6th November 2023

Market Update

Israel/Hamas

In this latest investment market update the focus is primarily on the economic and investment market implications of recent inflation releases and interest rate decisions. Since the previous edition of this article war has broken out between Israel and Hamas, which is a horrific situation and one which is likely to continue to be incredibly disturbing. Beyond the humanitarian challenge, from an investment focused perspective the likely biggest impact of the conflict is in the oil price. If the fighting were to develop into a large regional war, this could lead to disrupted oil supply and therefore significantly higher energy prices, which in turn would create a renewed source of inflation. Currently, as bad as this situation is, it has been contained within a small geographical area, which has limited global financial impact and therefore investment markets have so far not been overly affected by this horrible conflict.

Interest Rates Held

At their latest monetary policy meetings last week, both the Bank of England and the US Federal Reserve held interest rates at current levels. The UK sits at 5.25% and the US in a range of 5.25%-5.5%. Both decisions were widely expected, but with interest rate hikes, rather than cuts, the next most likely outcome of the decisions, investment markets were happy, with both equity and bond markets rallying strongly following the announcements.

Likely At Peak

The future path of interest rates will be dictated by GDP, inflation and employment data points over the coming months. Yet, markets currently believe the UK is now likely at its peak level, and so too the US, although there is more doubt here with a further hike a distinct possibility in the coming months.

We See Its Effects

While both central banks insist that further hikes may come, the wording released in their respective press releases has been interpreted as being on the 'dovish' side, i.e. leaning away from the more aggressive option of higher rates. On 1st November, Jerome Powell, chair of the US Federal Reserve said "monetary policy is restrictive [and] we see its effects". This has been interpreted as an acknowledgment that interest rates have risen a long way so far, to the point that they are slowing economic activity, and while the US economy has been surprisingly strong through this process, Powell and his colleagues now see evidence of some softening.

Judging the Lag

With economic growth still buoyant in the US and the labour market very tight, there has been concern that further interest rate hikes will be needed in order to quell this resilience, in an effort to further drive inflation downwards. Inflation has fallen far from its peak, but it is still above the 2% target and so the question has been whether interest rates have risen far enough? We must now wait for the lagged effects of tighter monetary conditions to take hold – will these be sufficient or will further hikes be needed? With the markets seeing Powell's comments as an endorsement for the former, optimism spread that we are at, or very close to, the top of this hiking cycle.

Shared Sentiment

Similar sentiment was clear amongst investors in response to the Bank of England's interest rate decision. Inflation in the UK has been particularly high and persistent over this period and this has contributed to the lower level of economic growth present here than in the US. Core inflation in particular has been problematic, which in turn has been supported by low unemployment and high wage growth figures. A lack of progress here has been a nagging concern despite headline inflation having fallen significantly over the past year, with UK CPI down from its peak of 11.1% last October to 6.7% now.

Looser Labour Market

Last week's Monetary Policy Report from the Bank of England, however, included a statement that should provide confidence that conditions are now moving in the right direct, as far as rate watchers are concerned: "A looser labour market and falling inflation are expected to contribute to a moderation in wage growth". While official wage data has not yet fallen significantly, the Bank suggest there are signs it will do. Celebrating lower wage growth may seem odd, yet in an economy struggling with inflation, such an outcome is what is desired by policymakers and investment markets.

Partial Yet Significant Recovery

Following the announcements of the interest rate decisions, equities rallied and especially those most sensitive to interest rates, with the UK mid-cap index, the FTSE 250, up over 3% on the day. Bonds, too, rallied heavily and once again especially those with most interest rate sensitivity. Pound sterling also made significant gains against the dollar. In the context of the last two years these gains are small, and in most cases represent only a small recovery on the losses which have been experienced, yet they are significant movements nonetheless.

A Step in the Right Direction

Investment markets have experienced a tough time since inflation concerns took off in early 2022, heavy losses were experienced that year and so far in 2023 markets have generally moved sideways as investors have been forced to wait while inflation and interest rates have risen higher and for longer than expected. Last week's developments therefore suggest we are closer to a period which is more conducive to positive investment returns. While this is only one step in the right direction so far, and there are likely to be missteps still to come, this gives a suggestion of the direction inflation, monetary policy and investment markets may take and therefore should be considered welcome news.

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