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OUT OF THE ORDINARY

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Two Becomes One

John Wyn-Evans
Head of Investment Strategy

Here's a question with an answer that might seem to require a magic trick of some type: How do you turn a two pound coin into a one pound coin? Well, the easiest solution seems to be to wait 25 years, and it will happen all by itself. I was reminded last week that the two pound coin was launched into official circulation in June 1998. Such has been the rate of inflation since then, with the consumer price index (CPI) more than doubling, that two pounds' worth of purchasing power in 1998 is worth less than a pound's now. To put it

another way, on average, everything costs twice as much as it did then, in nominal terms.

The truth is that most people haven't felt much of that effect because wages have tended to rise in tandem with prices. However, it is interesting to see how they have evolved. In the decade leading up to the financial crisis, wages grew not only in nominal terms, but also in real terms, as the economy became more productive. Some of this will have resulted from the beneficial effects of new technologies (the internet boom, for example), but I remain suspicious that some of it was an unsustainable illusion, driven by speculative and leveraged activity in the financial sector. Whatever the reason, real wages have been stuck since 2007. In fact, the Office for National Statistics' Real Average Weekly Earnings Total Pay Index remains marginally below its 2007 peak. No wonder the average worker in the UK feels as though they are not making any progress financially.

Consumer price growth was relatively benign over the period from 1998 until last year, such that the effects of inflation might be seen as similar to the effects of gently heating up a frog in water (the often-quoted, but possibly mythical "boiling frog" experiment, in which the frog remain blissfully unaware of the temperature change until it's too late). Even so, it is worth reminding ourselves of the power of compounding. A doubling over 25 years requires what looks like a relatively piddling annual rate of 2.8%.

However, recent inflation running into double digits is more like dropping said frog into a vat of boiling oil, with predictable consequences. Last week, we had the latest release of the UK Consumer Price Indices, and they were shockingly bad. Headline inflation remained at an annual rate of 8.7% in May, while the core rate, which strips out Energy and Food, rose to a new cycle high of 7.1%. This was more than enough to sting the Bank of England (BoE) into action the following day when it raised the Base Rate by 0.5% to 5% (against expectations of +0.25%) and signalled more increases to come.

How did financial markets react to the increase in the Base Rate?

What did markets make of all this? The biggest reaction was in the interest rate futures market, where expectations for the peak base rate shot up. Just three weeks ago, the market thought that the UK base rate would top out at around 5.4%. Now those expectations lie at 6.16%. That's effectively an extra 0.75% priced in, which is pretty remarkable when one considers that the base rate itself was no higher than 0.75% from February 2009 until May 2022.

Another consequence is that Gilt yields are now higher than they were in the wake of the Truss/Kwarteng mini-budget and LDI pension crisis of last September. That is not the greatest news when we also discovered last week that the country's fiscal debt-to-GDP ratio breached 100% for the first time since 1961. At least then it was on a falling trajectory as the country continued to grow out of its wartime debts. However, the Gilts market reacted relatively well to the Bank's aggression, deeming that it had finally administered the strong medicine that it should have dispensed earlier.

Even so, none of this was of any consolation to homeowners or prospective buyers, with two-year fixed-rate mortgages now priced higher than 6% and five-year fixes approaching that level. Much has been made of the "time bomb" metaphor, with 100,000+ mortgages coming up for repricing every month. The good news, at least for now, is that employment remains strong, although spending will no doubt have to be diverted from other areas of consumption. UK mid-and-small cap indices, which are much more exposed to domestic consumption, have underperformed.

Are other countries exposed to higher mortgage rates?

The UK is not the worst affected by higher rates, at least not immediately. Mortgagees in countries such as Australia, Finland and Sweden have much greater exposure to floating rate mortgages. House prices in those countries

have fallen by 7%, 6% and – a more alarming – 20%, respectively. Depending upon which survey you look at, UK house prices are either flat or marginally lower, although anecdotal evidence suggests something worse. In any event, it seems almost inevitable that things are going to deteriorate, especially in real terms.

How are equity markets performing?

Generally, equity markets seem to be drifting back into a "glass half empty" mode (having recently been more "glass half full" in their enthusiastic response to the potential productivity gains to be made from generative Artificial Intelligence). Economic data, in the form of Purchasing Manager surveys, generally took a turn for the worse last week. There were times in the past when weak data would have been greeted by a more positive market response, the "bad news is good news" theory by which it is expected that central banks will ease monetary conditions in response to a weaker economic outlook. However, the messaging from the US Federal Reserve, the European Central Bank (ECB) and the Bank of England remains very "hawkish". None of them wants to declare a premature victory over inflation.

Whereas the market seems willing to take the BoE at its word in light of the horrendous inflation data, and also the ECB, owing to its relentlessly hawkish rhetoric, it is challenging the Fed much more aggressively. At its last meeting, the Fed released its latest Dot Plot, which illustrates each member's estimate of where the Fed Funds rate will be in the future. The Fed seems to have largely won the battle for 2023, with the futures market slowly but surely pricing out rate cuts that it was previously betting on.

However, there remains a big disconnect for 2024. The end of 2024 futures rate is 3.82%, against a current effective rate of 5.07%. This continues to conflict with the Fed's Dot Plot, where the median dot is at 4.625%. Having said that, the Fed's members appear to be equally unsure, with the lowest dot at 3.625% and the highest at 5.875%. The rates futures reflect a belief by some participants that the US economy is going to weaken sharply under the pressure of high and rising interest rates and that the Fed will be forced to cut earlier and faster than it currently expects to.

What is the outlook for the US economy?

Our Global Investment Strategy Group is sticking to its guns in its opinion that the US will eventually succumb to a recession, but not a deep one. The manufacturing sector is probably already in a recession, judging by the latest PMI reading of 46.3 and the fact that employment in the sector is falling. But "making stuff" only accounts for around a sixth of total employment in the US, and one element of it is construction, which appears to be booming. This is a result of a shortage of existing homes for sale, combined with fiscal incentives to build more manufacturing capacity, especially in the fields of the green transition and semiconductors.

Meanwhile the services sector is still creating jobs, notably in Leisure and Hospitality. I note that last week, the data from the US Transport Security Administration that tracks the number of passengers going through airport security, hit a daily figure only surpassed (by a small margin) on two days previously, back in 2019. This two-speed economy only makes life more difficult for policymakers, increasing the potential for some sort of error. That could be over-tightening policy and creating a deeper recession... or loosening prematurely and needing to tighten even more aggressively in future. It seems to us that Fed Chair Powell is hell-bent on avoiding the latter outcome, which raises the recession odds.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	16.4%
GSK plc	4.4%
B&M European Value Retail SA	3.0%
Ferguson Plc	3.0%
Polymetal International Plc	2.7%
Next plc	2.7%
Rolls-Royce Holdings plc	2.3%

FTSE 100 weekly losers

British Land Company PLC	-13.3%
DS Smith Plc	-12.9%
Anglo American plc	-11.7%
Persimmon Plc	-10.7%
NatWest Group Plc	-10.2%
Fresnillo PLC	-8.9%
Smurfit Kappa Group PLC	-8.9%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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