RATHBONES

WHY NOT DEFLATION?

REVIEW OF THE WEEK
4 DECEMBER 2023

A BOUT OF RUNAWAY INFLATION COULD PERSUADE SOME PEOPLE THAT NO INFLATION WOULD BE BETTER THAN ANY AT ALL. THAT'S A DANGEROUS PATH TO TAKE.

Inflation continues to sink around the advanced world, with Europe the latest region to report faster-than-forecast drops in the important number.

An early estimate of CPI inflation for the Euro Area showed a significant deceleration in November to 2.4% from 2.9% the previous month. That was more than double its expected change. Sharp drops in energy costs helped drag the number down, but deceleration in the cost of services and goods were also helpful. European inflation had risen for roughly a year, peaking at 10.6% in October 2022. It has taken the same amount of time to return to within touching distance of its 2% target.

Like everything in life, politics and finance, a benefit given to one set of people is often taken from another set. Inflation is no different. Because inflation chips away at the value of the money, it's often perceived to be a bad thing for savers and lenders. Their money is becoming less useful as time passes, which means they must secure higher returns to factor in this sneaky time tax. Conversely, inflation is good for the spendthrift and the borrowers. Spending your money today avoids the effect of inflation and you have goods and services that would only cost you more in the future. Borrowing someone else's money means you enjoy the full spending power of the cash today, but when you repay it many years down the line the pounds aren't what they used to be.

In reality, it's not as stark as this. We're all a mixture of column A and column B. We have loans or mortgages and we have some savings and investments and we all spend on things we need and want. However, it's sometimes helpful to keep a cartoonish sort of schematic to remember what effect different economic phenomena have. When you boil it down, targeting low and stable inflation encourages people (and governments) to borrow to invest, whether in homes, businesses or infrastructure. It discourages hoarding cash – whether hiding it under the mattress or in ultra-safe bank accounts. This helps to ensure that society's capital is better used for the benefit of all. That investment and spending drives greater economic growth and increases the need for workers, which then puts more wages in people's pockets so they can spend and invest too, creating a helpful expansion that, bluntly, is how we have managed to create such wealthy societies in the last two centuries.

Targeting modest inflation is much better than the alternative – allowing deflation. If the value of money is constantly rising because of deflation, it discourages spending today (because goods and services will always be cheaper tomorrow), and so reduces commerce and economic activity. This means fewer employees are needed by businesses and therefore unemployment starts to rise. And because money is getting more valuable over time, loans become *more expensive* over time. Borrowers will be receiving fewer pounds in income and their properties will be worth less in pounds and pence, yet their loan principals will be the same number of now more valuable pounds.

Now, who's the most indebted borrower you know? It's not your neighbour, who's somehow buying another new Porsche. And it's not the government. It's your bank. Which is why deflation plays havoc on banks, leading to widespread failures, wiping out the savings and investments of thousands of customers. So rather than a happy, albeit bumpy, inflationary road to wealth and prosperity, you get a deflationary spiral that culminates in something akin to the Great Depression of the 1930s. Businesses stop investing or go bust, employees lose their jobs in droves, curtailing household spending and leading to yet more business failures. And throughout it all, banks go pop taking the life savings and business cash accounts of swathes of society with them.

While inflation can often be frustrating and sometimes unsettling, we think it's the best road to take. We may lose a bit on our cash, but we gain a whole lot more.

Rates should soon fall

That's not to say that overly high inflation is rosy – it's not. It comes with a bunch of other problems, mainly reducing the living standards of everyone and destroying much of the capital we've all amassed. While the 1930s were grim, the 1970s were also no rodeo.

For this reason, central banks are laser-focused on getting inflation back to its target and not allowing it to flare higher once more. Most central bankers have warned that they may yet raise interest rates further to snuff out latent inflationary forces from recent wage growth and supply chain upheavals. Despite this continued warning, investors have lately been quick to discount them and bet that interest rates will soon be dropping back.

This has been most pronounced in the US. Markets for locking in future interest rates imply a roughly 90% probability that the US Federal Reserve will cut its benchmark overnight interest rate by 0.25% by May. An almost 1 percentage point cut in rates is forecast by the end of next year. Investors are taking heart from falling oil prices and signals that economic growth is wavering. Household income growth has slowed to its lowest since last year. Meanwhile, this headline number has been buoyed by higher interest payments and dividends that are the preserve of the wealthy. These people are less likely to spend this extra cash, as opposed to poorer households, so it tends to give a limited boost to consumption. While spending has held up well, we think it's only a matter of time before higher rates, tougher loan conditions and lessened profits flow through to greater unemployment and a drag on economic growth. We will get some valuable insight into the economy this week with the release of US jobs growth and the unemployment rate.

This expectation of slower American GDP growth and lower interest rates have made the dollar and its assets less attractive to global investors. They have sold up to move to other, higher-yielding investments, which has pushed the dollar exchange rate lower against the currencies of its trading partners – including the pound. This fall in the 'price' of the dollar means that US-based investments are worth less in sterling for UK investors.

We think this will reverse in good time, however. We think the expectations for UK interest rates – and European ones for that matter – are off kilter. Just as the US economy should soon slow, we think Europe and the UK will be hit even harder. This would mean the Bank of England would need to make bigger cuts to rates in 2024 than currently forecast. If we're right, that would mean the UK won't offer relatively stronger rates of return than the US, which, all other things equal, would push the value of the pound lower.

While several members of the BoE's monetary policy committee have stressed concerns about the persistence of inflation and the potential need for "higher for longer" interest rates, we're not so sure. While it's definitely still a risk, we think it's more likely that the central bank will need to cut rates to support the economy. Central bankers haven't had the best track record of sticking to their medium-term guidance over the last few years: we expect the Bank to cut meaningfully at some point next year, by more than what the market is currently pricing in.

Europe is sort of already in this position. While the European Central Bank (ECB) don't want to declare victory prematurely and have been careful to talk a big game on keeping rates higher for longer, it must be mindful of the Eurozone economy. It's been stagnant since 2022 and even if the worst of Germany's manufacturing recession may be behind us, other Eurozone economies are slowing further. French third-quarter GDP was revised down 0.2 percentage points last week to -0.1%, and its October retail sales were very weak. These forces will carry on into 2024, so we expect the ECB to cut in Q2. For more on how we see the world and our views on 2024, **sign up for our next Investment Insights webinar** on 16 January.

We have renamed our fund management business, from Rathbone Unit Trust Management Limited to Rathbones Asset Management Limited. We believe the new name better represents our fund management arm and reflects our evolution into the modern business we are today, with a much wider range of funds and structures available to our investors. **Learn more here.**

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

The content contained in this document is for information purposes only and does not constitute as a recommendation to purchase any product or service, you should always take appropriate advice from a professional, who has made an evaluation at the point of investing. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested. Tax treatments depend on the individual circumstances of each client and may be subject to change in the future. Cashflow planning is based on assumptions and can only give an indication as to what may happen. They are not guarantees.