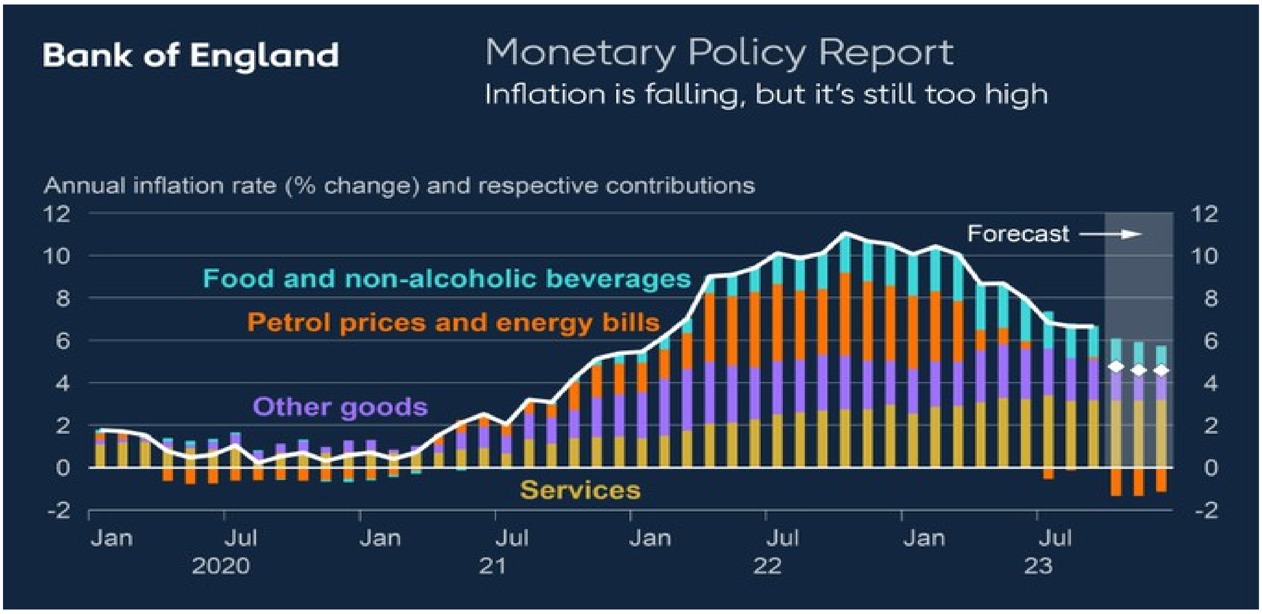
TIM UNDERWOOD

Monthly Newsletter – October 2023

On 2 November the Bank of England decided not to move interest rates.

"*The Monetary Policy Committee voted by a majority of 6-3 to hold Bank Rate at 5.25%. Higher interest rates are helping to bring inflation down. This means the speed at which prices rise is slowing. We expect inflation to fall further this year.*"



Looking at the above chart I could argue that falling inflation is due to lower contributions from petrol and energy bills, over which the Bank of England has no control. Notice they were negative in the last three months. So did higher interest rates really bring down inflation as they claim?

What higher rates have achieved without question is higher mortgage costs and as many as one third of UK households will see higher monthly mortgage payment kick in during 2024. Not up by 5 or 10% per month but far more, perhaps as much as 100% extra per month for some!

The policy of raising interest rates to reduce inflation is text book economic policy as is the Philip's curve which I remember from my university days. The concept is that if the labour market is tight then workers will demand more pay, which will force companies to raise prices which will force ever higher wages, leading to ever higher prices. The Philip's curve links employment to inflation so to get inflation lower higher rates puts pressure on companies and therefore less money for wages and the cycle is broken. This policy will of course result in higher unemployment but when that is clearly visible, central banks are able to lower rates without causing inflation and increase employment.

Since the Philip's curve concept is based on UK data up to the end of the 1950s there are some who think the relationship does not hold in the modern world. But it is still a concept discussed by central bankers. This from ECB council member Mrs Schnabel on 31 Aug 2023

"The second question facing policymakers is how fast the slowdown, should it persist, will succeed in reducing underlying price pressures. The slope of the Phillips curve is at the heart of this question. "

The ECB decided to leave their interest rates unchanged the week before the Bank of England and the USA central bank has also not moved rates. So the question is .. have the central banks stopped raising rates and when will they start lowering them ? Are they going to wait and see unemployment rise, as the Philip curve implies before acting? This matters to the economic and investment world. As earlier newsletters have noted, they are in danger of acting too late and create a global recession.

The Bank of England also made the following forecasts

Inflation:	Growth
2023 4.75% (prev. 5.00%)	2023 0.50% (prev. 0.50%)
2024 3.25% (prev. 2.5%)	2024 0% (prov. 0.50%)
2025 2% (prev. 1.50%)	2025 0.25% (prev.0.25%)

The bond market is a better forecaster and for some time now it has been forecasting a recession (see newsletter November 2022). So expect growth to be negative in 2024. In difficult times it is best to avoid certain areas and at the moment that suggests to avoid China (property debt problems for banks), high tech companies (very high valuations) and commercial property (debt needs to be refinanced at higher rates). But some areas do thrive even in recessions.

Two well know billionaires, Bill Gross and Bill Ackman, are now investors in bonds in the expectation that central banks will lower rates which is good for bond holders. Before they went public with this news we had already invested in bonds in the portfolios. The dividend yield is paid in cash into the portfolios and if indeed rates do fall in the coming months, a capital gain is possible.

Longer term however governments have issued so many bonds and continue to issue them, so at some point in the future bond prices will fall. But we are not there yet judging by the actions of the two billionaires. Timing is the key and constant attention to an ever changing situation.

Best wishes

Tim 6 November 2023

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