TIM UNDERWOOD

Monthly Report – June 2023

In June the US central bank decided to not raise interest rates after over one year of constant rises aimed at stopping inflation. Its decision to not raise was accompanied with statements that probably two more are needed this year. No action but a promise to take action in the future. The ECB and the Bank of England did raise rates. But the largest economy in Europe, Germany has gone into recession ... *Data from the Federal Statistical Office showed Europe's largest economy contracted by -0.3% in the first quarter of 2023, compared with the previous three months, when it shrank by -0.5%. The technical definition of a recession is two consecutive quarters of contraction (Guardian).*

Usually when an economy goes into recession the central bank lowers interest rates to make it cheaper to borrow and invest and to consume, in an effort to invigorate the economy. Conversely when inflation rises, rates are increased to make loans more expensive, cutting disposable cash and demand, resulting in lower prices. This is what the central banks have been doing for over one year as inflation rose from the end of 2021. But what if this traditional economic policy is wrong for the current world? That policy supposes inflation is demand lead. What if the inflation of late 2021 into 2023 was due to the supply shock as a result of lockdown policies by governments in reply to Covid19? This would suggest the last thing the economies needed was higher rates. What they needed was low rates to encourage production and improved supply of goods and services to respond to the supply shock. However central banks saw inflation and increased rates as always.

Contrary to central bankers, markets see it differently. Central banks can raise the over night rate but longer term rates are determined by supply and demand for long term bonds. This is the interest rate situation at the end of June 2023 for government bonds.

	Bank of England	ECB/Germany	USA
Overnight rate	5%	4%	5.25%
2 year bond	5.34%	3.26%	4,93%
10 year bond	4.44%	2.44%	3.86%

A key metric is the 2 and 10 year bonds and see how the longer term is lower that the shorter term. It is usually the other way around. So why would any investor buy a bond with a yield over the coming 10 years which is lower than investing over night or for 2 years? Because they see central banks lowering rates and soon.

Central banks have raised rates rapidly during the last year to fight inflation. The only reason they would drop rates is if inflation falls or if the global economy moves into a recession. The central banks got it wrong before (see my November 2021 report) maybe they will get it wrong again. Diversification, income producing assets and gold are the way ahead.

Best wishes
Tim

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Disclaimer - This is not financial advice.
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