Rathbones
Look forward

Review of the week

30 January 2023

Everything, everywhere, all at once

It's a manic week ahead, full of monetary policy, earnings and economic insights. Just the right time for a week of strikes to cause bedlam throughout the UK, from schools to railways.

Buckle up for a wild week. Three major central banks will be moving interest rates, a raft of important data and earnings will be released and a whole bunch of Brits are going on strike.

UK rates are going up for the tenth time in a row. Economists forecast a 50-basis-point increase that would take the base rate to 4.0%. Interest rate markets' current pricing implies the benchmark UK rate will peak at just under 4.4% in the summer. There's a persistent hope among investors that the world is approaching peak interest rates, but this is driven mainly by developments in the US. Across the Atlantic, hopes of a monetary policy pause are a bit more sound because inflation is already in mid-single digits and falling at a clip. Here in the UK, inflation is still in double figures and barely decreasing.

The UK economy does appear to be faltering - something that the Bank of England will need to keep in mind - but inflation is still very high. There is still a risk that prices stay out of control for long enough that it becomes a serious long-term illness for the UK - in fact, we think this is a greater risk for the UK than any other major economy. It's not altogether correct to assume that all central bankers will cease hostilities on inflation at the same time.

Inflation in Europe is also much worse than in the US, so the European Central Bank (ECB) may also need to continue tightening after the US Federal Reserve (Fed) has decided to pause and assess effects on the economy. Arguably, the ECB's actions are more important for the UK than what's going on with the US - Europe is our largest trading partner, accounting for about 45% of our imports.

If the Fed does stop raising rates soon, that could result in a weaker dollar due to the relatively lower interest rates on offer for holding dollars and potentially higher future yields for holding euros and pounds (where rates are still rising). All else equal, that means a stronger euro and stronger sterling *against the dollar*. This would reduce the sterling and euro cost of important commodities, like oil, gas, timber and metals, helping bring down inflation. However, if the pound weakens *against the euro* it would put upward pressure on inflation because it will mean more of the Continental goods we import - like food, cars and washing machines - will be more expensive.

Now, a disclaimer: we don't like to make forecasts on currencies for anything less than five years. Even that is probably too short a time horizon! Currencies are complicated and chaotic and prone to do the opposite of what you would expect and what the textbooks would tell you. We don't know how the pound, or the dollar or the euro will react to 2023. However, we think it's worthwhile to keep in mind what could happen if events don't play out as the majority expects.

If the higher interest rate argument now carries less weight, it could be bad news for the US dollar: on pretty much every other factor that can drive exchange rates - purchasing power parity, trade balances, fiscal policy, to name a few - the dollar looks overvalued.

And so, all eyes will be on the Fed as it raises rates on Wednesday. We think a 50bps hike is more likely than what the market is implying. Most investors think it will only be a 25bps rise. Voting members have used unusually direct language recently: financial conditions - how interest rate changes feed through into the real world - are looser than policymakers would like, and they are unconvinced that wage and service sector inflation (excluding housing) will fade rapidly.

Moving now to the ECB, is expected to hike its three benchmark interest rates by 50bps on Thursday, taking its main refinancing rate to 3.0%. The day before that announcement, the latest Euro Area inflation will be released: it's expected to drop by 20bps to 9.0%. We now know that German GDP unexpectedly dropped by 0.2% in the fourth quarter, down from a strong 0.5% rise in the previous quarter. That means another fall in Q1 would put the nation in recession, taking the rest of Europe with it. Germany is the Eurozone's engine room: German GDP is about 45% bigger than France, the other Continental heavyweight.

European earnings seem to corroborate this darkening picture. We're about a fifth of the way through earnings season and earnings per share in Europe have fallen 4% compared with a year ago. That's a massive 7% below what analysts had forecast, a huge miss. Sure, 60% of Euro Stoxx companies beat on profits, which doesn't sound too bad; however, this is actually the lowest hit rate since 2008. The negative surprises are largely due to higher costs, which businesses are struggling to pass on. This could be a warning that household demand has weakened considerably. Sales growth has been very strong, at 16.1% year over year, but a lot of this is because of a weakened currency. That doesn't bode well for 2023, when sales growth is likely to weaken. Paradoxically, it's typically harder for companies to raise prices to cover higher input costs when consumer inflation is lower (because punters are more inclined to notice).

With luck, this economic slowdown will help suck the wind out of the Continent's runaway inflation and reduce pressure on the ECB to keep hiking rates. That would be a large helping hand for the UK.

Strikes at the heart

It will be hard for many to keep an eye on markets with most English and Welsh schools closed, university classes cancelled and rail services hopelessly tangled between Wednesday and Friday. London buses will also be disrupted by the union walkout, particularly in the south and the west. Mercifully, the tube should be unaffected. Scotland's teachers have been on rolling strike for most of January and will continue into next week. Nurses and ambulance workers are following up with their largest strike to date next week, which will affect a third of England and most of Wales.

The concentrated strike action has been co-ordinated by the Trades Union Congress in protest of the government's reluctance to increase pay for the public sector and to object to the anti-strike legislation that just passed its second reading, which will introduce minimum service levels to ensure trains, schools, hospitals and postal services can still run, albeit partially, during future strikes. The unions say the law's powers are too broad, the penalties punitive, and both could be abused by government ministers. Despite the recent escalation of industrial action, after months of disruption, the government has so far made it clear it's not prepared to reopen talks over this year's pay. We'll be watching the outcome as the public sector accounts for almost one in five UK jobs.

Against the macroeconomic mosaic we discussed above, it's an important week for large, listed US companies, especially after several tech giants reported results last week. The US earnings season is faring better than in Europe. Earnings per share have fallen only 2% on a year earlier which is actually 1% higher than expected. The proportion of companies beating earnings estimates has been holding up a little above the historic average too, but softer than recent quarters. Again, while sales beats are trumpeted by businesses, rising costs and the difficulties in passing them on – and retaining profit margins – is the real issue.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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