28th September 2023

Market Update

Food Offsets Fuel

UK inflation figures from August were released in mid-September. While the pace of price rises has fallen in a convincing trend since the peak in October 2022, fears had been mounting that the latest figures would show a renewed jump, given the impact that recently rising oil prices would have. Such concerns have so far been unfounded however, with the headline number actually falling from July's reading. It was only a marginal drop (from 6.8% to 6.7%), yet with the slowing pace of food price rises more than offsetting the jump in motor fuel prices, a continued downward path in inflation could be seen.

Desired Impact

A jump in headline inflation may occur over the coming months (largely depending on the path of oil prices), but this month's number has been embraced. What was even more encouraging, was the drop in core inflation (headline inflation minus food and energy costs). Despite wages still growing at record rates, core inflation fell by 0.7% to 6.2% from the previous month's reading. Headline CPI is the most commonly discussed measure of price rises, yet it is core inflation which gives the most accurate reading of domestically generated price pressures and such a drop in the figures suggests that the cumulative interest rate rises experienced to date are having the desired impact.

No Change in Interest Rates

While it can be foolish to read too much into one month's inflation figures, the trends that are now building are evidently being taken seriously by the Bank of England, whose Monetary Policy Committee (MPC) met the day after the release of the inflation figures to set the UK's interest rate. Ahead of the inflation release, there were strong expectations that the MPC would vote for a further 0.25% hike in interest rates in this September meeting, and it was also considered a near even chance that yet another hike would come with November's meeting, which would have taken UK interest rates to 5.75%. However, with the arrival of the softer inflation data, the MPC decided no change in interest rates was necessary. A further hike may be required in the coming months if inflation does jump up again, but if not, it appears likely that the UK is now at peak rates, at 5.25%.

How Long Until Cuts?

Such a high point for interest rates feels uncomfortable for an economy which had grown used to the historically low borrowing costs which have existed since 2008's Global Financial Crisis. Yet, with market expectations in July predicting UK rates would peak at 6.5% this shows that conditions could have worsened further from here. Assuming that we are now at, or very near, the peak of interest rates, the question for investment markets is how long are we likely to stay at this high point, before rate cuts come along. 2024 seems the likely starting point for this trend, but how fast it develops will be important, with the path of America's central bank, the Federal Reserve (the Fed) being the most closely watched in this regard.

The Path for the US

The Fed also released their latest interest rate decision in mid-September and, like the Bank of England, held interest rates at their current rate (5.25%-5.5%). This was largely expected, but where markets were taken aback was in the Fed's forward guidance. The Fed suggested that rates would peak after one more hike later this before only falling very gradually over the coming years. Investors, on the whole, had been expecting a reasonably quick retreat from the high point rates are now approaching. While the Fed has long pushed against this assumption, it's latest projections were even more forceful than previous versions. In June the Fed's expectation was that they would drop interest rates to 4.5%-4.75% in 2024, whereas their latest projections are 0.5% higher. Beyond that timescale, further cuts are expected, but still only gradually, with the rate expected to be just under 4% in 2025 and to only fall below 3% in 2026. These are only expectations of course and it is highly likely that the true path of interest rates will differ depending on the path of inflation, and the strength of the wider economy.

Higher, For Longer

Markets have welcomed the progress the UK is making on the path to lower rates, yet the news of a longer than anticipated wait in the US caused mild losses as investors have come round to believing the Fed when they say rates will be “higher, for longer”.

Soft Landing

Markets are a little disappointed that they will have to wait before the good news of lower interest rates arrive, but the Fed is taking this more aggressive approach because of strength in the US economy. Much of 2022 was spent fretting over the recession that was likely to strike in 2023 and while this may still emerge in early 2024, the Fed has grown increasingly confident that they can manage the situation and that the much hoped for “soft landing” may actually be delivered. If a recession is avoided that would rightly be cause for celebration, but the flip side is that with economic growth proving more resilient, core inflation is likely to be more stubborn, which is why the Fed appears determined to play hardball.

Patience, but Positivity

Patience is required before victory can be declared over inflation, but with the falling figures we have seen over recent months, policymakers appear to now be in a good position. Recession risk is receding, inflation rates are falling, and interest rates will come down, even if it is a slow process.

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Future Money Ltd

James Watson House · Montgomery Way · Rosehill · Carlisle · CA1 2UU

0203 4570 387

www.futuremoney.co.uk