RATHBONES

A CONTINENTAL DOG'S BREAKFAST

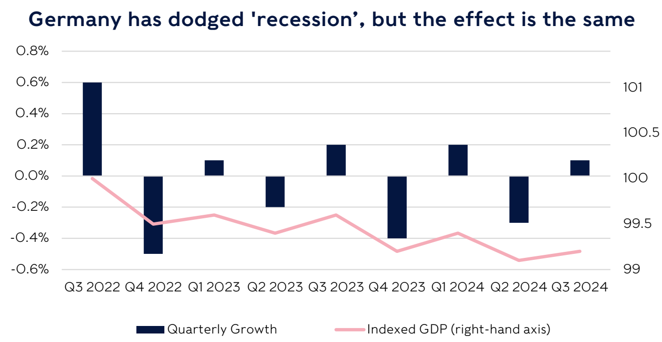
REVIEW OF THE WEEK
9 DECEMBER 2024

THE OUTLOOK FOR EUROPE LOOKS CLOUDY AS ITS TWO LARGEST ECONOMIES STRUGGLE. COMPARATIVELY, THE UK IS DOING GENERALLY OK. IT'S ONLY THE US THAT CONTINUES TO POWER AHEAD.

We're all well used to running down the UK and all its problems. Yet we can often forget that other nations aren't perfect either. Canada's central bank has already cut rates four times to 3.75%, including a half-percentage-point shift in late October, as its economy struggles. The former governor of the central bank argues that the country is already in recession and that the poor show has been masked by high immigration.

Europe's problems are well known: Germany's manufacturing industry is hurting badly, which flows throughout the small and medium-sized business eco-system that often supplies parts and services for it. For all intents and purposes, Germany is in a recession. Technically it is not, because the economy hasn't shrunk for two consecutive quarters. Instead, for two years it has bounced from a big fall in GDP one quarter to a small increase the next. You can see from the chart that the effect is the same: Germany's economy has shrunk by about 0.8% since the third quarter of 2022.

IF IT QUACKS, IT'S A DUCK



Source: German Federal Statistical Office

France is faring better on the economic front, although not fantastic. And that's with the government **spending an unsustainable amount more than it receives in taxes**. Prime Minister Michel Barnier resigned after losing the confidence of parliament last week. His attempt to reduce the government's budget deficit from 6% to 5% was rejected by alliances on the left and the right. Barnier will stay on as a caretaker while President Emmanuel Macron picks a replacement. This is becoming a theme. The parliament is divided almost equally between alliances of the right, left and centre. The left-wing voting bloc is the largest, yet the right-wing Rassemblement National (RN) is the single party with the most seats.

Another election to solve the deadlock can't be held until July 2025. Meanwhile, any attempts to fix France's financial woes are bound to annoy someone, making it unlikely that they will be able to make the necessary tax hikes or spending cuts. For its part, RN – the party that brought Barnier down – has said that it would be open to a grand coalition Budget developed by all parties. That could be a tough ask: the financing act must be agreed by the end of the year. If an agreement can't be made, France can roll over this year's Budget, but it could damage its credibility with global investors. The extra yield on French 10-year government bonds above their German counterparts (which investors demand as compensation for the added risk) has risen significantly over the past five months. Before Macron's snap election, announced in June, this 'spread' was below 0.5%. Today it's about 0.75% and has recently traded above 0.85%. This extra cost of borrowing won't squeeze only the government, but indebted households and businesses as well, which will weigh on economic growth.

The woes of France and Germany are a big problem for the Eurozone, as these two are its dominant economic drivers. It's quite an unusual situation, too. In the past, France and Germany have typically been the more together economies, while 'the periphery' has struggled with fiscal problems, growth concerns and investor worries about mismanagement of the public purse. Today, Spain, Greece and Portugal are doing quite well. Even Italy, to a degree. The European stock market has mostly shrugged this off. While it has underperformed US stocks so far this year, it has hit its highest level since the dotcom crash. That's helped by most of the companies making much of their cash overseas.

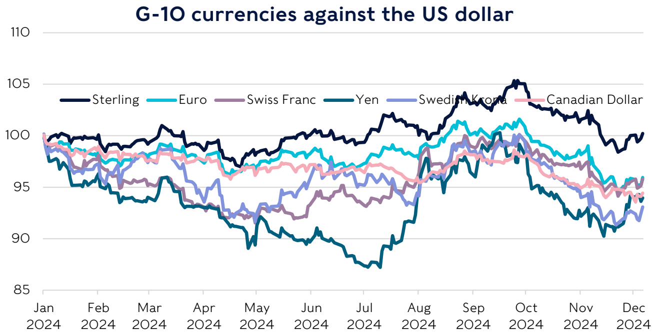
A flagging Eurozone isn't great for the UK: the bloc is our single-largest trading partner. Less demand for goods and services would hurt our exporters and weaken our economy as well.

The rate of exchange

The pound has held its ground against the dollar this year, in stark contrast to other major currencies. This seems to be because investors expect central banks elsewhere to make bigger and quicker cuts to their benchmark overnight interest rates to combat the issues we discussed above.

Sterling is currently trading at about $1.28. While that's down from the heady heights of $1.34 back in September, it's roughly where it has traded over the past year or so. Investors actually expect fewer rate cuts here than Bank of England Governor Andrew Bailey does. Last week, Bailey told the FT Global Banking Summit that he expected to make four quarter-percentage-point cuts in 2025. At first, the pound sank noticeably, but within hours it had instead gone higher. Currencies tend to rise if investors expect relatively higher interest rates and fall if they expect them to fall. UK government bond markets promptly shifted to assume three cuts next year. The poor guy, it's like investors were trolling him on purpose.

STERLING HAS HELD ITS OWN AGAINST THE DOLLAR, UNLIKE ITS PEERS



Source: FactSet; currencies' exchange rates against the US dollar, indexed to 100 at 31 December 2023, data to 6 December

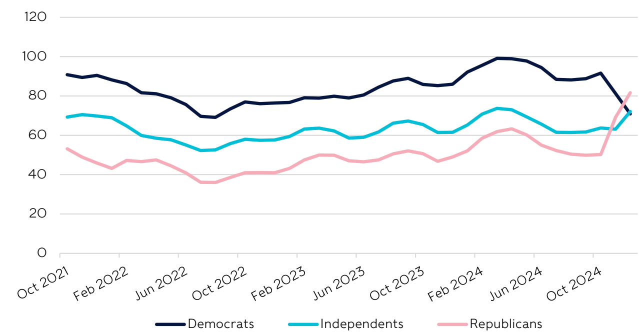
So will the markets be right or will Bailey? The answer will be written by inflation. Currently at 2.3%, if the measure remains close to 2% Bailey may yet be able to deliver four cuts. However, if this spins higher, the BoE will have to keep rates higher for longer. Energy costs are one concern, while another is the rise in wages and therefore prices in labour-heavy service industries. There are some risks on this front. The larger-than-expected increases in minimum wages, which come into force next year, the changes to employers' National Insurance Contributions announced at the Budget, and the prospect of a new workers' rights bill could all keep prices pressures in the services sector high. With government spending also due to ramp up next year, the risks seem skewed towards fewer cuts than the Governor expects.

As for the all-important US Federal Reserve, whose interest rate sets the benchmark for virtually all other assets, it's now overwhelmingly expected to make another 25-basis-point cut next week. Markets for pricing future interest rates put the probability at 87% after the US unemployment rate ticked up from 4.1% to 4.2%. That was despite the release showing 227,000 jobs were created in November, although these numbers are extremely volatile and prone to big revisions in subsequent months. That was higher than the 200,000 forecast. The only banana skin between the Fed and another cut is US inflation which drops on Wednesday. It's expected to remain at 2.6%. Any significant surprise above that could rock investors' confidence in the cut.

As for American households' view of the economy, they seem rather buoyant – especially about the prospects for the stock market. The University of Michigan Consumer Confidence survey rose in December for the fifth month in a row, hitting 74 and beating estimates of 71.8.

This was the first reading since the November presidential election result. Funnily enough there was a huge switch in the view of the economy from those who report themselves to be either Democrats or Republicans. After being in the doldrums for years, Republican voters are now more excited than ever about the economy. Meanwhile, Democrats' optimism has slumped. In recent years, Americans' whole economic view has been shaded by whether or not their preferred party's leader was in the White House. That dynamic doesn't seem to be going away.

WHATEVER COULD HAVE HAPPENED TO MAKE REPUBLICANS MORE CONFIDENT ABOUT THE ECONOMY?



Source: University of Michigan; data consumer confidence to December

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

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