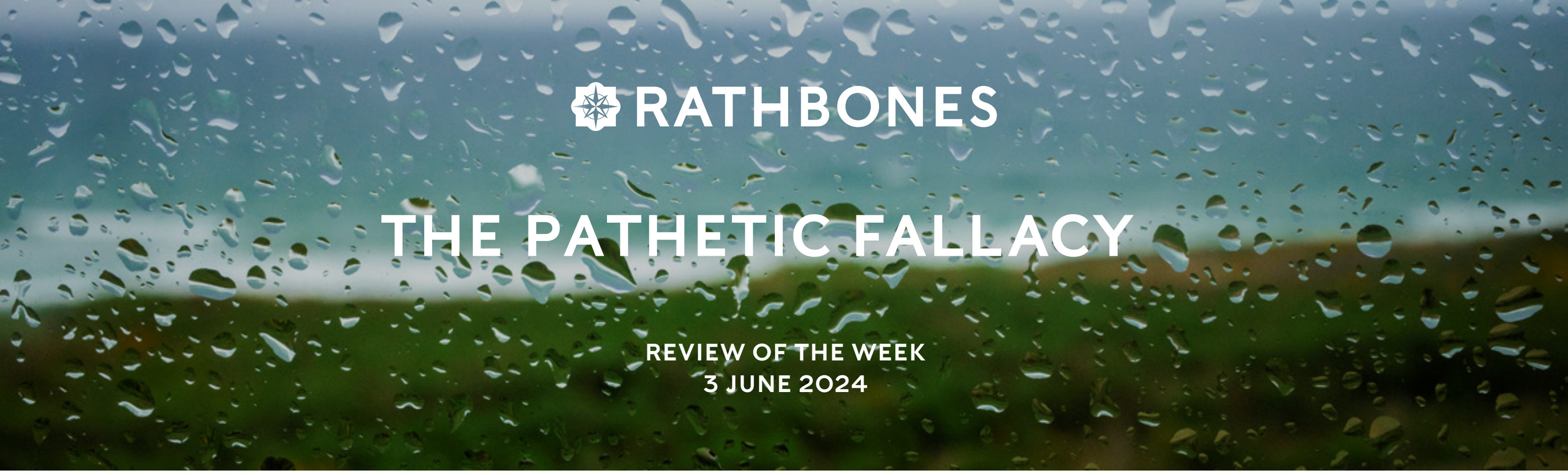

RATHBONES

THE PATHETIC FALLACY

REVIEW OF THE WEEK
3 JUNE 2024

UNCOMFORTABLE WEATHER HANGS OVER THE UK AND ITS MARKETS AS EVERYONE WAITS FOR A SIGN OF SUMMER.

As a soggy, muggy May melts away, markets are a bit restless as well. People are desperate for some unadulterated sunshine and lower interest rates. Yet if wishing were all it took, we'd all have raccoon tans and lower mortgage rates by now!

Our daydream also explains why central bankers must be careful with when they cut rates and by how much. Most Brits tend to be on fixed-rate mortgages, so just a quarter of mortgage-holders would see their repayments drop instantly with a rate cut. Yet tens of thousands of households remortgage each month, and they face much tougher rates than they've seen for decades. The prospect is daunting for many and arguably puts a dampener on spending as it approaches, with people preparing for big increases in what's often their biggest bill. That concern and fear could easily flip to elation and relief if rates are cut and the Bank of England (BoE) erects a signpost pointing down the hill. Especially if the decline looks like the one used for the annual cheese roll near Gloucester, which took place last week.

Happy, confident people tend to spend more lavishly than those who are bleak and troubled. And greater spending tends to push up prices, unless suppliers can easily increase stocks of the things everyone wants. The UK's ability to supply more homes, bars, restaurants, flights, food, drinks and workers is perhaps less limber than it used to be. So even now, with rates high, prices in these areas are increasing stubbornly.

But on the flipside, as we mentioned, each month tens of thousands of people *are* getting hammered with step-ups in mortgage payments that are, in some cases, double or triple what they were before. That takes its toll. If central bankers aren't careful, household spending (other than on mortgages, of course) will slump, sending the economy into reverse and causing widespread lay-offs.

In some ways, this situation is unprecedented because we've never gone from virtually zero rates to more than 5% in such a short time. You don't normally see such sharp divisions between identical households simply because some were lucky enough to have a mortgage fixed at an opportune time and others weren't. Meanwhile, another complication is that most homeowners in the UK own their homes outright. That means that higher rates are actually a *boon* for most homeowners because they're earning strong returns on their savings. In the past, the overwhelming majority of homeowners had a mortgage, making higher rates an unambiguous stick. Higher rates are causing big strains on renters though, with more people renting from the private market than ever before. Rents have increased rapidly, likely because many landlords must raise the rent to cover higher mortgage and tax charges.

So if you're a central banker you have a conundrum. If you cut rates too early, it could unleash greater spending and light another fire under inflation. Yet if you wait too long, the economy might crumple under the strain of higher borrowing costs. Meanwhile, there's a wildcard thrown in there by a very wealthy cohort of Baby Boomers that benefit from higher rates.

How do all of these unusual phenomena net out? Like the effects of climate change making our spring wetter and warmer, it's impossible to say for certain, even though most people have strident opinions on both subjects. The future is probabilistic. We can theorise and use data to come up with the most likely outcome, but unfortunately we won't know the actual outcome until it happens. One thing you can do is plan, however! So if you would like some tips on how to take control of your family finances and teach your young ones about money, **please sign up to next week's webinar**.

The Eurozone's first cut?

While the conundrum above was about the UK, it fits very well with the situation in Continental Europe and the US too. There are many differences – perhaps the most important being that the length of fixed-term mortgages tend to be much longer in the Eurozone and US than here. But the societal trends and economic challenges are roughly similar. The differences tend only to be of degree. Europe and the US also have a slug of very wealthy people approaching retirement if not retired already, big demands for services in particular and – in many areas at least – a lack of homes. They also share the wildcard prevalence of outright homeowners upending the typical effects of interest rates.

The Eurozone and UK dipped into recession last year, while the US powered on in 2023, driven by strong household spending and business investment and very large government spending. On the Continent that weakness, combined with big, sustained falls in inflation, has persuaded the European Central Bank (ECB) that rates should come down soon. Publicly, some voting members have all but said it will happen this Thursday when the ECB meets.

Admittedly, the latest Eurozone inflation data for May (released last Friday) was a bit hotter than most economists had expected. Headline inflation rose from 2.4% to 2.6% (rather than the 2.5% forecast). Core inflation (stripping out volatile energy and food) also rose, from 2.7% to 2.9% rather than staying flat. But overall, we think this is unlikely to derail the ECB's plans to loosen policy.

If we look at the recent dynamics of inflation and economic growth, it's clear why the ECB feels able to cut rates before the US Federal Reserve or BoE. While the sticky services component of European inflation ticked up in May and is running at roughly the same pace as in the US, it hasn't been elevated for anywhere near as long. And despite some green shoots, the eurozone economy is still in a tougher spot than the American economy. What's more, smaller European central banks have already opted to cut rates. In March, the Swiss National Bank cut its rate by 25 basis points (bps), with inflation back comfortably below target and not expected to exceed it over the forecast horizon. Then last month, Sweden's Riksbank cut by 25bps too, with the economy still in recession and inflation close to target.

While the case for the ECB to cut before the Fed and BoE is clear, we think some rate cuts will arrive before the end of the year here in the UK and in the US as well. That's not to say this will definitely happen! We've already outlined all the unknowns, complexities and risks that make the path of rates hard to determine. We just believe that, looking at the longer-term trends, it's more likely than not that rates will be falling before 2025 arrives.

For example, in the US first-quarter economic growth was revised down recently. The first estimate had been 1.6% annualised – much lower than the 2.7% originally forecast – yet after more information flowed into the US stats agency, that was reduced to just 1.3%. The Fed's preferred inflation measure, PCE, was in line, with monthly numbers decelerating faster than expected. Yet the all-important year-on-year number was flat at 2.7% as forecast. Core was also unchanged at 2.8%, albeit some economists had thought it would fall slightly.

Meanwhile, April US pending home sales were significantly weaker than expected: down 8% month-on-month, the largest drop in three years and the lowest reading of the index since the pandemic-hit April 2020. Here we see an American quirk of a widespread global problem: current mortgage rates of more than 7% are discouraging people from buying, especially those who are already locked into a typical 30-year fixed rate that's considerably lower.

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.