Rathbones
Look forward

Review of the week

6 February 2023

Blowing a gale

Markets were fanned higher by US monetary policy before getting driven backwards by contradictory economic winds. Uncertainty still reigns supreme.

The week was windy, my friends. A strong gale of economic surprises and central bankers' chatter toppled yields, whipped stocks higher and scattered currencies like leaves.

It was indeed the wild week we had expected. The US Federal Reserve (Fed) raised interest rates 25 basis points on Wednesday to the 4.50%-4.75% band as most investors expected. We had thought there was a good chance that the US central bank would hike by 50bps to send a message to the market that it was serious about raising rates to tamp down inflation. The reason for this message is that, for months now, there's been a huge disconnect between what the Fed is saying and forecasting and what the market implies through its pricing.

Since the October slump American and British stocks are up roughly 15%, while the European index has leapt almost 30%, as investors think rates won't go as high as the Fed (and other central banks) claim. These are big moves, especially considering the uncertain path of GDP growth and inflation. When asset prices rise, they loosen financial conditions in the economy. It's very easy to see in bond markets because higher prices mean a lower yield - companies can borrow money at a lower rate. But the effect also exists in stock markets - the greater the premium investors put on tomorrow's cash flows, the cheaper it is to raise new equity financing.

Higher stock prices also make people wealthier. They feel flush and are more likely to go out and spend, which boosts GDP growth and inflames inflation. The companies whose stock has gained in value benefit too - the equity in their business has increased, which flatters debt metrics, making it easier for them to get new loans (or perhaps issue new stock at higher prices). Again, the effect is to pump more cash into the economy, whether through the company returning cash to shareholders who may splash out on some post-Christmas sales, or by the company's executives ploughing it into higher wages to attract staff or into new factories or fleets of vehicles.

So why is this market recovery a troubling thing? Surely greater wealth for a greater number of people is the aim of the game. This is true. But the problem with the current situation is that there's a chasm between the path of interest rates that the Fed has laid out for everyone and the path that is implied by that surge in markets that we've just discussed. Somebody is wrong. If it's the market, that recent rally could go crashing chaotically into reverse. And that ephemeral increase in wealth may have encouraged households and businesses to take on more debt or spend more of their savings than was wise. That could make a recession all the uglier.

If *the Fed* is wrong, then the damage is more abstract, but still significant. There's a convention in monetary policy that central bankers should be able to tighten or loosen monetary policy with a few well-chosen words that can move markets. In the parlance, investors call this ability 'credibility', and it has been a crucial virtue for central bankers for decades. Perhaps forever. What investors are telling the Fed - through the medium of the market - is that they don't believe the Fed's forecasts for GDP growth, inflation and rates. That's not a good look for the Fed. And Fed Chair Jay Powell seems a bit too nonchalant about it for our liking. Which is why we thought the Fed might have gone for a 50bps shock last week, to drive home his message, to reinforce his credibility.

Of course, he has already tightened a considerable distance at an unprecedented pace. Most of the effects are yet to be felt in the real economy. Should the Fed tighten even more, just to send a message, when there's a strong chance that it may have already gone too far, that it could cause greater financial pain to tens of thousands, scattered throughout the country and time? There's a philosophical debate floating about this conversation as well: if the Fed is supposed to control financial conditions through words, then it is in the game of manipulating markets up and down at its discretion. At which point is it the Fed's job to think about its effects on shareholders and bondholders, rather than solely the economy? As we note above, it's more complicated than that, because the fortunes of capital - of investors - have significant knock-on effects on the economy itself, which also impact people's lives. But it is an uncomfortable discussion at the best of times, let alone in the 21st Century when widening inequalities have made central banking more politically fractious.

A laboured message

Perhaps Fed Chair Powell is content with letting the economy send investors messages on his behalf! At the end of the week, the US nonfarm payrolls release revealed a boom in January jobs growth. Almost 520,000 more jobs were created than destroyed last month, widely spread among all types of industries. That's the biggest gain since the summer, and double both December's figure and what economists were expecting. Now, nonfarms are extremely volatile month to month, so they should be taken with a pinch of salt. We always scan to the bottom of the release where you can find details of revisions to previous months from fuller data that has filtered in. Yet all of the past five months' job gains have been revised higher.

This labour market surge wrongfooted investors after a week of asset prices roaring higher, driven by hopes that deflating growth will help crumple inflation, forcing central banks to stop hiking rates and perhaps even soon begin cutting them. Stocks fell back slightly, while bond yields jumped higher again after last week's big falls.

Meanwhile, on the other side of the Atlantic, the Bank of England (BoE) was even more equivocal about the need for future rate hikes despite inflation floating above 10%. The benchmark British borrowing rate increased by 50bps to 4.00%, but the BoE's policy committee watered down a recurring reference to future rises, saying that further tightening would be forthcoming only "if there were to be evidence of more persistent pressures" on inflation. UK 10-year government bond yields collapsed by an astounding 30-odd bps in an afternoon, finishing the week at 3.00% (following the digestion of the US nonfarms report, the 10-year UK yield has jumped back to 3.20%).

Last week's decline in prevailing British yields - i.e. the amount that sterling investors receive for holding the currency - compelled sterling to jump off a diving board as investors sold the pound. Sterling dropped 2.7% against the dollar over the week and shed 2.3% against the euro. The European Central Bank (ECB) no doubt influenced global investors' fevered trading. The third major central bank to reveal monetary policy last week, the ECB raised its main interest rate by 50bps to 3.00% and - unlike its US and UK counterparts - promised a similar dose in March.

UK fourth-quarter GDP growth is released on Friday. The average prediction is for the economy to have gone precisely nowhere (0%). If so, the UK will slide past 2022 without falling into recession as was widely expected halfway through the year. This release will be closely watched for signs of unexpected strength that may push the BoE to adjust its course. As will information about wage growth, retail spending and PMI business surveys over the coming months.

The BoE's latest projections for the path of inflation underpinned its case that it could hold back on further rate hikes. Assuming the benchmark rate is kept unchanged at 4.00%, the BoE thinks CPI inflation will fall sharply over the next two years to below 2% by the final quarter of 2024. Albeit the BoE notes there are considerable risks to that forecast, with a definite skew to inflation being higher than expected. We couldn't agree more!

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.

Rathbones
Look forward

rathbones.com

rathbonefunds.com

Important information

This document is published by Rathbones Investment Management Limited and does not constitute a solicitation, nor a personal recommendation for the purchase or sale of any investment; investments or investment services referred to may not be suitable for all investors. No consideration has been given to the particular investment objectives, financial situations or particular needs of any recipient and you should take appropriate professional advice before acting. The price or value of investments, and the income derived from them, can go down as well as up and an investor may get back less than the amount invested. Rathbones Investment Management Limited will not, by virtue of distribution of this document, be responsible to any other person for providing the protections afforded to customers or for advising on any investment. Rathbones Investment Management International is the registered business name of Rathbones Investment Management International Limited which is regulated by the Jersey Financial Services Commission. Registered office: 26 Esplanade, St Helier, Jersey JE1 2RB. Company Registration No. 50503.

Rathbones Group Plc is independently owned, is the sole shareholder in each of its subsidiary businesses and is listed on the London Stock Exchange. Rathbones is the trading name of Rathbones Investment Management Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Regulation Authority and the Prudential Regulation Authority. Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. The information and opinions expressed herein are considered valid at publication, but are subject to change without notice and their accuracy and completeness cannot be guaranteed. No part of this document may be reproduced in any manner without prior permission.

Any views and opinions are those of the author, and coverage of any assets in no way reflects an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Fluctuations in exchange rates may increase or decrease the return on investments denominated in a foreign currency.