State of Play

Rates continue to rise

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The post pandemic cost-of-living crisis has some obvious consequences, not least of which is the additional pressure on family incomes. However, the wider ramifications have led to the start of normalised monetary policy including higher interest rates. How high will they go? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Why are rates rising?

One of the main responsibilities of central banks around the world is to set interest rates to maintain stable price rises, with most targeting around 2%.[1] After economies reopened, following numerous lockdowns and restrictions, the disruptions to supply chains and the lack of raw materials to meet the spike in demand has seen a return of much higher inflation than we have become used to. This has been exacerbated by the war in Ukraine, leading to higher commodity prices and therefore higher energy and petrol prices. There are several consequences of sustained higher inflation with the most apparent being the things we buy or consume day-to-day becoming more expensive thus affecting our spending power overtime.

One of the tools available within the remit of central banks in tackling inflation is to increase interest rates, therefore making borrowing more expensive and restricting spending power which further cools economic demand. Given that all major central banks are faced with inflation numbers at multi decade highs and significantly above their respective targets, the responses thus far have been to increase interest rates.[2] Originally most central banks had predicted that the initial spike in rising prices would be temporary, but as inflation continued to rise higher still, central banks have been playing catch up. The key questions for investors right now are:

- How high will they go?
- How fast will they rise?
- Will the rises help cool enough demand to bring inflation from nearing double digits in most countries back down to 2%, or will it trigger a recession?

Let's take a look at what has happened so far, and what factors may influence future decisions.

Hawkish Federal Reserve finally soften

Last Wednesday, the Federal Reserve (the Fed), the US Central Bank, increased interest rates as expected by 0.75%, bringing rates to between 2.25-2.5%.[3] This is the second consecutive month they have risen by 0.75% in line with the Fed's change to a more hawkish approach over recent months as the previous 0.75% increase was the biggest since 1994. When central banks maintain loose monetary policy, defined by lower rates and more liquid money supply, it is seen as 'dovish'. When the opposite happens with a tighter approach including higher rates, it is seen as 'hawkish'.[4] The statement that followed by the Fed Chair, Jerome Powell, provided an indication that the current trajectory for rates may slow over the remaining months of this year in an acceptance that the economy is slowing rapidly. Jerome Powell said 'We will continue to make our decisions meeting by meeting and communicate our thinking as clearly as possible. As the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases while we assess how our cumulative policy adjustments are affecting the economy and inflation'.[5]

Importantly, last week also saw the latest economic data released showing the US economy shrank in the second quarter of this year by 0.9%, much worse than the positive numbers that had been previously forecast.[6] Based on the agreed principles of a technical recession as being two consecutive quarters of decline, the US Government yet again cited unusual factors in how the data is calculated to claim that whilst the US economy had indeed slowed, it was not actually in recession, a conclusion also backed up by the Fed.[7] They point to a strong labour market as US unemployment is at just 3.6%[8], which is well below the theoretical accepted principle of economic 'full employment' of between 4-5%[9]. The narrow path the Fed must tread in trying to cool inflation whilst preventing a deep recession, means each decision on rate rises holds risks either way. Rising prices may have had a greater impact on economic demand than recent rate rises, which raises the stakes even higher on reaching the right conclusion to maintain this almost impossible balancing act. Market participants continue to watch for new data releases alongside the language used with each decision to evaluate any changes to the path for interest rates, and the impact this may have on bond yields and share prices.

Bank of England responds to mounting pressure

The Bank of England today increased interest rates by 0.5%, the highest rise in the 25 years since it was appointed to set interest rates by Gordon Brown, the former Chancellor of the Exchequer.[10] This move has been anticipated by market participants after mounting pressure on the Monetary Policy Committee (MPC) over the last week following the Fed's decision to increase their base rate by 0.75% for the second consecutive meeting. As I have outlined in previous updates recently, on top of the obvious UK inflation challenges, the MPC treads a similar narrow path between curbing inflation and tipping the UK economy into recession. In addition, because of the weakness of pound sterling this year, if they fail to keep pace with rate rises and financial tightening elsewhere, further falls in the UK's currency brings with it the prospect of higher import prices exacerbating inflation further.

Stock markets make a recovery in July

After a dreadful June, investment markets made a welcome recovery in July. The last couple of weeks have seen earnings releases from some of the major global market companies like Amazon and Apple, most of which have beaten forecasts and provided some insight into the road ahead.[11] Leading the way, the NASDAQ jumped over 10%, closely followed by the wider US stock market, the S&P 500, which rose over 6% during July.[12] Both Europe and the UK had strong positive months with the only outlier being China which saw falls of over 7%, dragging emerging markets just into negative territory.[13]

Bonds have had one of the worst starts to a year for decades as yields have soared in response to inflation and central bank interest rate hikes.[12] As the global economy slowed and markets started to price-in a slowdown in the future path for interest rates, yields fell away boosting bond values in the process.[12] US high yield led the way with a total return of over 4%, and even UK Government bonds with a more modest 0.85% delivered a positive return for July.[12] Investors will no doubt be watching inflation data with great interest over the next few months to see if inflation has started to peak thus taking the pressure off central banks and allowing them to soften their stance on future rate rises. The 'soft landing' they seek between cooling inflation and avoiding recession is still the narrowest and shortest of runways, so only time will tell if they manage to achieve the seemingly impossible.

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 1 August 2022.

[1] International Monetary Fund, 3 March 2022
[2] Investing.com, 1 August 2022
[3] Times Newspaper, 29 July 2022
[4] Investopedia, 24 April 2021
[5] Federal Reserve, 27 July 2022
[6] CNBC, 28 July 2022
[7] Financial Times, 27 July 2022
[8] Bloomberg, 8 July 2022
[9] Investopedia, 24 April 2021
[10] The Times, 3 August 2022
[11] The Times, 30 July 2022
[12] FE Analytics, 1 August 2022