INTEREST RATES REMAIN TOPIC OF THE DAY

MARTIN CURRIE
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UK quarterly macro update

MAY 2024

- **UK inflation has fallen from its 41-year high and is falling faster than the US**
- **With the Bank of England (BoE) expected to cut interest rates, could it be the first central bank to ease policy?**
- **Consumers have more disposable income which may allow inflation to stagnate**

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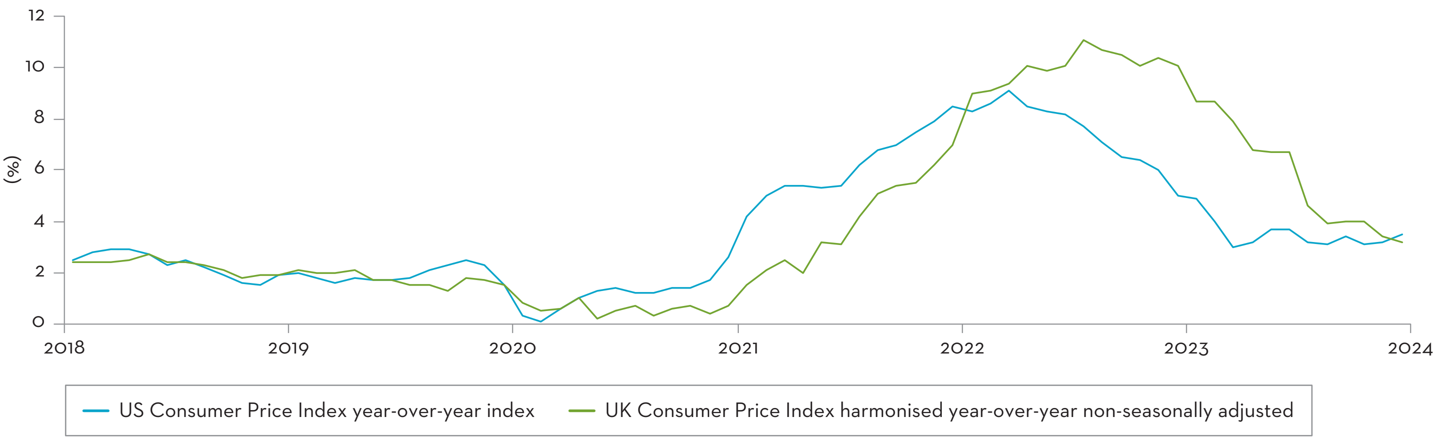
From an investor's perspective, inflation is critical in driving interest rate policy and plays an important role in equity valuations. Despite increased uncertainty from geopolitics, inflation remains the topic of the day for investors as we progress through 2024.

There were signs at the end of 2023 that inflation may decelerate faster than expected, with large downside surprises to consumer price data on both sides of the Atlantic, propelling bonds and equities higher.

UK inflation falling faster than the US

Economic data has remained far more robust than had been predicted with inflation remaining stubbornly high, more notably in the US (blue line below). In the UK (green line below), inflation has fallen from its 41-year high of 11.1% in 2022 to 3.2% in March 2024.

UK vs US inflation rates over the last five years – Consumer Price Index (CPI)



Source: Bloomberg, Office for National Statistics & U.S. Bureau of Labor Statistics, April 2024.

Looking through spring and summer, monthly inflation releases will continue to be the most anticipated macro data points. The Office for Budget Responsibility (OBR) are expecting inflation to average 2.2% over 2024, with further moderation in the coming months.

Despite the reticence of interest rate setters to diverge significantly from the US Federal Reserve (Fed), we are on the lookout for any emerging signs that we may see the BoE or European Central Bank (ECB) move first to ease policy. Policy makers have done well to shape expectations meaning that bond yields have increased without the need for any explicit action taken on rates. For reference, the market implied estimate is that the BoE will reduce rates by 0.6% this year versus the 1.6% expected in January. Similarly the Fed is expected to reduce rates by 0.4%, compared to January's estimate of 1.5%.

The market is therefore not expecting a drastically different approach, but with jobs data showing some signs of softening in the UK and inflationary forces prevailing in the US, this expectation may be proved incorrect.

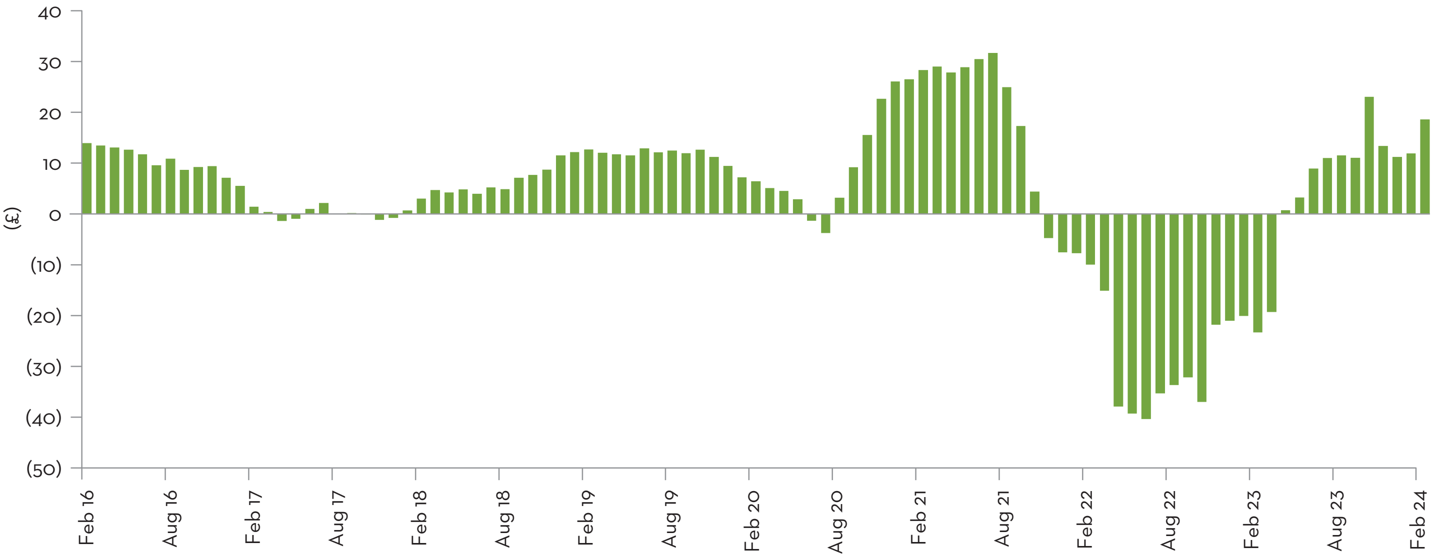
With energy prices due to fall 12% in April, and another fall expected in July, the UK's path back 2% inflation looks achievable. But there are concerns the last mile may prove to be most difficult due to several factors.

*The Consumer Price Index (CPI) measures the overall change in consumer prices based on a representative basket of goods and services over time. It is one of the most widely used measure of inflation.

Increased consumer spending could cause inflation to stagnate

As energy costs moderate, domestic inflation is now being driven by the cost of services which in turn is being driven by higher wages and a healthy consumer that has more disposable income. The Asda income tracker which takes average household net income minus a basket of essential goods to give an idea of true disposable income, shows positive momentum.

Year-on-year change in Asda Income Tracker (£)



Source: Asda income tracker report. January 2024.

On balance, inflation in the UK seems more manageable than say in the US. Federal spending in excess of tax receipts and the confidence boost from higher stock markets means growth remain high in the US. As a result inflation remains much more of problem, with the monthly reading for US CPI currently at 0.4%.

In the meantime, as markets have absorbed the shift in rate expectation, sectors such as banks have continued to perform well on a relative basis. On the other hand higher multiple, more growth orientated equities are underperforming. This looks set to continue until the balance of evidence points to the need to cut rates sooner or more aggressively than expected

Source for all data Bloomberg, April 2024 unless otherwise stated.

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