Rathbones
Look forward

Review of the week

9 May 2023

A very British coronation

A King is crowned and most of England went to the polls last week. Coming up is a Bank of England rate hike and an update for American inflation.

King Charles III was crowned on a classic, drizzly English Saturday. The pageantry of the dignified arm of the British state followed only a few days after the more frequent, yet no less important, ritual of the efficient arm: the English local elections.

The UK can be an odd place for those unaccustomed with its way of life. Our fierce defence of tradition still leaves room for the new. Take Oxford and Cambridge, two of the world's oldest universities, which lead the charge in cutting-edge developments in biotech, health sciences and artificial intelligence. A more concrete example is London, a jarring yet joyous amalgamation of soaring, adventurous skyscrapers and beautifully conserved historic architecture. Britain really is unique.

Around the world, democratic rights are fading and civil unrest is rising. The ability to crown a monarch - arguably an anachronism, whether revered or not - while in the same week also hosting a free and open election for local representation, without great antagonism, drama or upset, is something all of us should be proud of and thankful for, regardless of our political beliefs.

With all but one council declared, the English local elections showed a large swing toward Labour, the Liberal Democrats and the Greens at the expense of Conservative and independent/small party councillors. The Conservatives lost 963 councillors and control of 48 councils; Labour added 635 councillors and gained 22 councils; the Lib Dems added 418 councillors and gained 12 councils; the Greens doubled their councillor count by adding 200; and the number of independent/small party councillors fell by 374.

The next general election won't be held till January 2025 (if the current government leaves it as late as it can), so any potential regime change is a while off yet. Still, these numbers suggest investors should pay more heed to the policies of the Opposition, as they could be coming to power in 18 months or so.

Meanwhile, another staple of British life is strikes by railway workers. Unions have declared strikes for Friday and Saturday, the first since early February, after refusing pay offers of 9% and 8% from train operators. Of course, those suggested hikes are still below inflation, which has been above 10% since September.

The Bank of England is still concerned about double-digit inflation, but perhaps a bit less than a few months ago. It slowed the pace of its rate hikes at its last meeting. Inflation in food and services still look concerning. But policymakers are taking some comfort from developments in energy markets: wholesale gas prices have plunged as European economies have adapted to life without Russian supply. They are lower now than immediately before the invasion of Ukraine. That should feed through to lower utility bills in the second half of this year.

The BoE is expected to raise rates by 25 basis points to 4.5% on Thursday. The US Federal Reserve and the European Central Bank last week raised rates by 25bps to 5.25% and 3.75%. Global interest rates have risen a very long way extremely quickly. As we repeat often: it takes between a year and 18 months for the full effect of an interest rate move to feed into the economy, so the increases in the latter half of 2022 may yet bite. It makes sense for central bankers to pause, assess and reflect. In Europe, where rates have risen more slowly, investors expect another two 25bps increases.

While we agree that inflation should fall back in the major economies later this year, we think there's a sizeable risk that it will snag at a percentage point or two above the 2% targets. While inflation is falling, central bankers it will be easier for central bankers to sit on their hands. However, if inflation flares up again or if its descent melts away early, pressure for more rate hikes will return. This is particularly acute in the UK, where inflation remains extremely high.

Good job, America

On the other side of the Atlantic a rift is growing between a persistently strong jobs market and banks' weakening appetite for lending to the businesses that are fuelling the boom.

America is creating more jobs than expected, keeping its unemployment rate at an extremely low 3.4%. Annual wage growth accelerated slightly to 4.4% last month. The travel, leisure and hospitality industries are creating much of the new jobs; lower-paid workers have received the strongest increases in pay hikes. Even as US households keep spending their bigger pay cheques, a central bank survey of lenders shows banks are aggressively tightening their standards for offering loans. The latest Federal Reserve Senior Loan Officer Opinion Survey shows banks are becoming extremely picky about lending money and increasing the rate of interest, particularly to businesses and commercial property projects. Banks are more cautious about residential loans and mortgages as well, but not to the same extent as they are for businesses.

Typically, it's the behaviour of households that drives developed economies to cycle from boom to bust and back again. When they spend freely, it flows through to greater profits for businesses, which emboldens them to invest in new opportunities, which means hiring more staff and buying more kit. That boosts other businesses and increases household income further which creates a flywheel of confidence, knock-on spending and business formation. That works in reverse on the way down, too. When people spend less and save more, it reduces company sales and profits, encouraging them to cut costs and jobs and discouraging investment in new projects. That reduces household income and makes people reluctant to set up that new business or make big purchases.

Today, households are still spending, especially in the US. However, borrowing costs and expenses are rising both for them and their employers. This is why we think it's very likely that the US, Europe and UK will enter mild recessions later this year. Because of this, we have a bias towards more defensive businesses - those whose products are hard to go without, even in straitened times. While some despair that the UK is becoming a backwater of global equity markets, it's important to note that it boasts a greater proportion of defensive sectors than other markets. Not only that, but UK stocks trade at a meaningful discount to their peers around the world.

Recessions are always painful. They are a euphemism that elides the hardship of lost jobs, shelved dreams and emotional stress for millions. However, a mild recession may help central bankers get a handle on inflation, which is also a crippling phenomenon, particularly for poorer households and nations. In a recession accompanied by falling inflation, bonds should be expected to do well compared with stock markets. However, for us to shift significantly into the longer-lived bonds that would benefit most from a slowdown, we would want to be sure that central bankers were finished hiking rates. For that to happen, we think unequivocal evidence of a weakening labour market is required.

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

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