19th July 2023

Market Update

Lower Inflation

This morning saw the release of the latest inflation figures for the UK and for the first time in many months, the pace of inflation came in lower than expected. Headline CPI was recorded at 7.9%, down from last month's reading of 8.7% and below expectations of 8.2%. Core inflation also fell, with the annual pace of price rises coming down from last month's 7.1% to 6.9%. Within the headline measure, the main causes of the falls were lower motor fuel costs and food costs which are rising more slowly than they were a year ago.

Good News

For both measures of inflation to be falling is good news for the economy and for them both to come in below expectations is good news for investors, with equities and bonds both rallying strongly today.

One Step Along the Path

Where the good news is limited, however, is that this is just one step along the path to more stable prices. Today's announcements suggests the Bank of England won't have to be quite as aggressive as it otherwise would have been; markets are now expecting next month's interest rate decision to be a 0.25% hike, rather than 0.5% and market pricing suggests that rates are expected to peak at around 6%, rather than the 6.5% previously predicted. Yet, even those lower interest rate expectations will still be very restrictive for the economy. Both individuals and businesses will continue to struggle with higher financing costs over the coming years as mortgages and other loans roll over from the lower fixed rates previously taken out to today's elevated costs.

Marginal Gains

Restrictive monetary policy will continue to be necessary. While the rate of price increases has fallen, prices are still increasing quickly. As mentioned above, motor fuels are now falling in price, but food costs are still rising, albeit at a slower rate than 12 months ago. Food prices increased by 0.4% from May to June 2023, whereas from May to June 2022 they increased by 1.2%. This has allowed the annual figure to fall from 18.4% for May 2023 to 17.4% for the 12 months to June 2023. A step in the right direction, certainly, but it is clear that much further progress is required before cost-of-living concerns fade away.

Goods vs Services

In general, the pace of inflation in goods is now slowing significantly, from a peak of 14.8% in October 2022 to the current level of 8.5%. Headline inflation has fallen too over this time period, but by a smaller amount. This is due to the price movements of services. The Office for National Statistics show that in October 2022 services inflation was 6.3%, whereas now it is at 7.2% (just below the peak of 7.4%, achieved last month). A big part of the cost in providing services is wages. The UK labour market remains very tight, with unemployment at just 4% and with average total pay across the UK growing at 7.3% per annum.

Wage Growth is Key

Such high wage growth is of course very much welcomed by individuals, but at a national level this makes returning inflation to the Bank of England's 2% target very difficult. The Bank is therefore very likely to keep interest rates high until there is a notable increase in unemployment and/or a large decrease in wage growth. While today's announcements are positive, only once labour market figures approach more normal conditions are inflation levels likely to return towards target on a sustainable basis.

Patience Rewarded

Markets are celebrating this progress today as it is the first good news received for a while. This shows the direction sentiment will likely take when inflation is defeated and therefore provides evidence that investors in markets – who have endured a turbulent period since early 2022 – should be rewarded for their patience. But with inflation still well above target, further progress remains necessary.

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Future Money Ltd

15 Victoria Place · Carlisle · Cumbria · CA1 1EW

0203 4570 387

www.futuremoney.co.uk