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Cash: Losing its Crown

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It is monetary policy week in the key G7 economies, and the Federal Reserve in the US has already landed with, perhaps, an early Christmas present but just possibly a hint of a gnarly New Year hangover.

The United States sets the tone and direction for developed world interest rates. The world economy is highly integrated and cannot be immune to developments in, still, the world's largest and dominant economy. Expectations are that the ECB, and the Bank of England will follow the US lead and "pivot" to a lower trajectory for interest rates in 2024 than we, and the markets generally, were expecting.

Lower interest rates are clearly good news for highly indebted consumers and mortgagees and, let us not forget, for highly indebted developed economies where debt to GDP ratios are typically 100% of GDP. Lower rates will provide relief for all.

What has caused this rather abrupt volte face? We think there are two reasons: one positive, the other, not so much.

Firstly, as we all know, interest rates rose sharply last year in response to rapidly rising inflation. We regard inflation as a nurse regards her thermometer, it is an indication of underlying health. If the reading is too high, there is too much money chasing too few goods; too low and there is insufficient demand to absorb all the goods and services the economy can produce.

The combination of the pandemic, the Ukraine war, and post-pandemic fiscal stimulus had conspired to impose both a demand shock and a supply shock simultaneously. In other words, consumers had more money to spend than they thought but the world supply chains for food, energy, and manufactured goods were impaired by conflict, thus forcing up the price of available supply.

Central banks responded by attempting to "shrink demand" to fit the available supply. They do that by raising the price (lowering the demand) for borrowing.

Inflation has duly fallen. More technically, the money supply – the volume money in circulation – has plummeted across the US, the EU, and in the UK. However, Core inflation targets remain well above target. In the US the target is 2% but Core inflation remains at 3.5% which would not normally be low enough to stimulate talk of significant rate cuts.

This brings us to the second, perhaps not so positive, reason for the talk of cuts in borrowing costs today. Central Banks are intended to be independent of government but clearly, they are not immune to the political cycle and certainly not a cycle as febrile as the Trump/Biden contest of 2024.

The Federal Reserve is desperate to be seen to be above the political fray. At the same time, Donald Trump has impugned the idea of the independence of the Fed. The Fed tries to avoid making changes to interest rates in election years. It does not want to be accused of electoral interference.

The Chairman, Jay Powell, is attempting to deflect future criticism by laying out the trajectory of large interest cuts (which will have a large stimulatory impact on the economy) before he enters the maelstrom of a deeply embittered election year.

What does this mean for investors?

Two points stand out. Firstly, returns on cash deposits will fall quite quickly in 2024 and secondly, inflation may not fall as low or as fast as it would have done in a different part of the electoral cycle. Indeed, the US Central Bank is taking quite a risk with such a dovish view which might come back to haunt it.

The bond markets allow investors to fix high interest rates for long periods into the future, hedging the consequences of falling deposit rates. (As we have noted previously, higher, and additional rate taxpayers have a once in a generation opportunity to fix high, tax-free, and risk-free, returns in low-coupon gilts.)

Of course, lower rates will be good news for growth assets. A lower cost of borrowing will feed directly to the personal and corporate bottom line, supporting an upturn in aggregate spending and a rise in profitability.

On the back of Jay Powell's announcement, the outlook for 2024 has undoubtedly strengthened but we will be keeping a keen eye on those inflation numbers just in case they return to spoil the party.

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