RATHBONES

RUNNING HOT AND COLD

REVIEW OF THE WEEK

INFLATION IS FALLING NICELY IN THE US, WILL BRITISH CPI FOLLOW SUIT THIS WEEK? MEANWHILE, CHINA BATTLES DEFLATION AS ITS ECONOMY STUTTERS.

American inflation has cooled considerably, yet wage growth is still running hot, making another interest rate rise almost certain next week.

CPI dropped a full percentage point to 3% in June, cheering investors and bringing the US Federal Reserve (Fed) within touching distance of victory. There's still a way to go, however. Core inflation, which ignores energy and food, is much higher at 4.8%, having dropped from 5.3%. A roughly 15% fall in the cost of energy compared with a year earlier was the main factor dragging headline CPI below core.

Core measures are what the Fed focuses on. There was good news here, too, though. The month-on-month change in core CPI was 0.2%, while economists had expected 0.3%.

Fed policymakers like to strip housing costs out of core CPI, because the official data measures what renters, for example, are paying now even if their rent was fixed in a contract signed 12 months ago. While this is useful to know, it doesn't help the Fed assess current price pressures. The monthly change in CPI ex-housing was a smidge below zero – a very rare phenomenon since data began in 1968. The annual rate of US core CPI ex-housing is still 2.8%, so there's a little more for the Fed to do, but a rate below 3% is a major development.

Wage growth and some service sector inflation figures are still punchy. The Atlanta Fed's wage tracker decelerated from 6.0% to 5.6% in June, yet it's still higher than any other time since it was started in 1997. Reinforcing this pay boost, the University of Michigan's US Consumer Sentiment Index came in above expectations as strong wage growth coincides with slower price inflation. An under-reported component of this survey is consumers' long-term inflation expectations: this hit the highest level this cycle, at 4.5%, and is a further indication that the Fed's work is not yet done (anchoring long-term inflation expectations is a hugely important part of the price setting process).

These profound disinflationary forces support our contention that we're not living through another 70s rerun. Instead, we believe that we're in a new (or should that be the old?) normal of 2%-4% global inflation rather than the 1%-3% of the 2010s.

The market for interest rate futures suggests a 95% chance of a 25-basis-point rate hike at the Fed's meeting on the 26th before a considerable pause. A pause is one of the conditions we wanted to see in our 'new equity bull market' checklist. Indeed, stock markets rose nicely last week, buoyed by hopes that the US rate hiking cycle is coming to an end. However, our historical analysis suggests that the final rate increase is not a buy signal for stocks when economic growth is deteriorating and when stock prices don't adequately incorporate that slowdown. This is the situation we find ourselves in today, which is why **we remain defensive in our positioning**.

UK inflation has been a different story, however. After a disappointing May result, the Bank of England slapped a 50bps increase on borrowing costs for households and businesses. June's CPI number is released this week and is forecast to fall from 8.7% to 8.2%. Another disappointment will push rate expectations up more. We still expect a significant fall in UK CPI by the end of the year (a circa 20% fall in energy bills will come through after July, for example). But, as we have said for some time, the risk that inflation gets stuck on the way down is highest in the UK among the major advanced economies.

We've been asked if the public sector pay deal for doctors and teachers could further derail hopes that UK inflation could be brought under control. We don't think it will make a huge difference: the wage bill as a percentage of GDP is relatively small and the increase still means that these workers are enduring a substantial real-terms pay cut that's worse than the average worker in the private sector. Private sector wage increases can lead to higher price inflation when companies pass on higher wage bills via higher selling prices. This channel doesn't operate in the public provision of the NHS and state education.

China wobbles

Inflation is still hot in Europe as well, albeit not as spicy as in the UK or as thermometer-popping as Southern

Europe's temperatures. Euro Area CPI for June will be reported this week. It's forecast to drop from 6.1% to 5.5%. Unfortunately, the anti-cyclone generating dangerously hot weather is expected to stick around for weeks yet. China is also battling extreme, record-breaking heat. It's a completely different story for its economy, though. While accelerating from an annual growth rate of 4.5% in the first quarter to 6.3% in the second quarter, GDP fell well short of the 7.3% expansion expected. China is a different beast to other large nations – this amount of growth would be unheard of in the West! – but inflation can be a helpful tool to assess Chinese GDP on its own terms. When an economy consumes less than it could if it made full use of all its workers and capital (what economists call 'potential GDP'), it tends to drag down inflation. (Similarly, when an economy consumes more than it can produce, it pushes inflation higher.)

While inflation has been ripping all around the globe, this lack of demand for goods and services in China has pushed inflation there *down* from 2.7% a year ago to exactly 0% in June. Unemployment, at 5.5%, has shifted much higher than the 4%-4.25% rate of the previous 20 years or so. The young have been particularly hard hit, with more than one in five young people between 16 and 24 years old out of work or study.

The post-lockdown recovery in China seems to be already fizzling out – our scepticism at the turn of the year was somewhat contrarian at the time, yet things have played out as we expected. Because of this, China is unlikely to provide much economic support to the rest of the world. The decision late last year to lift its strict 'zero-COVID' policy sparked hopes of a strong recovery in the economy. But momentum has clearly faded in the past few months. Growth in investment and retail sales has been far weaker than expected. And the deep downturn in China's housing sector has resumed after a brief pause. Concerned about debt levels and reinflating a housing bubble, officials there remain wary of delivering much extra support. They aren't willing to provide what they call 'flood-like' stimulus, the massive waves of infrastructure spending which fuelled the past couple of strong rebounds in China's economy. Instead, their efforts so far have been small scale, mainly just concerned with putting a floor under the property sector and ensuring completion of existing projects. The recent cut in interest rates by just 0.1 percentage point epitomises this very tentative approach.

The recent upbeat mood among stock market investors seems to be riding hopes that the US Fed is going to pull off nirvana: a soft landing. That means returning inflation to below its 2% target without causing a recession. We're not so optimistic. As we say often, it takes between one and two years for the full effects of a rate hike to filter into an economy. American borrowing costs have risen rapidly and stratospherically, there's still many percentage points of tightening yet to truly sink in.

Add a hobbled China to the mix and there's a definite prevailing downdraught to global growth. We don't expect a gruelling recession like the Global Financial Crisis, because this time round big banks are much more tightly regulated and in better shape. But a mild retrenchment seems most likely as 2023 grinds on, with a subsequent recovery sometime in 2024.

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