State of Play

Rate rises continue

23 March 2023

After calm eventually returned to investment markets following the panic caused by the collapse of Silicon Valley Bank (SVB), investors turned their attention to central banks. UK inflation unexpectedly rose in February, demonstrating that policymakers are caught between a 'rock and a hard place'. Will they still raise rates? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

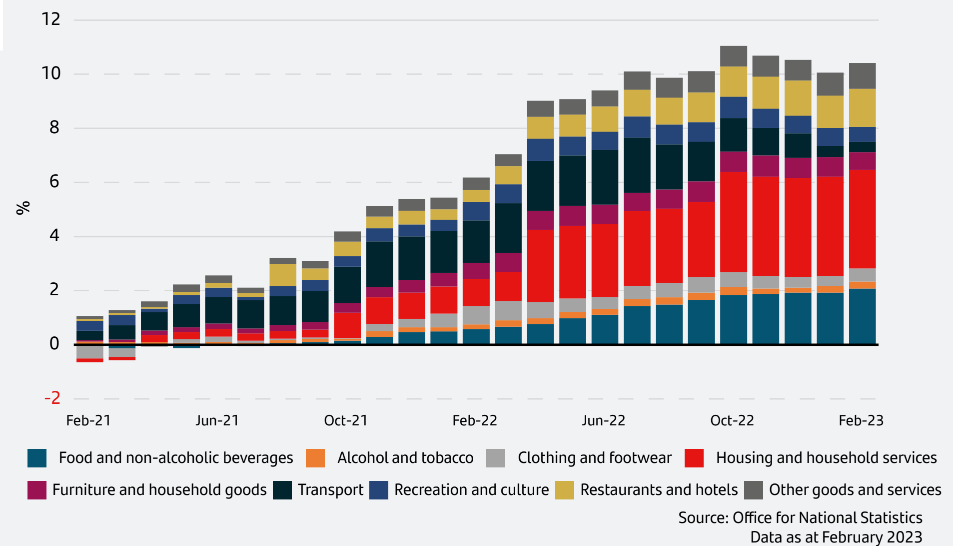
Key highlights from this week's State of Play

- UK inflation surprise
- US rate decision
- UK rate decision
- Market update

UK inflation surprise

The last 30 years or so have probably been a golden period that many will look back on with fond memory as rising prices remained lower than the historical average, allowing policymakers to reduce interest rates to reflect this change in our financial environment. Clearly, globalisation and advances in technology allowed for more goods to be made at a lower cost, suppressing price rises for a prolonged period. When the global financial crisis shook our financial world, central banks responded radically by cutting interest rates to near zero and printing vast sums of new money to help the global economy recover from the crisis. Fast forward to the last 18 months and all of this seems like a distant dream.

Contributions to the annual Consumer Price Index inflation rate

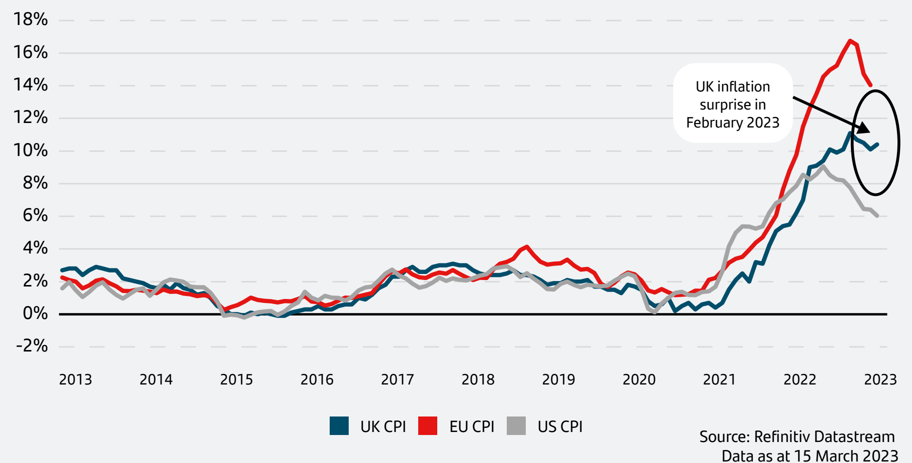


Source: Office for National Statistics
Data as at February 2023

The latest inflation data for the UK from the Office of National Statistics (ONS) surprised market participants as the Consumer Price Index (CPI) for the year to February rose by 10.4% compared to 10.1% in January and importantly, much higher than the 9.9% forecast. The leading components of this unexpected increase in rising prices were food and beverages at an annual inflation rate of 18.2%, which I am sure any reader of this update will know if you have taken time to analyse any recent food shopping bill. Core inflation, which ignores volatile energy, food, alcohol and tobacco prices, also rose sharply to 6.2% in February, up from 5.8% the previous month, exceeding economists' expectations of a slowdown to 5.7%.[1]

In the last few updates, I have explained the role of central banks in trying to navigate the changes in our financial world and how difficult this task can be when you have competing influences on your decision on interest rates. Currently, this represents for me the ultimate – 'between a rock and a hard place'.

10 Year annual Consumer Price Index



Source: Refinitiv Datastream
Data as at 15 March 2023

The collapse of SVB Bank in the US was primarily driven by the rapid reverse of loose financial conditions and low interest rates. Whilst their business model was fundamentally flawed and carried huge concentration risk, their eventual demise was caused by withdrawals of vast sums of capital from their corporate clients, looking to utilise the cash raised when launching their business idea rather than approaching the bank for a traditional loan, because the interest charges would be too expensive. The consequences for businesses of aggressive monetary policy by the central banks in raising rates cannot be underestimated. When interest rates rise and borrowing money becomes more difficult and expensive, weaker businesses tend to fail. While this is a normal part of the economic cycle, it is the first time the banking sector has been truly tested since the global financial crisis. Therefore, policymakers must balance the need to bring down inflation over time to their long-term preferred target rate of 2% by slowing consumption without breaking the economy.

Federal Reserve interest rate decision

The last couple of weeks will have tested the US Federal Reserve (The Fed), as their aggressive stance on rate hikes precipitated the fall of SVB Bank. Their swift response to protect SVB clients' capital and the reintroduction of additional new money into the system is in some ways a reflection of how quickly monetary policy has changed in the last 18 months. Now that markets have calmed from the stormy waters of last week, it came as no surprise when they announced their decision to increase interest rates by 0.25%, which was lower than the expected 0.5% before the banking crisis erupted. The Fed Chairman, Jerome Powell, hinted at a possible pause in future rate hikes as he described the economic fallout from the banking crisis as uncertain. The mixed messaging immediately saw US stock markets fall on concerns that the monetary policy decision and the uncertainty of the next few months spread unease amongst investors. The Fed's open market committee said: "The US banking system is sound and resilient. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity,

hiring and inflation." The likely impact of tighter conditions, which is where banks are more reluctant to lend and start to charge companies and individuals higher interest rates, is a further slowdown in economic output. The balancing act of bringing down inflation, slowing the economy and avoiding a deep recession is a challenging one. The Fed will next meet in early May, when we will see how the committee views the future and decide whether to press the pause button or tighten further.

The Bank of England rate decision

Following swiftly on the heels of the Fed, the Monetary Policy Committee (MPC) at the Bank of England had the same dilemma. How much do they raise rates? As expected, the MPC decided to raise rates by 0.25% taking the base rate to 4.25%. The MPC was split 7 votes to 2 in favour of the rise. Whilst the surprise inflation numbers will have concerned the committee, no doubt they are cognisant of the impact of tightening conditions on the banking sector and the longer-term impacts on future economic growth for the UK. Interesting comments were made in the bank's announcement statement on the recent financial turmoil; 'There have been large and volatile moves in global financial markets, in particular since the failure of Silicon Valley Bank and in the run-up to UBS's purchase of Credit Suisse, and reflecting market concerns about the possible broader impact of these events. Overall, government bond yields are broadly unchanged and risky asset prices are somewhat lower than at the time of the Committee's previous meeting. The Bank of England's Financial Policy Committee (FPC) has briefed the MPC about recent global banking sector developments. The FPC judges that the UK banking system maintains robust capital and strong liquidity positions and is well placed to continue supporting the economy in a wide range of economic scenarios, including in a period of higher interest rates. The FPC's assessment is that the UK banking system remains resilient."[2]

Market update

Last week reminded me of why emotions play such an important role in retail investors decision-making. When panic sets in and uncertainty overwhelms both common sense and time horizons, it is understandable why so many choose to rush for the exit. However, whilst the last couple of weeks represent the first true test of the banking sector since the global financial crisis, now that the dust has settled, it does at least demonstrate that the changes in regulation requiring banks to hold sufficient capital to protect against contagion when markets are in crisis mode have worked. For many, the recent falls in stock markets, especially in the UK, have been seen as an opportunity to invest at a discount.

The deal for UBS to takeover a troubled Credit Suisse, backed by the Swiss Central Bank, helped calm market nerves. However, having recently reached an all-time high of over 8,000, the FTSE 100 fell to 7,234 at one point on Monday just after the market opened before recovering strongly in the last few days to over 7,500 at the time of writing. The bond market has also experienced extreme volatility throughout the unfolding SVB story in the last two weeks. The last 7 days have

seen 10-year UK Gilt Yields oscillate violently before dropping close to 3% before rising back up above 3.5% following the release of the UK inflation data and investor calm.[3]

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 23 March 2023.

[1] Office for national Statistics, 22 March 2023
[2] Bank of England, 23 March 2023
[3] Investing.com, 22 March 2023

Important Information

For retail distribution.

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