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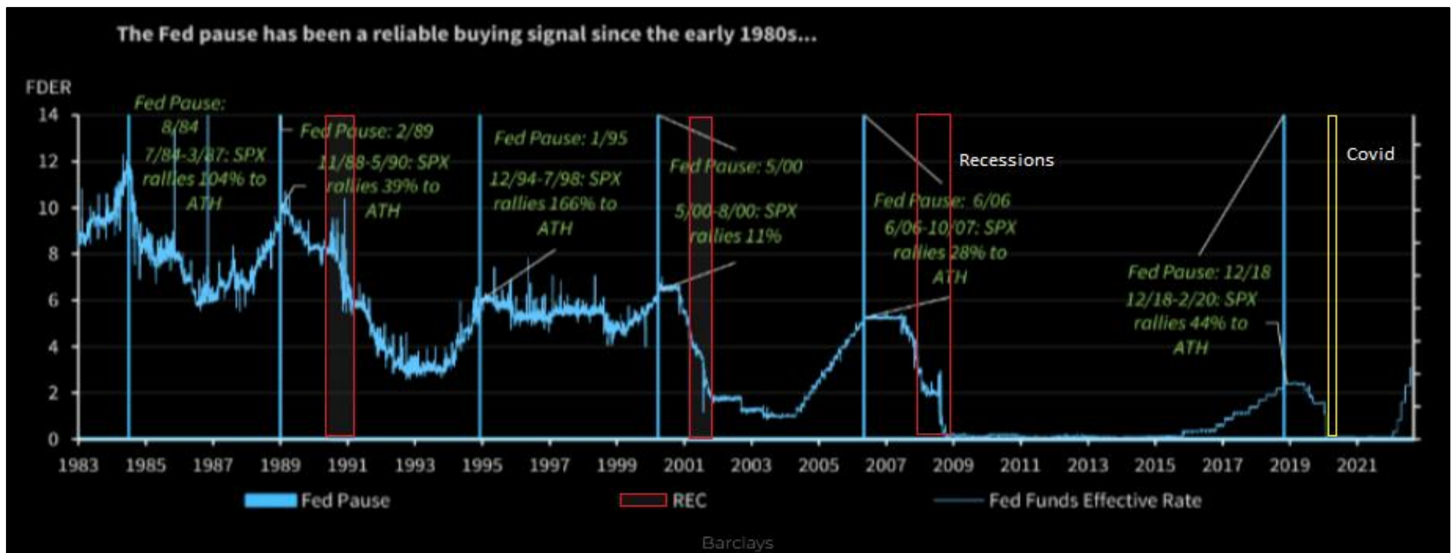
Market View

Are we there yet? In investment you never truly know until you can look backwards (with the benefit of hindsight) and realise yes we were there! What can be said is that several of the economic and market conditions that are needed to confirm that the dramatic rise in global interest rates and thus the difficult market conditions may be close to passing, are starting to fall into place. Central to all of this is the US Federal Reserve Bank. Markets follow the flow of money into and out of the Central Banks with the Fed the leader. Money flows out, markets go up and go down when it is restricted. The Fed has just signalled that, as long as inflation continues its current downward trajectory, then it is prepared to halt the record breaking increase in interest rates. As the chart below shows the act of halting is very significant for the markets. Historically, share prices rise, even before a company profit-crushing recession arrives. This is the time shift between the markets and the real economy that still confuses many, even professionals. The Fed has said it is data dependent i.e. it will make future decisions based on the inflation and unemployment data. Inflation in the US does appear to be a little more persistent than hoped but there are signs in the commodity markets and in Producer Price Inflation numbers that it may soon moderate. Job openings are falling and layoffs accelerating, the odds of a US recession are rising.

The Last Interest Rate Increase



This chart shows the US interest rate with the blue bar highlighting the short term peak. The red bars are recessions and this shows the time shift between the Fed trying to precipitate a recession to bring inflation down by raising interest rates and it actually happening. There are clear signs that one is now imminent in the US. The Fed Chair still thinks there is a reasonable possibility of avoiding one, but economic history suggests otherwise. Almost half of America's 4,800 banks are already burning through their capital reserves. They may not have to "mark all losses to market" under US accounting rules but that does not make them solvent, a lot of the US banking system is potentially bankrupt. The Fed has made this happen. This will probably reduce the flow of cash to businesses and ultimately to consumers. We are starting to see personal mortgage rates move up in the US, as well as credit card interest rates, a sure sign that the Fed's restriction of the supply of money is finally having an impact on Main Street. Though for Wall Street it is good news. The worse the economic news is, the quicker the Fed halts and then starts to relax its polices. Joe Biden will also be taking a close interest, he does not want a prolonged recession.

US Unemployment

One of the unusual aspects of the post Covid recovery has been the shortage of labour. There remain many shortages for particular roles. Indeed Harley Davidson announced a significant write-off of motorbike leases due to a shortage of Repo Agents to take repossession! Whilst many industries such as the big technology companies have announced redundancies, this has not as yet shown up in higher US unemployment rates. But we are seeing signs of a slowdown. In the US the number of job advertisements has dropped sharply. The most recent JOLTS data showed that layoffs were at the highest since December 2020 (Covid) and new openings were also at a low. This should in theory take pressure of wage demands and thus help bring inflation down. US courts

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have just seen 57 large company insolvencies in Q1, the busiest quarter since 2009. This is another sign that the Fed's medicine seems to be finally working

The New Carolean Age

As the second Elizabethan era formally passes to a new Carolean one (Latin for Charles) it is perhaps appropriate to take stock of the UK economy. Particularly when the media rhetoric is almost wholly negative about its performance. The UK economy moves according to the political cycle as well as following dutifully behind the US one. The next General Election has to take place by January 2025, indeed most indications are that it would be November 2024 at the latest, though this would coincide with the US Presidential vote, maybe suggesting May/June 2024? Most media comments talk about the UK being the last to recover and having the highest inflation and slowest growth. However, the actual evidence paints quite a different picture.

Annual GDP Growth	UK	FRANCE	GERMANY	USA
2023 estimated	0.1%	0.2%	0.0%	1.1%
2022	4.1%	2.6%	1.8%	2.1%
2021	7.6%	6.8%	2.6%	6.0%
2020	-11.0%	-7.9%	-3.7%	-2.8%
2019	1.7%	1.8%	1.1%	2.3%

Annual Inflation	UK	FRANCE	GERMANY	USA
Core estimated	6.0%	5.7%	5.2%	4.6%
Core Rate	6.2%	5.9%	6.2%	5.6%
Official Rate CPI	10.1%	5.9%	7.2%	5.0%

Govt Debt to GDP	UK	FRANCE	GERMANY	USA
2023 estimated	100%	112%	66%	129%
2022	100%	112%	66%	129%
2021	97%	113%	69%	127%
2020	97%	115%	69%	129%
2019	85%	97%	60%	107%

Source: tradingeconomics.com

Firstly, it should be noted how similar all these numbers are, the UK is not generally out of line with either the USA or indeed France and Germany. The UK did seem to have a bigger GDP impact from Covid though it must be remembered our lock-downs were earlier, so there may well be some timing differences involved in these numbers. This is perhaps also reflected in our higher post Covid growth numbers. Core Inflation is again very similar. The often quoted high level of UK national debt actually looks to be pretty good in international terms. It also seems that post Jeremy Hunt's two Budgets this number is falling rapidly and much faster than the OBR's Budget forecast. This is reflected in the strength of the pound against the dollar. The UK is, however, struggling from a lack of a true growth strategy. US President Biden's Inflation Reduction Act is bringing manufacturing back the US especially for microchips and electric vehicles. Europe is planning to do the same. There are very few signs that an equivalent plan is being considered in the UK. As we have written before the Truss/Kwarteng Budget seemed to be the final attempt to deliver the low tax, deregulated, Singapore on Thames that leaving the EU promised. If the markets will not allow such a move, then what's next? There is speculation that a return to Schengen/EU Customs Union is being considered. The FTSE Mid 250 index and the Gilt indices are amongst the biggest global fallers during this difficult market period, down by 17% and 26% respectively since end December 2021. The UK does have a relatively strong balance sheet and it's current and forecast growth and inflation data is in-line with Europe's key players and not that far away from the USA, it is thus very hard to find evidence that supports the media criticism, the UK does, however, need a workable growth plan.

Markets

"Sell in May go away and don't come back until St Leger Day", is an old adage for many market participants. It doesn't always work, though it does reflect the beginning of the normal negative summer seasonality when market liquidity dries up, governments close for the long break and thus new market-moving news and policies are scarce. Markets are presently still fully focused on the various "spinning plates" of inflation, unemployment and thus interest rates. Now they have a US Banking one to worry about as well. US Commercial Real Estate, car finance and credit card defaults are just starting to creep up and the US housing market continues to be weak, especially new builds. This is all suggestive of an imminent slowdown in US economic activity thus raising the risk of higher unemployment and debt defaults. i.e. " a proper recession". This is what the markets, based on historic precedent, have been predicting for the last 12 months. It might still "be different this time" as job losses could be absorbed in a labour market still in places desperate for staff, but there is the risk that the US banking crisis may yet get far worse and allow the predictions to come true. This would increase the probability that the Fed has halted raising interest rates for now and will start looking for reasons to cut. Much will depend on the various inflation numbers and particularly the Core numbers. Gasoline prices are falling and soft commodity prices such as Wheat, Corn and Soyabean keep falling also. Inflation is coming down, it is just a question of when it appears in the statistics. So markets seem to be entering the final stage of this difficult period. The Fed needs inflation to fall to target soon, the US bank and forthcoming commercial real estate crisis may just be the final dose of economic medicine to help them achieve their goal. Markets meanwhile, as we enter the Summer doldrums, are looking for the peak in interest rates, they are hoping it has just happened.

May 2023

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