March 2023 | Market update

High inflation keeps pressure on Fed to hike interest rates

The US central bank said interest rates may need to move to a higher level than expected and stay there for longer to ensure inflation continues to fall.

Global equity markets and US bonds took a turn for the worse after higher than expected US inflation and strong jobs growth fuelled fears that the US Federal Reserve (Fed) will need to raise interest rates further to contain price rises.

While inflation is coming down, the pace of reduction appears to be slowing. US inflation continued to cool in January, rising at a rate of 6.4% compared to 6.5% in December. This is the seventh month in a row inflation has fallen, but prices are still increasing by more than is considered healthy. US jobs growth continues to surge, defying fears of a slowdown. The economy added 517,000 jobs in January, more than double the employment growth the previous month.

The Fed raised its benchmark interest rate by a quarter percentage point to a range of between 4.5% and 4.75% – the eighth increase since March 2022. The US central bank said more rises may be needed to cool inflation and the surprisingly robust jobs market, although there were hints of rate cuts in 2024 if price rises continue to ease.

UK narrowly avoids recession

The UK narrowly avoided recession at the end of last year despite output falling by more than expected, with zero growth in the final three months of 2022. Although the economy shrunk by 0.5% in December, this was offset by growth in the two previous months.

After negative growth in the previous quarter, the figures mean that a recession – commonly defined as two quarters of negative growth – was technically avoided. With inflation continuing to fall, there is less pressure on the Bank of England to continue raising interest rates, which has helped the performance of government bonds.

Inflation fell for the third straight month in a row to 10.1% in January, down from 10.5% in December. At the beginning of February, the Bank raised interest rates by 0.5% to 4%, the highest since the financial crisis of 2008, and warned more hikes could be on the way. The FTSE 100 also hit an all-time high after breaking the 8,000 point barrier.

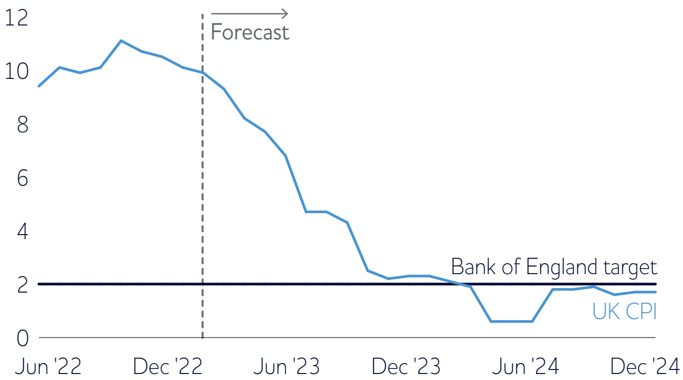
Euro area GDP beats estimates

The euro area beat expectations by posting positive economic growth of 0.1% in the final three months of 2022, reducing fears of a potential regional recession. Inflation across Europe dropped for the third consecutive month in January, easing to 8.6% from 9.2% in December, adding evidence that price pressures have peaked. The European Central Bank (ECB) raised interest rates again by half a percentage point, taking its key rate to 2.5% – the highest since November 2008 – and said that it would carry on raising interest rates further..

Chinese stocks dipped as tensions with the US escalated after an alleged Chinese spy balloon was shot down over the coast of South Carolina. The incident risks the prospect of the US imposing further sanctions on China following the ban on semiconductors last October. Consumer spending in China isn't rising as fast as expected, suggesting that it may take a while for the country's economy to get back to pre-pandemic levels.

Figure 1: UK Consumer Price Index (annual change, %)

Many economist believe inflation is likely to fall back down by the end of this year to levels that are more consistent with recent history.



Source: Pantheon Macroeconomics.

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