rise in interest rates, the economy is performing much better than anybody had anticipated, and inflation is beginning to slow. Policymakers should have more confidence about pressing pause sooner rather than later. Many months ago, policymakers described the ideal scenario of raising rates to tame inflation while avoiding pushing the economy into recession – a soft landing. They appear to have achieved this and other trends provide hope that inflation can be meaningfully reduced if not defeated without choking off the economy, so long as the Fed does not overshoot.

The US M2 Money Stock



Source: Federal Reserve
Data as at June 2023

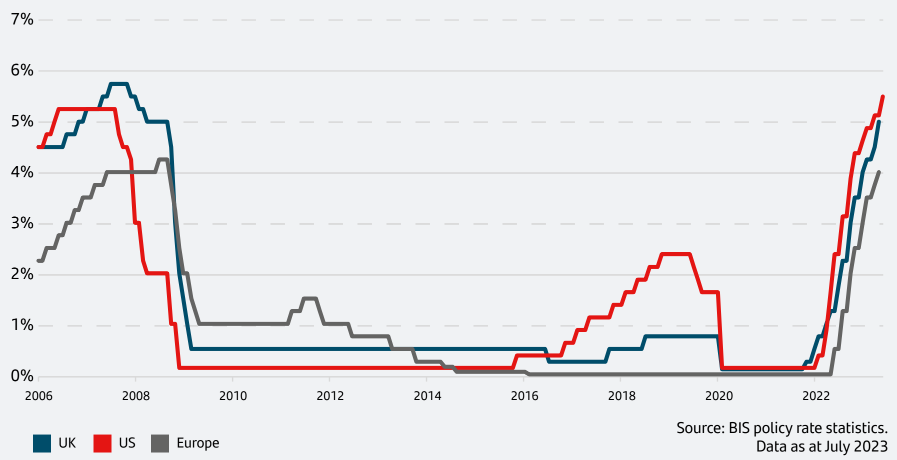
The US M2 Money Stock is critical in understanding and forecasting money supply, inflation, and interest rates in the US. Historically, when the money supply dramatically increased in global economies, there would be a dramatic increase in the prices of goods and services, which would then follow monetary policy with the aim of keeping inflation levels low.

Fed decision on interest rates

As expected, the Federal Open Market Committee decided to increase interest rates by 0.25%, taking them to their highest level in 22 years.[4] While the decision was to increase in this meeting, they left the door open for future meetings, sparking speculation that rates have reached their peak. However, in their statement and subsequent press conference, the Chair of the Fed, Jerome Powell, explained that they intend to monitor the economic data and if necessary, increase rates again in 8 weeks' time when they meet in September to decide their next move. The committee remains concerned about a tight employment market, with unemployment still at near record lows of 3.6%. In a statement following the decision, the Fed's rate-setters said: "In assessing the appropriate stance of monetary policy, the committee will continue to monitor the implications of incoming information for the economic outlook. The committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the committee's goals."

So far, since the Fed started raising rates, their primary goal has been to bring down inflation, and they would be prepared to do what it takes to achieve this. The approach appears to be working, as price rises have cooled from their peak and remain just 1% above their 2% long-term target. Commentators have described the soft landing as the 'immaculate disinflation', which, put simply, is what I described earlier. Reducing inflation without crashing or sending the economy into a sharp recession. Some have said this couldn't be done and this amounts to a magic trick considering the events of the last three years. However, so far, although it is too early to tell how the monetary tightening will affect the economy in the next few months, their magic appears to be more than an illusion.

Interest rates



Source: BIS policy rate statistics.
Data as at July 2023

Market update

Investment markets were unmoved by the Fed decision at the time of writing. This week saw a busy week of earnings, with some of the 'magnificent seven' (Apple, Google, and META – formerly Facebook) reporting their latest results. So far this year, the US market has outperformed the UK, but with a huge concentration of returns. According to the MSCI World Index, over half of this year's returns have been delivered by just 10 companies.[5] While the UK has lagged other international markets, last week saw the best week since the start of the year, with the FTSE 100 rising over 3% as investors repriced shares following the larger drop in inflation numbers than had been predicted.[6] Perhaps more importantly, this also saw a sharp drop in bond yields, which led to a rally in values. As I have explained many times previously, when bond values rise, bond yields fall and vice versa. All eyes now turn to tomorrow's Bank of Japan meeting to decide their next move, with many expecting policymakers to maintain their low interest rate stance despite the new Governor appointed in April pledging to implement a new strategy to help their economy escape the current controlled and restrictive regime. For UK investors, next week's Bank of England Monetary Policy Committee meeting on Thursday and subsequent decision on interest rates will weigh on people's minds. There is consensus on a rate rise, but differences of opinion about how much. Many expect the bank to follow on from last month's surprise 0.5% hike with a further 0.25% rise, but others see a repeat of last month. UK policymakers face some subtler and more local challenges and a less resilient economy than the US. With more than a million people face with refinancing their current fixed-rate mortgages over the next 18 months, rate rises have been slow to impact consumer demand, but there are signs the medicine is beginning to work. While it would appear the UK has avoided the very gloomy Bank of England predictions of a 15-months recession, UK consumers and businesses are arguably under greater pressure than their US counterparts and achieving the 'immaculate disinflation' described earlier seems more like an economic miracle than a magic trick. We will wait and see what they decide, and probably more important, how investors react to policymakers' journey 'back to normal'.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

Note: Data as at 27 July 2023.

[1] Federal Reserve, 26 July 2023
[2] Federal Reserve Bank of St. Louis, 30 June 2023
[3] Bureau of Economic Analysis, 31 May 2023
[4] Federal Reserve, 26 July 2023
[5] MSCI World Index, 26 July 2023
[6] Investing.com, 26 July 2023

Asset Management

A Week in the Markets

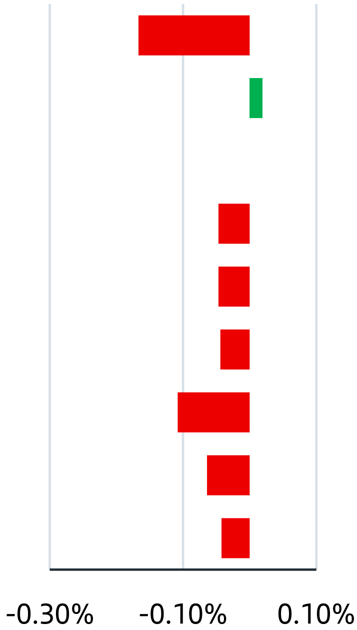
Performance

Index	Value	Change	%	12 Month High	12 Month Low
FTSE 100	7,664	229.16	3.08%	8,014	6,826
FTSE 250	19,200	633.64	3.41%	20,615	16,611
Dow Jones Industry	35,228	718.66	2.08%	35,228	28,726
S&P 500	4,536	30.92	0.69%	4,566	3,577
NASDAQ	15,426	-139.93	-0.90%	15,841	10,679
Hang Seng	19,075	-338.52	-1.74%	22,689	14,687
Nikkei 225	19,075	-338.52	-1.74%	22,689	14,687
CAC 40	7,433	58.23	0.79%	7,577	5,677
DAX	16,177	72.15	0.45%	16,358	11,976
FTSE Eurofirst 300 Eurozone	2,481	32.82	1.34%	2,547	1,950
S&P TSX Composite Index	20,548	285.44	1.41%	20,767	18,206
Commodity markets*					
Gold	$1,960.65	1.40	0.07%	$2,047.01	$1,628.00
Crude Oil	$80.89	1.24	1.56%	$112.70	$70.96

Source: Eikon, prices displayed in the local currency.
*Gold Bullion London Bullion Market $ Per Metric Tonne Ounce Delay & Brent Forties and Oseberg Dated Free on Board Northsea Crude used for commodity performance.
Source Data from the 17 July 2023 to 21 July 2023.

10-year bond yields

Country		Variation	12 Month High	12 Month Low
UK	4.28%		4.67%	1.81%
US	3.84%		4.23%	2.61%
Japan	0.48%		0.51%	0.17%
Euro	2.43%		2.75%	0.76%
Germany	2.43%		2.75%	0.76%
France	2.99%		3.24%	1.35%
Italy	4.07%		4.82%	2.95%
Spain	3.47%		3.79%	1.86%
China	2.65%		2.99%	2.62%



Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	$1.29	**-0.02%**	$1.31	$1.07
Euro	GBP > EUR	€ 1.16	**-0.01%**	€ 1.20	€ 1.11
Yen	GBP > YEN	¥182.24	**0.55%**	¥183.76	¥154.73

Source: Eikon.

Source Data from the 17 July 2023 to 21 July 2023.

Important Information

For retail distribution.

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