25th August 2023

Market Update

Market Seesaw
Over the past month markets have continued to follow the pattern which has been common to 2023 so far. Rally when economic activity looks weaker as interest rate expectations can ease, then fall as inflation pressures mount and thoughts return to higher rates. Late July saw such a rally in western equity markets, then losses took hold in the first half of August, before a further period of recovery over the past week. Although not perfectly correlated, similar trends can also be seen in bond markets. While there are other topics which are impacting the economy, this seesaw dynamic shows that inflation remains the most important factor in determining global investor sentiment.

Mission Incomplete
In the UK, headline CPI is now at 6.8%, having fallen from the previous month's reading of 7.9%. This is the second month in a row of significant falls in reported inflation and this trend is of course very welcome. Yet, while headline inflation is now well below its peak (11.1% in October 2022), core inflation was unchanged over the month at 6.9% and is only marginally below its 7.1% peak, which was reached in May 2023. The Bank of England will be pleased that headline inflation is falling, but with no convincing downward trend in core inflation, their job is far from complete.

Energy Costs Fall
The biggest factor in the fall in headline CPI was lower energy prices. Prices for gas and electricity surged last year following the invasion of Ukraine and while wholesale prices retreated long ago, retail prices have been slow to react. This was in a large part due to the Ofgem price cap which sheltered us from the peak of prices last winter, but equally prevented the quick pass through once prices fell. In July however, a significant drop in the cap did occur, allowing gas prices to fall by 25% between June and July, as calculated in the ONS's inflation figures. Electricity prices also fell 8.6% month on month.

Food Inflation Easing
Another factor in the improving headline CPI rate was an easing in the annual rate of food price inflation (14.9%, down from 17.4% in June).

Real Wage Growth
Lower energy prices and slowing food price rises will ease cost of living pressures. Meanwhile wages are now growing at 7.8% which is faster than headline inflation meaning we have *real* earnings growth and so that the acute phase of this latest economic squeeze is perhaps now behind us.

Core Inflation is Core to the Challenge
Challenges will remain however. Lower energy costs were always likely to result following last year's bounce, yet the remaining, more persistent, inflation factors will be harder to defeat. This brings us back to core inflation and the further work the Bank of England has to do.

Where Interest Rates Help
As previously discussed in these updates, core inflation is headline inflation less volatile factors such as food and energy costs. What's left is a better barometer of domestically generated inflation and these are the factors which can be more affected by changing interest rates; a higher interest rate doesn't help pump more gas or grow more wheat as a way to bring down energy and food costs!

Labour Costs
The inflation rate in total goods in the economy has been falling since October last year, yet the rate of price rises in total services has been continually increasing over this time. A large proportion of the

cost of delivering services is the labour cost and this is why the rising wage figures mentioned earlier are not entirely welcomed by the Bank of England.

Unemployment Rises

While wages rises continue to increase as they are, the Bank will have to keep monetary policy in a restrictive position, i.e. maintain high interest rates. Andrew Bailey and his colleagues at the Bank are likely to take some comfort from the fact that despite rising wages, unemployment actually increased this month (4.2% up from last month's 4% and 3.8% the month before). This therefore provides an initial sign of softer labour conditions, which, if it continues will likely restrain pay growth and so ultimately bring services costs and also core inflation down.

Softening Business Confidence

What the Bank are also likely to have welcomed, in a twisted fashion, is weak Purchasing Manager Index (PMI) readings which came out on Wednesday 23rd August, showing that most businesses now expect worsening conditions.

Bad-News-Is-Good-News

While it appears odd for the Bank of England and investment markets to be welcoming negative developments like higher unemployment and weaker business sentiment, they are doing so as both provide evidence of a slacker economy, which would allow them to lower interest rates, or at least raise them by less than otherwise. This 'bad-news-is-good-news' mentality accepts that moderate weakness in the economy now, while not pleasant, is preferable to a harder downturn later, which becomes more likely if interest rates have to rise by more.

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