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15th June 2023

Market Update

Growth - Just

The UK economy grew by 0.2% in April, partially offsetting the 0.3% fall in March. Thanks to a strong February, over the past three months the total figure is growth of 0.1%. Hardly a high figure, but given that it is positive, it is better than many expectations from earlier this year. The fall in wholesale gas prices after a mild winter has been one factor in this, while resilience in the labour market has been another.

Feedback Loop

Unemployment reached its low point of 3.5% last summer and since then had been slowly increasing. This alone was surprising given the challenges facing the economy could easily have seen a faster rise in the jobless rate. Yet, in the latest data, released earlier this week, unemployment actually fell again dropping to 3.8%, from last month's 3.9%. Unemployment being so low is usually considered a positive sign, but when inflation is so stubbornly high, as it currently is, the tight labour market is increasingly a problem. Further data out this week showed that average wages increased at an annual rate of 7.2% in the three months to April, which outside of the recovery from the covid pandemic is the highest figure on record. This is creating a self-reinforcing feedback loop, where workers are seeing high inflation rates and so are demanding higher wages, this means spending in the economy increases and therefore further inflationary pressures are created.

Further Rate Hikes

Consequently, interest rate expectations are continuing to rise and this is spilling over into bond markets, which have seen borrowing rates jump over recent weeks. The yield (interest rate) on short term UK government bonds is now higher than it was in the aftermath of Liz Truss and Kwasi Kwarteng's confidence shaking mini-budget last autumn. The Bank of England's base interest rate is currently set at 4.5%. The Bank's latest policy decision will be released next Thursday and there is a near certainty that rates will be increased by at least 0.25%. Market expectations for the highpoint of interest rates have shot up over recent weeks, with a figure of approximately 5.75% now being expected by the end of the year. This expectation may well come down if the labour market and inflation suddenly weaken in the meantime, but it shows that the Bank's job is not yet complete.

Pause, for Now

While inflation is proving overly stubborn in the UK, in the US it is falling quickly. The latest CPI figures were released this week with a figure of 4% for May, down from 4.9% the prior month and well down from the peak of 9.1% reached last summer. "Core" inflation, which strips out volatile factors such as food and energy prices also ticked down this month to 5.3%, but with a previous reading of 5.5% the slowdown here is much less than in the headline CPI figure. The US central bank, the Federal Reserve, last night announced their latest interest rate decision and for the first time this hiking cycle, they did not make a change to interest rates, believing that more time is needed to assess the impact of the cumulative rises imposed over the past 15 months. The Chair of the Fed, Jay Powell, did however strongly hint that a further one or two rate hikes will be needed, likely starting at their next meeting, in July.

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Meanwhile, in China

The US therefore seems closest to controlling inflation, while for the UK there seems further to go. In China, meanwhile a very different challenge is faced. The Chinese economy had been expected to experience a strong surge in economic growth this year after being released from nearly three years of lockdown in late 2022. While this initially occurred, it has since disappointed in its pace, with domestic consumers less willing to go out and spend their lockdown savings as we in the west did, and with a property sector still struggling after a state induced slowdown over the last two years. China has an official target of 5% GDP growth this year and if a figure anywhere near this is achieved, then this will be much higher than in the western world, but it is still a lower number than the world's second largest economy and markets have been used to. In order to counter this lacklustre performance, the Chinese central bank has just reduced interest rates.

More to Come

While the US, UK and Europe are all hiking rates, China does not have the same issue with high inflation and therefore is able to add stimulus in the current environment. While more support will be needed than the 0.1% cut just imposed, that action has now been taken shows the Chinese government is not satisfied with their current prospects and suggests that more aggressive action will be taken in the coming months. Should this emerge then it is likely to have a strong impact on the economy and consequently markets are improving in this area, after what has been an up and down year so far.

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