Macro Outlook Summary

July 2022

Central Banks have been busy. The US Fed hiked 75bps on 15th June bringing Fed Funds to 1.75% and signalled more to come. The UK BoE hiked 25bps on 16th June bringing the o/n rate to 1.25% while the ECB held rates at zero but indicated higher rates might be appropriate in July. Headline inflation data pressed higher in the US rising from 8.3% to 8.6%. Core inflation edged down to 6% in May, but food, energy and rental prices jumped strongly to mask this underlying improvement. The Fed is now clear that whichever way the data is viewed they are behind the curve and need to catch up quickly. UK inflation edged up from 9% to 9.1% again with core inflation edging down to 5.9% while food and energy rocketed north. Eurozone harmonised inflation rose strongly from 7.4% to 8.1% but here core data also rose from 3.5% to 3.8%. Despite the turmoil in European economies being caused by the Russian invasion of Ukraine it is getting increasingly difficult to understand the Lagarde-ECB hesitation and 'wait and see' stance as inflationary pressures continue to build.

With varying degrees of conviction central banks are now finally focused on addressing the inflation problem. They have no choice if credibility is to be preserved, even though the US, UK and Eurozone narratives have begun to diverge. After two years of Covid related US consumer transfer payments, US end demand strength and a tight labour market are clear. Strong demand in the re-opening economy is adding to cost push inflationary forces and the Fed is clear that tighter monetary policy is needed to dampen demand and relieve some inflationary pressure.

In the UK the picture is different as the average UK consumer simply doesn't have the balance sheet strength of their American cousins. UK consumer confidence has been falling all year as income accounts have been hit hard by the rising cost of living with minimal balance sheet support. UK personal savings are back to pre-pandemic levels around 6% and household disposable income is unchanged over the same period while in the US it is up strongly. The average Eurozone consumer has far less access to credit and consequently carries less debt with higher savings. The EU personal savings rate is 13% even though this has also fallen back to pre-pandemic levels. In short, US and EU consumers have come out of the two year Covid disruption in better shape than the UK consumer.

Why is the strength of the consumer relevant? Because as interest rates are pushed up by central banks there are two markers on the interest rate barometer of great importance. One is the rate at which inflation tips over and the other is the rate at which the real economy tips over and the question is which one comes first. The more indebted the consumer the greater is their sensitivity to rising rates. Consumers have never carried more debt than in this cycle. Higher debt levels increase the transmission of monetary policy to consumer behaviour so we expect with each step up in rates the consumer's negative response will grow. Judging at what interest rate level the economic tipping point is reached is key to central banks engineering a slowing of consumer demand and hopefully turning the inflation trend but not triggering a recession. Recessions are clearly not good for corporate earnings nor stock markets.

At this juncture it seems most likely that the UK will hit the economy tipping point marker first and the economic downturn will reduce inflation due to demand failure. In contrast the US stands a marginally better chance of escaping recession given the relative strength of the consumer and their ability to withstand higher rates, so possibly inflation data will inflect and turn downwards before signs of material economic weakness appear. Most puzzling is Europe where consumer strength and their ability to withstand higher rates is clear but the central bank still seems to doubt the reality behind the inflation data and the need to act now.

Lagarde may be right that the European economy and Germany in particular are being hit hard by the Ukraine war and with the consequent economic slowdown, meaningful ECB rates hikes would be unhelpful. But this prioritises the preservation of growth over the importance of controlling inflation which for a central bank is a particularly risky strategy. Being so slow to make so little change to monetary accommodation in the face of rampant inflation and consumers clearly able to withstand higher rates looks like a free option being left on the table and a huge policy mistake.

Equally disconcerting are recent ECB noises around ideas for re-introducing restrictions on government bond short selling. In her most recent speech Lagarde talks about a 'new instrument' which the ECB are working on and plan to present to the board shortly. If this is an early indication that the ECB actually believes that free capital markets are not in the public's interest and that higher inflation does not justify concomitantly higher government bond yields then there is plenty of trouble ahead. The manipulation of government bonds market yields and credit markets to ultra-low rates since the GFC has led to a gigantic credit boom which was almost plausible given inflation was sitting near zero. But we are clearly now in a different regime. Normalisation in government and corporate yields will result in significant losses for those involved but the idea that the ECB should intervene to control rising yields and widening spreads to conform with whatever changes they regard as appropriate will simply exaggerate further the imbalance between buyers and sellers of credit instruments and ultimately create an unnecessary and greater crisis in the future.