Rathbones
Look forward

Review of the week

26 June 2023

An independent scapegoat?

The Bank of England is throwing the kitchen sink at runaway inflation. Will it be enough, and are there some things that are outside its control?

The Bank of England really took the gloves off last week. After inflation remained glued to 8.7% and core inflation (everything barring food and energy) kept rising steadily, the central bank raised its interest rate by 50 basis points - twice what was expected - to 5.0%.

Markets for locking in future interest rates suggest a 70% chance of another half-percent hike in July. We've come a long way over a year or so. The Bank of England (BoE) has come under fire for not acting quickly enough or shifting rates high enough to keep inflation tamed. Yet the BoE was the first major central bank to start hiking rates after the pandemic and has increased the rate virtually in line with the US Federal Reserve (the UK's increase was 4.9% from a 0.1% low, while the US went from 0.25% to 5.25%). When the BoE first started raising rates (and for many months after) many investors and talking heads decried the decision, with some saying it was "irresponsible". Now the BoE is being lambasted for not having done more.

We're not pointing this out to be spiteful or to have some cheap laughs. We're casting our minds back because it's important to remember how we've got to where we are, and not rewrite history. Public dialogue is always too loud and too fast these days. The internet fuels this frenetic energy, but we can all try to fight against it by taking a breath before coming down on hard conclusions. In the past, we felt the BoE might have hiked too hard too fast, but we always thought there was more chance of rates having to go higher than there was of them undershooting. Throughout we found the BoE's communications with the markets lacklustre and often confusing. Hopefully the latest turn will create a more forthright and brutally honest BoE.

We've also admitted, several times over the last couple of years, that central bankers have tremendously difficult jobs that we're glad not to do. We're glad there are other people who do step up to the task though. Over the past 30-odd years independent central banking has proved itself a very strong public institution, insulating a dark and dangerous magic from politicians. Tinkering with the cost of borrowing is tremendously powerful and it takes a strong character to avoid bending it to your uses. A few cuts leading up to an election can unleash a stock market rally, boost house prices and make it easier for households and businesses to splurge. Happy voters tend to vote for the status quo. The problems tend to arrive after the votes have been counted.

We hope that this institution of independent central banking remains strong after the current wave of inflation. It's been a lesson for all of us, that's for sure. One thing to mull over: the spread of things that a central bank can control might be wider than usual in certain circumstances. Traditionally, banks try to look through food and energy to the inflation underlying because they can't control the weather (which determines good or poor harvests) or the price of energy, which is set by global players. But the rest of it - local demand for goods and services - should be controllable (with a long lag) by adjusting the rate of interest. By raising it, the cost of households making big purchases with borrowed money goes up and new business ventures become less attractive because they are less profitable with higher financing costs. This tends to reduce the need for new jobs and limits hiring, wage growth and spending, and thereby cooling inflation.

But what if a nation's potential GDP growth (the total amount that it can produce without driving inflation higher) is reduced by an unforeseen combination of economic effects and policies that are the remit of politicians, not central bankers? What if the flow of workers becomes restricted right at the time that people decide to retire early in droves? What if there are greater costs to export and import goods because of a regime change in border controls, putting more pressure on inflation? What if travelling overseas becomes a much more expensive pastime? What if a phase-out of mortgage payment deductions from buy-to-let landlords' taxable rent receipts has dovetailed with huge rises in lending rates, driving eye-popping rent hikes across the country?

This last issue is becoming a serious one that is little talked about. At the end of last year, the average landlord had almost five buy-to-let mortgages, and 60% of landlords had at least part of their portfolio financed with borrowing. When these come up for remortgage, many landlords are finding themselves losing money each month since they can no longer offset mortgage payments from their taxes. They can claim a 20% tax credit on the interest portion of their payments, but that's not enough given the size of mortgage increases. Higher mortgage payments are wiping out the profit and then some, so landlords are trying to stanch the flow with spectacular rent hikes. This phenomenon may also help explain the recent unexpectedly large self-reported income tax receipts received by the government.

How do you control these factors as a central banker? There are decisions that politicians can make that affect these areas, but central bankers can only deal with the situation they find. Yet because the central bank is tasked with managing inflation, it can be at risk of becoming a scapegoat for things outside its control.

Better early than late

We think strident rate hikes (including what has already been delivered over the past 18 months) are already starting to bite on the UK economy.

Next month there will be another sizeable step downwards in the cost of power for households and businesses. The idiosyncrasies of the UK energy market mean it takes longer for changes in the wholesale price of power to flow through to retail prices than in Europe and the US. July is the next date when the energy price cap falls. This should help drag down headline inflation, albeit it won't be in the numbers till August's news release. After last month, the jury is out on core inflation, yet the BoE's latest moves should start to dampen people's inflation expectations, which then feeds through to spending and wage negotiations.

Despite the recent disappointment in inflation, we still think the BoE is approaching its peak in rates. We believe it should be finished by the end of the third quarter. The next BoE rate-setting meeting is in early August, so if it hikes 50 basis points at the next two, that would leave UK rates at 6% by late September.

UK government bonds have responded to the BoE's sharp rate rise by falling in price (therefore the yields have risen, as they move in opposite directions). The largest price falls were in bonds that have one to two years before maturity because the prevailing short-term rate of interest is closely tied to the BoE's rate. One-year bonds yield 5.35% and two-year bonds yield 5.20%. Further out, 10-year UK government bond yields aren't as high. Currently they trade around 4.30%, slightly down from the 4.50% they reached a couple of weeks ago. When short-term interest rates have much higher yields than their longer-dated counterparts, that tends to signal that a recession is coming. Essentially, what it's telling you is that interest rates are going to rise in the next six months or so, but then start falling after that, likely because of recession. Longer-term bonds do best when GDP growth is stagnant or falling and central bankers are cutting interest rates to support the economy. The reason for this is that a long-term bond is a locked in interest rate that becomes attractive when new debts are issued with lower interest payments. Sort of like if you had a five-year term cash deposit paying you 5% and prevailing interest rates slump to 2%: you're getting a better return than what's offered in the market, so you're pleased as punch. The difference is that bonds can be sold on to others, so their value can be priced in the market.

We recently started to increase the proportion of government bonds in portfolios from relatively low levels because we believe the peak of global interest rates is approaching. We knew interest rates were likely to go a little higher, but we're at the point where they offer decent yields along with portfolio protection in case of an economic downturn. It's hard to know ahead of time where the peak in rates will be, but historically bonds tend to perform well from that point onward.

Our research suggests that it's important to have a decent allocation to government bonds at the point of peak interest rates and that it's better to add to government bonds a little too early than a little too late.

If you would like to hear more about what's going on in the global economy and how it affects the way we invest, please join us for our next Investment Insights webinar on Tuesday 11 July at 12.30pm. You can register here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

Rathbones
Look forward

Important information

This document is published by Rathbones Investment Management Limited and does not constitute a solicitation, nor a personal recommendation for the purchase or sale of any investment; investments or investment services referred to may not be suitable for all investors. No consideration has been given to the particular investment objectives, financial situations or particular needs of any recipient and you should take appropriate professional advice before acting. The price or value of investments, and the income derived from them, can go down as well as up and an investor may get back less than the amount invested. Rathbones Investment Management Limited will not, by virtue of distribution of this document, be responsible to any other person for providing the protections afforded to customers or for advising on any investment. Rathbones Investment Management International is the registered business name of Rathbones Investment Management International Limited which is regulated by the Jersey Financial Services Commission. Registered office: 26 Esplanade, St Helier, Jersey JE1 2RB. Company Registration No. 50503.

Rathbones Group Plc is independently owned, is the sole shareholder in each of its subsidiary businesses and is listed on the London Stock Exchange. Rathbones is the trading name of Rathbones Investment Management Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Regulation Authority and the Prudential Regulation Authority. Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. The information and opinions expressed herein are considered valid at publication, but are subject to change without notice and their accuracy and completeness cannot be guaranteed. No part of this document may be reproduced in any manner without prior permission.

Any views and opinions are those of the author, and coverage of any assets in no way reflects an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Fluctuations in exchange rates may increase or decrease the return on investments denominated in a foreign currency.