RATHBONES

GOODBYE TO ALL THAT?

REVIEW OF THE WEEK
21 OCTOBER 2024

A BIG SHIFT IN CONFIDENCE THAT UK INTEREST RATES WILL KEEP FALLING APACE INTO THE END OF THE YEAR SENT BRITISH GOVERNMENT BOND YIELDS SHARPLY LOWER LAST WEEK. THE 10-YEAR GILT YIELD FELL FROM 4.21% TO 4.06% AFTER INFLATION PLUMMETED FROM 2.2% TO 1.7%.

Since coming to within touching distance of the central bank's 2% target in April, inflation had seemed to have hit a stubborn floor. No longer: economists had forecast September's inflation figure to fall to 1.9%, but in the end it went much, much further. That big fall was driven mostly by large drops in petrol prices and airline tickets. Yet the most helpful part of the report in terms of delivering good cheer to investors was a hefty deceleration in services inflation. The cost of labour-intensive things like car repairs, legal work and restaurants has been increasing by at least 5% annually since June 2022. At its height in the summer of 2023 services prices were rising by more than 7%. In the latest inflation release, services inflation dropped from 5.6% to 4.9%. While half of the drop was caused by the big fall in the cost of airline tickets (which are a service, not a product), stripping out airline prices still shows services inflation falling steadily.

This easing in services inflation could mean that wage growth is finally coming back to a level that's more in tune with target inflation. One thing to watch, however, is the release of the new Living Wage rates on Wednesday. An outsized increase here may put a fly in the ointment. If wages and services inflation do continue to moderate it makes it easier for the Bank of England (BoE) to cut interest rates without causing an inflation rebound. Current bond market prices suggest investors think between 1.25% and 1.5% of cuts are coming before the end of 2025. That would put the UK Bank rate, payable on overnight deposits at the Bank of England, at between 3.5% and 3.75%.

Of course, lower interest rates flow through to lower borrowing costs for everyone in the UK, from households paying mortgages to businesses looking to invest in long-term kit and **the government trying to balance the books**. If those rate cuts can be delivered without reigniting inflation, they should help drive the economy and, hopefully, encourage the investment that the UK badly needs.

Speaking of the Budget, it's perhaps the most anticipated of recent memory. The rumour mills have been grinding away incessantly for months, creating a whole raft of possibilities, tips, concerns and existential crises for everyone from buy-to-let landlords and higher earners to the AIM stock market, pensioners and wealth inheritors. What is most surprising is how little the government has actually said officially about what will be in the Budget, considering the level of speculation that has often reached the air of certitude.

Now, 'officially' is an operative word here. Budgets are no longer the tight ship they once were. It seems to have become de facto policy to brief ahead of the release of a Budget, along with virtually all other policies, to see how it will land with the public. No doubt it helps with messaging as well: floating a big increase in a tax, then delivering a more modest rise can dilute grumbles with relief.

We can't rule out that many of the changes forecast by commentators and punters haven't originated somewhere in Whitehall, but we also can't ignore that some could have been cooked up by people with axes to grind. You should be careful about acting on incomplete information, especially with uncertainty and rumour swirling in the air. We always recommend getting in touch with your financial adviser before doing anything drastic. If you don't have one and would like one, **we would be happy to help**. If you would rather learn more about financial affairs for your own peace of mind, you can also sign up to one of **our financial awareness courses in November.** Or, if you think you could do a better job of being the Chancellor, **the FT has you covered**. Give it a go, it's actually a lot of fun. Much more fun than standing at the dispatch box for real we would think!

Protectionism from who?

On Tuesday, the IMF publishes its latest World Economic Outlook, a twice yearly round-up with projections of the prospects for the global economy. On the eve of that release, **Europe is not looking good**. Its GDP growth has struggled to rise above stall speed since its initial post-pandemic rebound and France especially has got itself in a fiscal mess.

The European Central Bank is trying its best to support the bloc by cutting interest rates and reducing the cost of debt. Last week it delivered its third quarter-percentage-point decrease of the year, putting its overnight deposit rate at 3.25%. There are many issues holding back European growth – at least in its two largest economies – yet one is particularly worrisome: a slowdown in China. Lots of European manufacturing is aimed at making quality vehicles, appliances, machinery, production lines, machine parts and the like that China has bought in droves over the past few decades to enable its gargantuan infrastructure investment and construction boom and to fill new homes and roads with modern domestic tech and cars. It has also delivered luxuries, like wine, spirits and designer handbags to the newly affluent.

Today, China is having to straighten out lots of overbuilding, so it no longer wants as many machines as it once did. Residential construction has fallen by two-thirds and is back to 2006 levels. We don't envisage all that much of a rebound. Chinese households are also leery about spending because the economy isn't seeming so rosy. Meanwhile, overarching it all, Chinese suppliers have improved massively and are becoming the go-to brands for everything from fridges, televisions and cars to industrial machinery. That increased competition means European producers are securing less of the pie than they once were. In fact, often the Chinese competition is making inroads into European producers' home markets as well.

This reversal is causing economic pain, but also fuelling trade policy on the Continent. Earlier this month, the EU increased tariffs on Chinese electric vehicles from 10% to 35%. China responded by increasing the levy on EU brandy to 39%. The US is veering the same way, levying 100% tariffs on Chinese EVs several months back. The latest tit-for-tat increases and the recent weakness of China have weighed on European luxury businesses and carmakers.

Another warning sign for EU growth and for the strength of demand out of China dropped last week. A specialist Dutch manufacturer of high-tech computer chip printing machines posted good numbers, yet at the same time flagged its upcoming orders were half what it had been expecting. About half of its sales go to China and Taiwan. That caused a short-lived wobble in other semiconductor companies, both in Europe and around the world **only a few weeks after China's stock market soared on hopes for an economic revival.**

China's government has proposed a huge list of tools to return vitality to the Chinese economy and its markets. We will have to see whether they do the job or not. If China continues to slow, these sorts of blips may become more numerous.

*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.*