RATHBONES

# A LOT GOING ON

REVIEW OF THE WEEK
30 OCTOBER 2023

**THERE'S A VERITABLE SEA OF MOVING PARTS OUT THERE IN THE GLOBAL ECONOMY, WHICH ARE KEEPING INVESTORS ON EDGE. THE BIG QUESTION IS, HOW WILL THEY INFLUENCE CENTRAL BANKERS?**

The big conundrum investors and central bankers are grappling with today is whether economic growth and inflation always go hand in hand.

Traditionally, you would say the current red-hot US economic growth must stoke up inflation. That's because, bluntly, Americans are buying more than the economy can adequately produce. If everyone wakes up to a money shower and runs out to buy lemonade and TVs, odds are that the soda-makers and electronics stores won't have enough to fill the demand. Lemons take time to grow and TVs usually come on a boat from the other side of the world.

This means the shop owners are onto a winner: they whack up their prices and people will still pay, so they make more money. But soon punters cotton on and ask their bosses for higher wages because everything's getting more expensive, which then means the shop owners need to pay their own staff more because otherwise they'll go elsewhere. Meanwhile, when they've gone to re-stock their lemons and TVs they find that other businesses are willing to pay more to get hold of them because last year's large profits have encouraged more people to get into the lemonade and TV businesses, while the number of trees and have factories probably hasn't changed much in a year. Profits get squeezed, workers get grumbly and investors get nervous. No one can really tell whether they're in a better or worse situation than a year ago.

This is a highly simplified narrative of what's happened in the US since the pandemic (obviously, there's more to life than lemonade and TV), but we're at an interesting point in the story. American economic growth has accelerated in recent months and headline inflation has picked up with it, from 3.0% in June to 3.7% in September. Some economists spy promising signs that inflation will soon deaccelerate again, yet forecast falls in rents have yet to flow through as expected and trouble in the Middle East has sent the oil price spiking higher. Meanwhile, households have continued to spend with abandon – total spending jumped 0.7% in September, higher than the 0.5% expected.

As for us, we still believe above-capacity GDP growth drives inflation. However, we think the US economy must soon fade because of the gravity exerted by phenomenal increases in borrowing costs, which will ease inflationary pressure. While everyone seems obsessed with the spending habits of American households, we're looking more broadly – at businesses as well.

## A Hurdle for Business Investment

The US Federal Reserve (Fed) meets this week to decide on interest rates and is overwhelmingly expected to sit on its hands. We think that's the best course. Since the Fed last hiked its benchmark rate to 5.5% on 26 July, the yield of a 10-year US Treasury bond has risen a full percentage point to 4.88%. This a big increase in borrowing costs in just a few months. Treasuries are the bedrock on which mortgages, consumer loans and business funding rates are built. And the Fed didn't have to lift a finger.

While everyone fixates on the short-term benchmark rates set by central banks, it's the longer-term rates set by bond markets that arguably really matter. Broadly, these are investors' best estimates of how interest rates will average out over the next decade. Today, the 10-year American Treasury is telling us that the Fed will be cutting rates sometime in the future, but not that much, and not by as much as people expected only a few months ago.

More practical than its signal, the rate on a 10-year government bond can be thought of as a hurdle for businesses. When it costs more to borrow, it increases the total cost of financing a business. That means more companies start to shelve projects as they become unprofitable – the profits expected from their replacement production line or new service fall below the cost of paying shareholders and bondholders. In this context, we have noticed weakness in private business investment (excluding re-stocking, which can obscure more meaningful trends).

Many US recessions have arrived despite resilient household spending: 1948, 1960, 1969, 1981 and 2001. And it's actually quite rare for total household spending to fall by more than 0.5% in a downturn. Our research shows that investment is usually the big swing factor for whether a recession arrives or passes by. Private investment contracted significantly in the second half of last year, only to rebound strongly in early 2023 thanks to government incentives from the several stimulus programmes. That impulse faded again in the third quarter. And now that lending conditions for business are even tighter, we think it's likely to get worse in the coming months – just when, in our opinion, the US consumer starts to deliver much less growth.

Meanwhile, the Bank of England decides on its own path of UK interest rates on Thursday. Most economists expect the committee to leave the rate at 5.25%, despite the nation's inflation refusing to budge from 6.7% – the highest in the G7. The European Central Bank kept its benchmark interest rate steady at 4.5% last week after 10 consecutive increases.

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.

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