RATHBONES

DOWNCAST, BUT OUT (SPENDING)

REVIEW OF THE WEEK
19 FEBRUARY 2024

THE UK SLUMPS INTO RECESSION EVEN AS PEOPLE'S SPIRITS AND RETAIL SALES RISE. MEANWHILE, TROUBLE MAY BE BREWING IN AMERICAN INFLATION.

The UK officially entered recession in July 2023, according to the Office for National Statistics' current estimate. GDP dropped 0.3% in the fourth quarter, worse than the -0.1% forecast, and succeeding a 0.1% drop in Q3. Two quarters of falling GDP is widely considered to mark the start of a recession. Britain grew a miserly 0.1% over the whole of 2023, and it has stagnated since the spring of 2022.

We believe this recession, which we have long flagged, will be mild and relatively short, not least because our analysis suggests it won't be accompanied by a banking crisis. So does the International Monetary Fund (IMF), the financing arm of the United Nations, which recently updated its forecasts for GDP among its roughly 190 member countries. The IMF expects the UK to grow by 0.6% this year and by 1.6% next, suggesting that Britain will have returned to growth by the end of 2024.

We talked last week about how contradictory UK data have been. Some measures of activity and mood are straight out terrible, yet others imply the country is skimming along fine (if looked at in isolation). Retail sales have flipped from awful to outstanding in a month. Having slumped 3.3% in December, they rebounded with a 3.4% increase in January – the largest monthly jump since April 2021. No single industry drove the swing, either, with rises in all sectors of shopping bar clothing retailers.

UK services in particular (everything from lawyers and accountants through to tour operators and pubs) have been on a strong run for months. Meanwhile, rising post-inflation wages and falling mortgage rates seem to be boosting household sentiment. Another cheering note will be the continued decrease in the unemployment rate, which dropped by 10 basis points to 3.8% in December. Economists had thought it would increase by the same amount to 4.0%. Job security holds a lot of sway over people's inclination to spend.

British businesses are also more optimistic lately, which is a helpful sign. That may be because they smell that the current economic contraction will put greater pressure on the Bank of England (BoE) to cut interest rates. We are of the same view. As inflation continues to drop in the UK, we think the BoE will cut rates several times over the spring and summer. Of course, that's provisional on inflation, which has paused at 4% in recent months. We believe this hiatus will be fleeting, however, and inflation will fall back in coming months. But sticky inflation is one of the larger risks facing both UK stock and bond prices. All else equal, higher-than-expected rates would mean an increase in bond yields (so a fall in their price) and a reduction in the value of companies' future profits. Not only that, but tighter financing would continue to squeeze an economy that's already struggling to grow.

So why are we convinced that UK inflation is on the way down? The energy regulator's price cap is due to fall substantially in April. If the drop is the roughly 15% forecast, it would cut inflation by almost 0.8 percentage points at a stroke. Combined with decelerating food price growth, that could bring inflation below 2% in Q2.

An Atlantic difference
Looking more broadly, the IMF expects global growth to be a respectable 3.1% this year, and 3.2% next year as European economies bounce back (albeit less strongly than had been assumed three months ago).

The IMF's forecast of 2024 US growth has increased markedly – up 0.6 of a percentage point to 2.1%. This much stronger economic activity is having an effect on inflation as well. As more money sloshes around the US, demand for goods and services – particularly services – is outstripping supply. That is heating up inflation more than people would like. It's not just services though. After years in the doldrums, measures of the health of US manufacturers have rebounded to levels that imply they are growing again. A potential driver could be the huge amounts of government spending directed at infrastructure and green energy in recent years starting to flow around the country.

While it's not all roses – pandemic-era savings are likely depleted and there are signs that businesses are cutting back on staffing hours – we think the chance of a US recession in 2024 has fallen to roughly 50/50. So we come back, as always, to inflation. With less chance of economic contraction, the US Federal Reserve (Fed) will be less inclined to reduce rates than perhaps it would if GDP growth were much weaker. And, to be fair, with good reason: the trend of falling inflation has stalled in the US.

The three-month rate of change in core inflation, which removes energy and food prices, is now higher than both the six-month and year-on-year change.

The inflation problem child is the US service sector. **Some argue that it's just housing costs that are pushing inflation higher**, which isn't a problem because housing measures lag the real world by many months. Others say it's just methodological quirks in the computation of medical service prices, or long-term uplifts in the cost of car insurance that don't reflect broader underlying trends. But January's print was different – the increase in inflationary momentum was broad-based, across virtually all types of services.

What does this mean for the Fed's interest rate strategy and therefore for markets? We've noticed this burgeoning reversal in American disinflation for three months in a row now. When combined with the resurgence in US economic activity, we think there's a risk that fewer rate cuts will arrive this year than investors hope. It's true that the Fed targets PCE inflation, rather than the garden variety CPI favoured by most other nations, and that is a much more benign 2.6%. But consistently stronger inflation in CPI versus softer PCE is starting to resolve in favour of CPI. And we think that's a concern for the Fed.

Because of this resurgence in US inflation, we prefer UK bonds to US ones right now, as they should provide better and less costly protection if global equities fall sharply.

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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