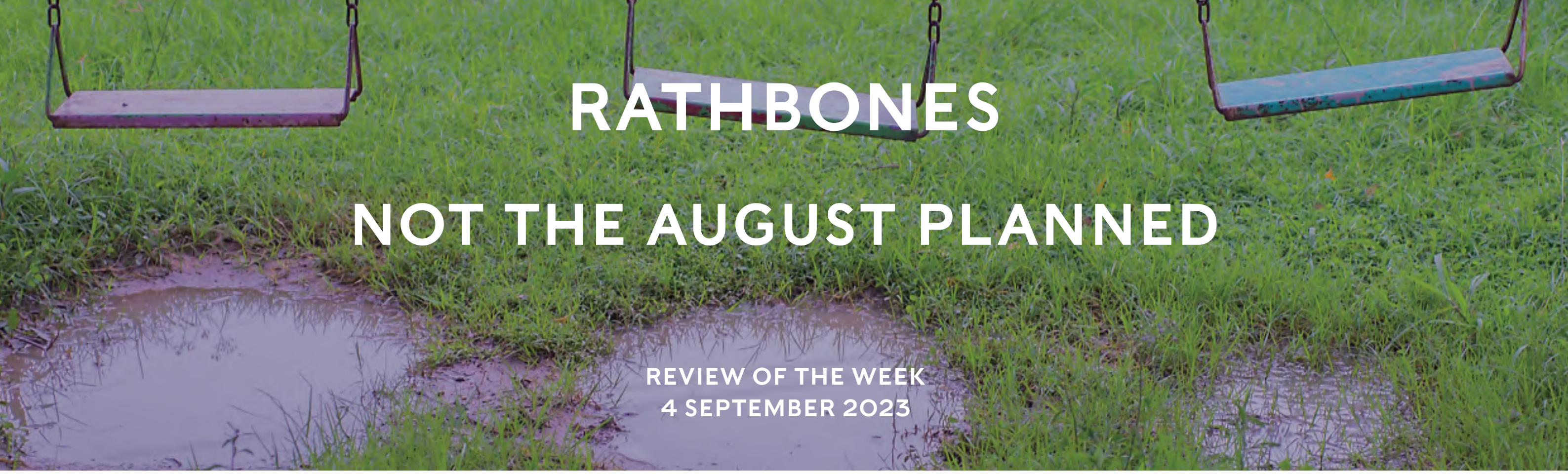

RATHBONES

NOT THE AUGUST PLANNED

REVIEW OF THE WEEK
4 SEPTEMBER 2023

HOPES FOR A QUIET SUMMER WERE DASHED BY DIFFICULT-TO-READ ECONOMIC DATA, SWINGING BOND YIELDS AND HOLIDAY DRAMAS.

Well, it wasn't quite the peaceful August we all would have liked. Heatwaves sparked fires and weird weather across the Northern Hemisphere while the UK had to contend only with a wet, muggy summer and the complete collapse of air traffic control on Bank Holiday Monday.

The pressure was high in bond markets as well, with prices for government bonds bouncing around considerably as investors chopped and changed their views on the path of interest rates as economic data rolled in. The US 10-year government bond yield hit a post-Global Financial Crisis high of 4.3% mid-month as a slight rise in inflation and signs of a strong economy made its price slump. The UK counterpart also spiked to levels not seen in 15-odd years – its high was 4.7%. Both bond yields dropped back in the second half of August as investors started to question whether central banks will increase interest rates much further.

No hike is forecast at the coming US Federal Reserve (Fed) monetary policy meeting of 20 September; investors expect another 25-basis-point rise in the Fed Funds Rate to the 5.50%-5.75% band sometime in final quarter of the year. However, these expectations are as changeable as the weather. They swing dramatically on how strong the US economy looks. Just before we went on holiday US GDP growth accelerated to 2.4% in the second quarter, helping push bond yields higher. Last week the second estimate revised that growth to 2.1%, easing pressure on yields. As we've said before, GDP data is a *lagging* indicator. It tells you about the past, not about what is likely to happen in the future. It's a huge job gathering, processing and analysing all the information that appraises an economy, so when it's released it's already pretty stale.

One of the most watched and least understood areas of the American economy is the strength of households. The nation is still creating a reasonably healthy number of jobs each month, albeit nowhere near as strong as first economic releases suggested over the summer. Like GDP growth, new job numbers were revised sharply lower recently. Instead of 185,000 jobs created in June, the number was 105,000. And for July the figure dropped from 209,000 to 157,000. Still, wage growth at 5.7% is still well above inflation, which ticked up in July to 3.2% from 3.0% the previous month. And some trackers of household confidence are elevated.

This all seems at odds with sky-high borrowing rates and significant jumps in the cost of living. How long before economic reality catches up with people is the big question. The proportion of US consumer loans that are behind in payments has jumped significantly from virtually 0% in 2021 to 2.4%, which was the rough average of the five years leading up to the pandemic. Is this a sign that the large piles of savings accrued during the pandemic have now been depleted among lower and middle-income households? We will be watching these sorts of measures for further signs of economic stress among everyday people.

A tale of two continents

Economic strength and success in the fight against inflation has not made the leap across the Atlantic, however. Despite avoiding recession earlier this year, the Eurozone has sagged over the summer. Its inflation rate has plateaued at 5.3% for the past two months while its economy expanded at an annualised rate of just 1.2% in Q2 after six months of going nowhere. Germany, in particular, has deteriorated markedly in recent months. It is now forecast to be the only major economy to shrink this year. The war in Ukraine hit Germany worse than most because of its heavy dependence on Russian gas. The COVID lockdowns and subsequent slowdown in China have also squeezed it because fewer exports of machines and engineering goods are now flowing east. But it hasn't been an easy time for Club Med either. Red-hot temperatures have caused lots of fires, interrupting tourism and leaving large repair bills.

Even though Europe is having a tough time, employment has remained strong. This is an interesting feature as typically a fall in economic activity pushes businesses to lay off workers. The overall Eurozone unemployment rate has dropped this year from 6.7% to 6.5%. Over the past eight months unemployment has risen only slightly in Germany from 5.5% to 5.7% and is still very low by historic standards. This robust labour market will keep the pressure on inflation, so it's no surprise that the European Central Bank's policymakers are taking note. Monetary policy on the continent is difficult to read.

The UK is in a similar bind. Our inflation is still the highest of the major economies at 6.8%, as is our wage growth (unfortunately, not in real terms – or, after adjusting for inflation). One ray of sunshine was that Q2 British GDP growth was twice as fast as expected at 0.4%, or 1.6% annualised. After warnings early in the summer that the Bank of England would take its benchmark interest rate to 6.5%, sanity has returned and it seems most likely that the central bank has finished with interest rates. If the inflation rate refuses to fall in the coming month or two, another 25-basis-point increase will no doubt arrive. However, murmurings from the BoE's committee seem to show that the prevailing consensus is for keeping rates at this high level for a longer period of time, rather than continuing to hike aggressively until something breaks.

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.

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