State of Play

Crunch call

21 September 2023

Throughout the last few years, central banks have been under intense pressure to react to a fast-changing economic environment. Initially, they supported individuals and businesses when the global pandemic emerged by cutting the cost of borrowing. They then rapidly reversed this approach in order to combat inflation. As they approach the expected peak in interest rates, what are the risks of going too far, and importantly, what could be the consequences for both investors and borrowers? Simon Durling, from Santander Asset Management, shares his thoughts in this week's State of Play.

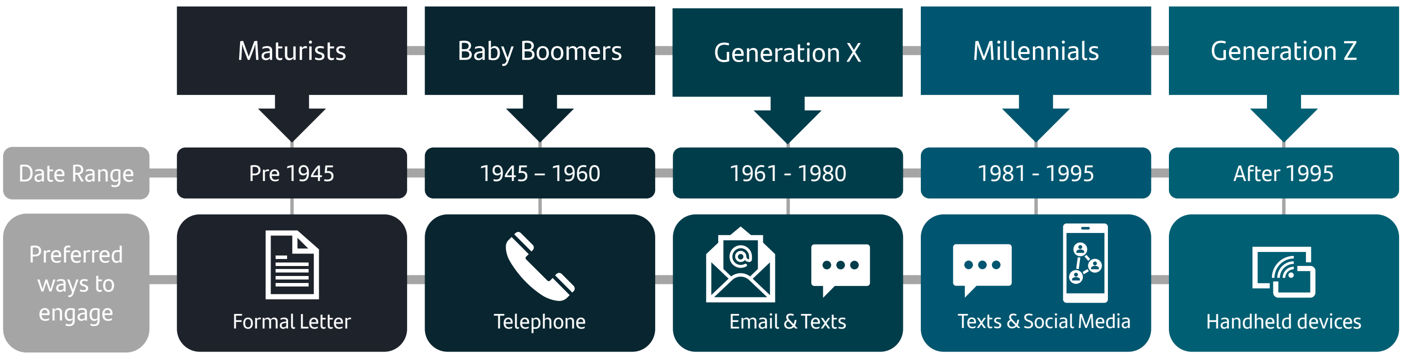
Key highlights from this week's State of Play

- Squeezing too tight
- Latest UK inflation data
- Federal Reserve rate decision
- Bank of England rate decision

Squeezing too tight

As I am sure you will bear witness, the last couple of years have been a shock to our financial system. The diagram shows the breakdown of various generations, depending on when you were born. Most of generation 'Y' and all of generation 'Z' have never lived with anything other than very low interest rates and comparatively low inflation. At the end of the global restrictions, too much demand for goods chased too little supply, pushing up prices. As inflation began to rise, the war in Ukraine exacerbated the problem pushing up commodity prices, especially gas and electricity. Rewind back to Autumn 2021, when the Bank of England's view then was that the return of higher inflation would be temporary, waiting until December to raise rates by just 0.1%, taking the rate to 0.25%.[1] Nearly two years later and 14 consecutive rises in rates, UK interest rates are now 5.25%.

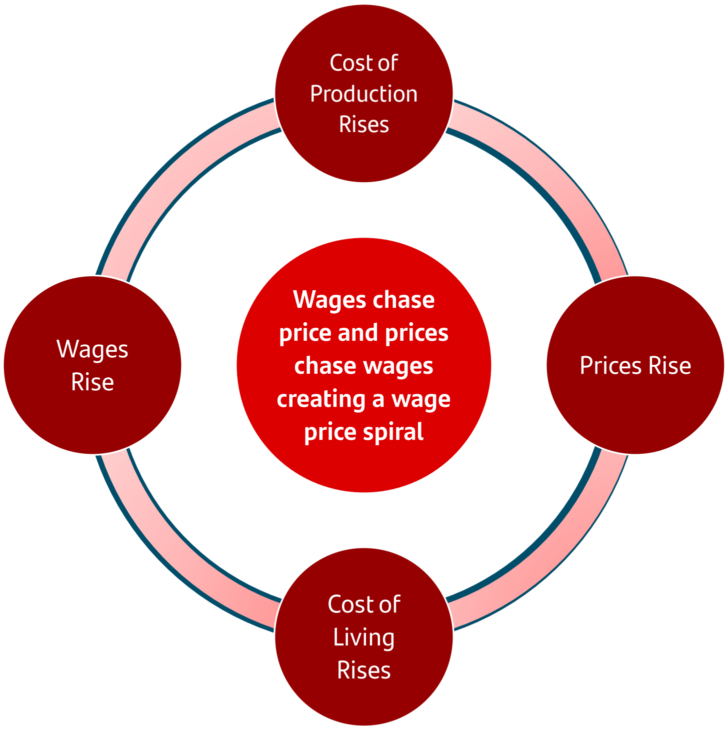
Breaking down generations



Source: Jerome Chamber of Commerce.

Last week, the Office for National Statistics (ONS) announced the UK economy contracted in July by an unexpected -0.5%.[3] Since the Bank of England predicted in early November last year that the UK would suffer from a 15-month recession[4], the economic numbers have been very resilient. While wet weather was highlighted as one of the main causes of the slowdown, policymakers may take this as a sign that higher rates are starting to impact growth and, in turn, bring down rising prices. In many respects, if you combine slower growth, a weakening job market, and headline inflation falling, you would be forgiven for thinking – job done. However, the Monetary Policy Committee (MPC) is very aware that core inflation has risen above headline inflation and wage growth is at record levels, with this month's data showing average wages growing by 8.5%.[5]

As I explained in last week's update, the concern is 'second-round' effects. This is where high inflation triggers the employee to negotiate a higher wage to compensate, and the company passes on this wage rise to the price they charge the consumer. The concern is that this vicious cycle means inflation becomes embedded. Not caused by too much demand chasing too few goods, but by a wage spiral driving up prices. When policymakers then keep raising rates to combat demand, the economy flatlines or goes into recession, but the inflation and wage spiral continue independent of the economic slowdown. If this sounds familiar (depending on what generation you fall into), then it is – it is called 'stagflation'. Stagnant growth and rapidly rising prices can be very destructive and hard to escape from.



Catherine Mann, one of the members of the MPC, said last week in a speech to the Canadian Association for Business Economics[6] that she wants to keep raising rates and is prepared to go too far, rather than not far enough, regardless of the obvious consequences. She believes the risk that inflation becomes embedded is greater than the risk of pushing the economy into a deep recession. Mann is considered the most 'hawkish' member of the committee, which in simple terms means she is in favour of higher interest rates and tighter monetary policy (less money in the financial system) to keep a tight grip on inflation. The alternative is known as a 'dove' – prepared to tolerate higher inflation to keep rates lower and conditions easier for businesses and individuals.

In many respects, this is the battle ahead for the committee. Balancing the need to bring down inflation while avoiding unnecessarily pushing the economy into a deep recession. As you can imagine, writing State of Play involves a lot of research, and from what I have read over the past few weeks, some market commentators have been bold, predicting that the next rise will be the last, and some even say the current level of rates is enough. They argue that higher borrowing costs only lead to more inflation.

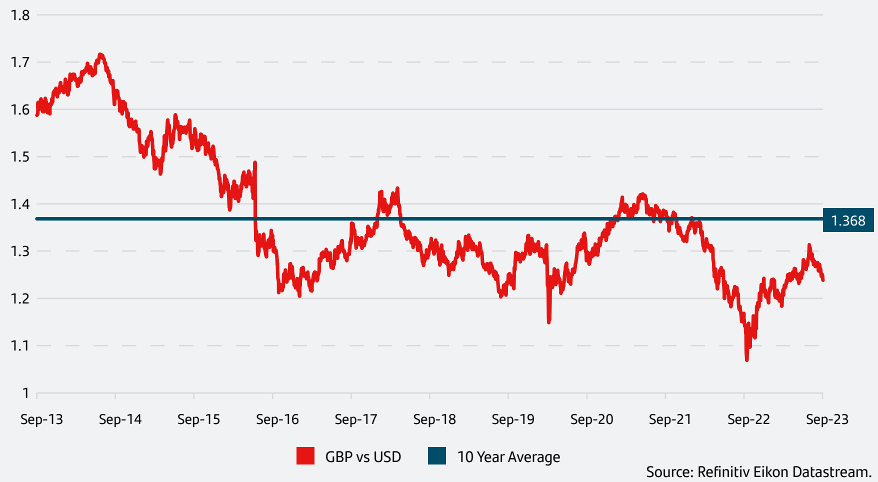
Latest UK inflation data

According to the Office for National Statistics, in the 12 months to August, the Consumer Price Index (CPI) was measured at 6.7%[7], an unexpected small decrease (7.1% was forecast) on last month's reading of 6.8%. Importantly, core inflation, which excludes energy and food costs, fell sharply from 6.9% to 6.2%.[7] The ONS report states, 'The slight easing in the annual inflation rates in August 2023 principally reflected offsetting contributions across six divisions. Large downward effects from restaurants and hotels, food and non-alcoholic beverages, recreation and culture, and furniture and household goods were partially offset by upward contributions from transport, and housing and household services.'[7] Certainly, these latest figures will no doubt be a huge relief to policymakers as they make their crunch calls on interest rates. Next month, we can expect a further fall in the headline rate as the sharp rise in the cost of household energy bills last autumn will drop off the basket of goods calculation.

US Federal Reserve decision

As widely expected, the US Federal Reserve (Fed) decided to pause the rise in interest rates. The Fed Chair, Jerome Powell, warned investors that they may still raise rates again in November and not to expect as many cuts in rates in 2024. While they paused briefly back in June, only to increase again in July, this time round feels different.[8] US inflation has gradually slowed following an aggressive approach taken by the Fed in 2022. While they started increases later than the Bank of England (BoE was December 2021 vs Fed in March 2022), the boldness in the rises, often 0.5% but sometimes 0.75%, appears to have pulled off the impossible – what is known economically as a 'soft landing'. This is where increases in interest rates and monetary tightening (less money in the financial system) bring down inflation but, crucially, avoid sending the economy into recession. The landing strip for this was always seen as very short and very narrow, but they seem to have found a way. The other important consequence of the Fed approach when compared to either the EU or the UK, is the strength of the dollar. All commodities are priced in dollars, which, certainly for the UK, has meant some of the price rises we have witnessed have been simply down to the weakness of the UK pound. While some of this has been reversed since the start of this year as the pound strengthened against the dollar from a low last year of $1.04 in the aftermath of the mini budget crisis, to a high this year of $1.31 (in July 2014 it was $1.70). Since then, it has eased back to $1.24 at the time of writing.[9]

GBP vs USD



Source: Refinitiv Eikon Datastream.
Data as at 15 September 2023.

Bank of England interest rate decision

Following surprise inflation data and economic contraction the MPC were divided when they met to decide on interest rates. Five of the nine members of the committee decided to pause rates, out voting the other four who would have prefer to raise rates once more. The Bank's Governor, Andrew Bailey had the deciding vote, as the committee tried to balance the latest inflation data against backdrop of current economic slowdown. In a statement, Bailey said: "Inflation has fallen a lot in recent months, and we think it will continue to do so. That's welcome news. But there is no room for complacency. We need to be sure inflation returns to normal and we will continue to take the decisions necessary to do just that."[10]

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 21 September 2023.

[1] Bank of England, 9 August 2023
[2] Bank of England, 21 September 2023
[3] Office for National Statistics, 12 September 2023
[4] The Guardian, 3 November 2022
[5] Office for National Statistics, 12 September 2023
[6] Reuters, 12 September
[7] Office for National Statistics, 20 September 2023
[8] Federal Reserve, 20 September 2023
[9] Investing.com, 19 September 2023
[10] Bank of England, 21 September 2023

Asset Management

A Week in the Markets

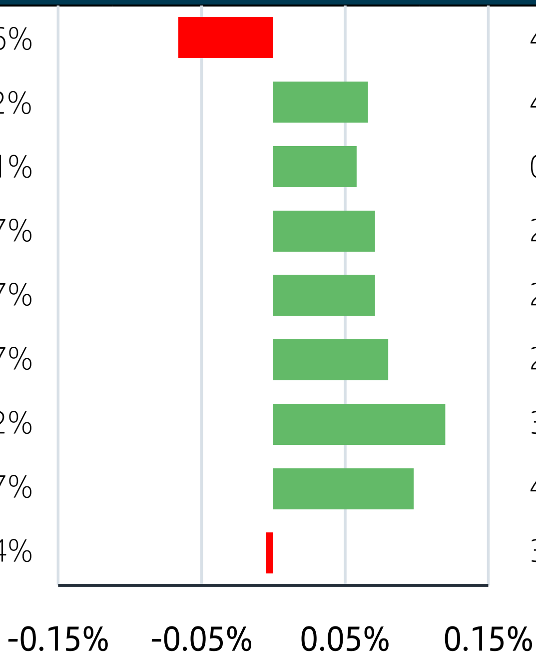
Performance

Index	Value	Change	%	12 Month High	12 Month Low
FTSE 100	7,711	**233**	**3.12%**	8,014	6,826
FTSE 250	18,790	**327**	**1.77%**	20,615	16,611
Dow Jones Industry	34,618	**42**	**0.12%**	35,631	28,726
S&P 500	4,450	**-7**	**-0.16%**	4,589	3,577
NASDAQ	15,202	**-78**	**-0.51%**	15,841	10,679
Hang Seng	18,183	**-19**	**-0.11%**	22,689	14,687
Nikkei 225	33,533	**926**	**2.84%**	33,753	25,717
CAC 40	7,379	**138**	**1.91%**	7,577	5,677
DAX	15,894	**149**	**0.94%**	16,470	11,976
FTSE Eurofirst 300 Eurozone	2,412	**35**	**1.46%**	2,547	1,950
S&P TSX Composite Index	20,622	**548**	**2.73%**	20,767	18,206
Commodity markets*					
Gold	$1,928.05	**6.10**	**0.32%**	$2,047.01	$1,628.00
Crude Oil	$95.84	**4.18**	**4.56%**	$99.93	$70.96

Source: Refinitiv 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 11 September 2023 to 15 September 2023.

10-year bond yields

Country		Variation	12 Month High	12 Month Low
UK	4.36%		4.75%	3.01%
US	4.32%		4.34%	3.29%
Japan	0.71%		0.71%	0.23%
Euro	2.67%		2.75%	1.73%
Germany	2.67%		2.75%	1.73%
France	2.67%		2.75%	1.73%
Italy	3.22%		3.25%	2.24%
Spain	4.47%		4.82%	3.61%
China	3.74%		3.79%	2.77%



Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	$1.24	-0.01%	$1.31	$1.07
Euro	GBP > EUR	€ 1.16	0.00%	€ 1.17	€ 1.11
Yen	GBP > YEN	¥183.01	-1.33%	¥186.51	¥154.73

Source: Refinitiv Eikon.
Source Data from the 11 September 2023 to 15 September 2023.