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Taking The UK Temperature

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I was somewhat surprised to glance out of the window one morning last week and to see snow falling. Even though there were warnings, the ambient temperature in central London is usually a bit higher than in the surrounding area and so snow doesn't always make it to the ground. I have learned the hard way over the years that if I have to travel anywhere outside the north/south circular road early in the morning to play football or golf, I have to be prepared for it to be a few degrees chillier than at home.

With everything that's going on around the world today, ranging from elections to geopolitical strife, the focus of these commentaries is often on events far away from here (and definitely beyond the north/south circular), and that is reinforced by the fact that we (and our industry in general) continue to invest more of (y)our assets overseas in search of the best possible returns. But while those financial assets are increasingly internationalised, most people's single largest asset, their house, is very much in the UK, as are their biggest liabilities, such as a mortgage or other loans. That being the case, it's time to reflect on more domestic matters for a change.

Last week saw a bit of a temperature drop in the economic data that was published in the UK. Well, at least the activity data. Unfortunately, the one indicator that everyone would want to cool off faster, the Consumer Price Index, came in hotter than expected. Apart from giving us a snapshot of the domestic economy, all this also has implications for interest rates, the direction of which might concern you depending on whether you are sitting on a pile of cash savings or carrying a mortgage.

If we first look at UK economic data at the broader level, one lens to use is Citigroup's Economic Surprise Index (CESI). This scores economic releases relative to the consensus of economists' expectations. It is a classic mean-reverting index, meaning that the reading will always come back to zero. When it's in negative territory, it means that economists have been too optimistic and when it is positive it means they have been too pessimistic. It's a pretty good proxy for the underlying momentum of the economy. In normal times it rarely will go lower than -50 or higher than +100, although during Covid (which was distinctly abnormal) it bottomed out at -140 and then rebounded to +214. Even during the Global Financial Crisis those extremes were "only" -65 and +168.

I'm sure that you will recall that 2023 was a pretty miserable year for the UK economy concluding in a technical recession in the second half of the year (defined as two successive quarters of shrinking GDP) as higher interest rates took their toll. CESI bottomed out in February 2024 at -54 and the economy went through a nice period of surprising to the upside, with the index rising to a peak of +66 in June. Maybe former Prime Minster Rishi Sunak really did believe that there was an opportunistic feelgood factor that he could take advantage of when he called the snap general election.

Sadly it's been all downhill since then, with the index hitting zero at the end of September and now sitting at -48. I don't think it would be unfair of me to put at least some of the responsibility for that on the shoulders of the Labour government (although, because it's a mean reverting index, perhaps it's just the fall below zero that is more of its doing). There were effectively three months ahead of the Budget for people to worry about possible tax changes, and the messaging from Downing Street was very much along the lines of "the country's finances are in a mess and you are going to help to bail them out"!

We covered the Budget outcome in more detail a few weeks ago, but it's notable how many more companies and trade associations have come out angrily to protest against the costs being imposed on them, especially in terms of higher employers' National Insurance Contributions and an increased minimum wage. At some point, some of these increased expenses will be reflected in higher spending by their recipients, the government in terms of the NICs and lower-paid workers in terms of the minimum wage, but, for now, it is holding many companies back from making new investments. This is all the more galling for the fact that ahead of the election there was some optimism building that a new government with a strong mandate and five years of runway ahead of it would increase companies' willingness to invest.

Some of the economic data series that have come in weaker than expected this month so far include employment, industrial production, September GDP, the government's finances, retail sales and finally the latest round of purchasing manager surveys from S&P Global. Indeed, the latter saw the composite reading (which combines services and manufacturing) fall below 50 again for the first time since October 2023. The fifty mark is (loosely) supposed to demarcate the ground between economic expansion and contraction.

If there is normally any silver lining in such weak activity data, it lies in the expectation of lower interest rates. However, the Bank of England's hands appear to be tied at the moment by some aggravatingly strong inflation prints. Whilst the headline year-on-year consumer price index for October was expected to rise from a nice low 1.7% in September owing to a combination of base effects and a scheduled increase in energy utilities' consumer price cap, it came in at a higher-than-expected 2.3% (which counts as a negative surprise in the CESI). The core rate was 3.3% against a consensus forecast of 3.1%.

The main culprit was services inflation of 5%, which is itself driven to a great degree by wage inflation, which is running at 4.8%. Despite a relatively soggy economy, there is still a dearth of workers, and we have noted in the past the increase since 2020 of almost a million people who are unavailable for work for health reasons. And, of course, we have also seen some punchy pay increases for public sector workers including junior doctors and train drivers. While it's good to see people's wages increasing as that creates more potential demand, it would be better if they were the result of increased productivity, which does not appear to be the case.

What about interest rates then? As recently as mid-September, the futures market was pricing in a 0.5% cut in rates by the end of this year. The current probability of even just a 0.25% cut is effectively zero. Yes, there is a 0.25% cut expected in February, but there has also been a major rejigging of expectations for what happens after that, with maybe three or four quarter-point cuts expected by the end of 2025 rather than as many as six just a few weeks ago.

I have written several times in the past about the motivation for central bank interest rate adjustments being important to how they are received. Moving "because you can" is OK; "because you have to" is not. If higher interest rate expectations were purely the function of strong growth with benign inflation, then great. But weak growth and sticky inflation is not such an attractive combination. And while there is limited expectation that rates will actually have to go up again, "higher for longer" does take the wind out of the economy's sails, especially as savers who will benefit from higher interest receipts have, by their nature, less propensity to spend.

I don't want to get too gloomy about this. Labour's planned fiscal expansion will kick in at some point, and initiatives to encourage more domestic investment by UK local authority pension funds could also bear fruit, but that is going to be a longer term benefit, should it materialise.

Another arena in which all of this plays out is the foreign exchange market. The pound has been conspicuously weak against the US dollar, falling from a recent peak of $1.34 in late September to a current $1.26, giving back all of its appreciation since May. Despite the prospect of interest rates remaining stubbornly higher in the UK, that prospect is even stronger in the US following a resilient economic performance and then the Trump election victory (with his policies deemed, initially, at least, to be supportive to the dollar), not to mention another wave of investment flows. Unfortunately, given that most global commodities are priced in dollars, this also exacerbates our inflation problem.

It's worth pointing out that the pound is virtually unchanged against the euro over the same period, hovering around the €1.20 mark (and up from €1.16 since May). If anything, Europe is even more vulnerable to the threatened tariffs, given that it has an overall trade surplus with the US. France and Germany, historically the main engines of growth on the Continent and struggling and mired in political uncertainty too.

A further reflection of these forces can sometimes be seen in the relative performance of large and small capitalisation shares. The large cap FTSE 100 Index performed better than small and mid-caps until the pound started to strengthen in May and tends to underperform when the pound is stronger for several reasons. The main one is the translation effect owing to the fact that around three-quarters of FTSE 100 profits are derived overseas. Then there is the fact that a stronger currency often reflects a more buoyant domestic economy, which is where the lion's share of small and mid-cap profits are earned. Finally, domestic costs are also reduced by a rising currency as imports offer better value, helping to boost profit margins.

We continue to believe that UK small caps offer good value to investors and have been somewhat neglected, although we are having to be patient. So far this year, the total return for the FTSE 100 Index has been 11%, while it has been 8% for mid-caps and 10% for small-caps. Small cap returns have tended to be lumpy when they come, often in the form of companies being bid for, and takeover premia north of 50% are par for the course. With the pound weaker again and private equity funds sitting on plenty of dry powder, we could see more activity, although bidders might yet bide their time as they wait for the effects of the Budget to be fully incorporated.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Sage Group plc	20.8%
Smurfit Westrock	9.6%
Melrose Industries PLC	7.6%
Halma plc	7.6%
Hikma Pharmaceuticals Plc	7.4%
Imperial Brands PLC	6.8%
BT Group plc	6.5%

FTSE 100 weekly losers

Company	Change
JD Sports Fashion Plc	-21.1%
B&M European Value Retail SA	-8.5%
Ocado Group PLC	-4.4%
Lloyds Banking Group plc	-3.6%
Admiral Group plc	-2.9%
Burberry Group plc	-2.1%
Taylor Wimpey plc	-1.5%

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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