TIM
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Monthly Report – September 2023

In September the central banks in USA, Europe and the UK had their regular meetings and again decided on their interest rate policy. As we have noted earlier they have been very keen to raise rates to try to reduce inflation. Raising rates is the go to central bank policy to bring down inflation. But what if the central banks are wrong using this policy and what if they are instead setting up the global economy for a recession?

Economics is about demand and supply for goods and services. If demand goes up and supply does not, then in theory the price of those goods or services will increase. The central banks measure price rises as inflation and their solution to rising prices is to reduce demand by raising interest rates. Higher rates means higher bank interest payments for companies and higher mortgages rates for people, so there is less money in the economy to chase up higher demand and prices. But this ignores the supply side. What if the supply side is cut back and it is this which leads to higher prices? Then higher interest rates do not help reduce inflation.

Looking back to the panic around the cv19 drama, supply issues were certainly a problem and therefore perhaps the inflation of the last year in the main economies, was not due to higher demand but due to supply disruptions. We have actually seen this happen in just the last couple of months with the oil market. The OPEC producers have cut back oil supply and oil prices have risen. But last month the ECB raised interest rates again to now 4% in their efforts to lower inflation. But they did not explain how higher interest rates in Europe will increase oil supply from OPEC. The USA and UK did not raise rates last month and kept them on hold, but both these central banks have already increased rates over the last year by significant amounts. In fact they were the biggest rate rises from near zero ever. Central banks do not seem to be concerned that raising rates too much, will tip the Western economies into recession, which means less economic activity, less growth, profits, wages and higher unemployment.

Higher rates have already negatively impacted commercial property developments. Also private property values are dropping. The property markets are shutting down in Germany, the UK and the USA. This will impact demand and consumer spending and as there is a lag effect, expect this to develop far more in 2023 and into 2024. One hopes of course that central bankers know what they are doing and will not cause a global recession. But look at my November 2021 report which quoted the ECB web site at the end of 2021... *the staff projections foresee inflation at 2.2% in 2021, 1.7% in 2022 and 1.5% in 2023.*

It turned out to be 2.5% in 2021, 8.8% in 2022 and at 30 June 2023 is 5.5%. One wonders how accurate are current forecasts. Now the ECB forecasts inflation for 2024 at 3.2% and for 2025 at 2.1%. Remember it is forecasting inflation which is driving current interest rate policy, which is a huge factor in economic activity, resulting in growth or a recession.

While no one can predict the future perfectly and forcasts are by their nature not going to be totally accurate I do wonder if central banks are going to hold rates too high for too long? This is particularly the case when there are other factors at play to threaten the economies. If recession does come in the next 3 to 6 months what will the central banks do?

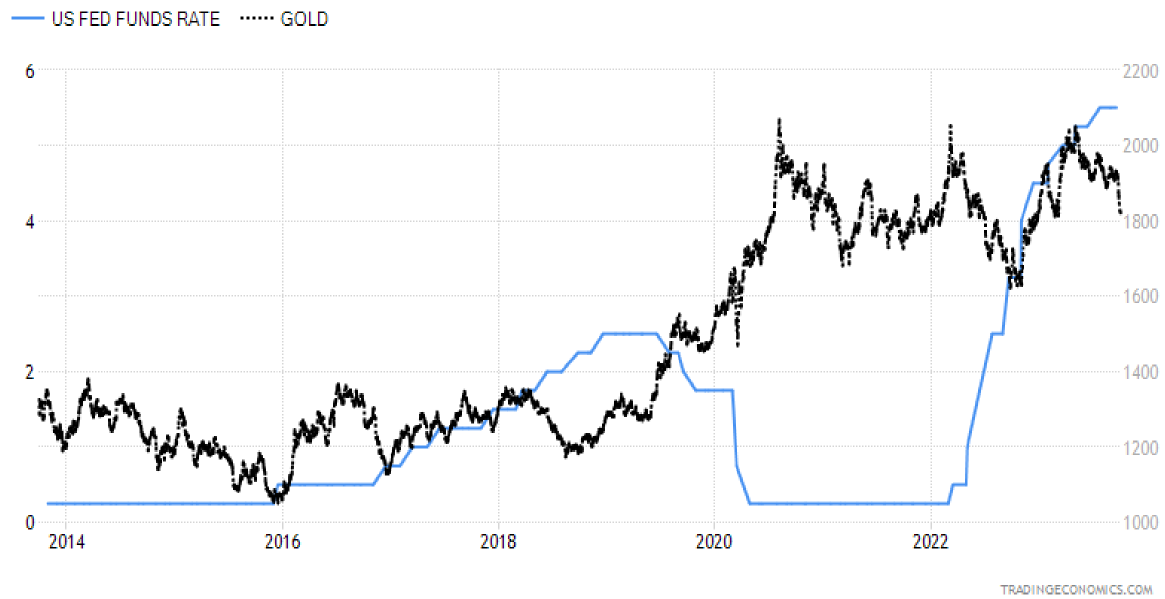
In my view, if the economies drop into recession, central banks cut rates, significantly and quickly.

It is always the case that economies are well into a recession before the authorities confirm that fact and therefore the first piece of negative news might not cause much of a reaction. Germany produced two consecutive quarters of negative GNP growth, the usual definition of a recession and yet the ECB ignored this and raised rates last month. *"After GDP growth entered negative territory at the end of 2022, the German economy has now recorded two consecutive negative quarters," says Ruth Brand, President of the Federal Statistical Office.* Press release 25 May 2023. But when it is fully acknowledged it will have a significant impact on the investment world.

Lower rates might suggest higher share prices however when this policy is as a result of a recession, profits and therefore share prices will be under pressure. Bonds usually do quite well as lower rates means bonds become more attractive due to their relatively secure capital and the income yield. Other income producing assets can also do well while the highly rated tech stocks, with profits promised years into the future, do poorly. But we have been here before and quite recently.

In May 2019 rates in the USA were around 2.5% and then they were cut to zero by mid 2020. See the blue line in the chart below. The black line is the price of gold which moved from about $1,300 to over $2,000 in the same period. That is a gain of some 50%.

In addition to dropping interest rates significantly the central banks might create huge amounts of money as they have done in the past when faced with a problem.



Currently gold has dropped back to about $1,850 as the US dollar has been strong and US interest rates are at 5.5%. Are the central banks going to cut interest rates if a recession develops and also create a lot more money? Will history repeat itself?

Best wishes

Tim   4 October 2023

Disclaimer - This is not financial advice.

See www.timunderwood.com for details and reports   Contact tim@timunderwood.com