SIP Wealth Management
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# *Q4 2023 Market Outlook*

12th September 2023

## UK Inflation and Interest Rates

Since Q1 of 2021, the 'cost of living crisis' has gripped the UK. The annual rate of inflation reached a 41-year high of 11.1% in October 2022, and remains substantially above the UK government target of 2.5%. There are many contributing factors to the sharp increase in inflation, but the primary drivers are of course, the covid-19 pandemic, the war in Ukraine and the global energy crisis.

In simple terms, inflation erodes the purchasing power of money, making goods and services more expensive. A low rate of inflation (unlike current conditions) is manageable and encourages economic growth, as people and businesses can better plan their savings and investments. In contrast, a high inflationary environment is unpredictable and damages the economy.

To combat and control inflation, central banks use interest rates as a primary tool. By raising interest rates, central banks aim to cool down economic activity and reduce inflationary pressures. The effect of this monetary policy in action, is clearly shown in figures 1 & 2 below:

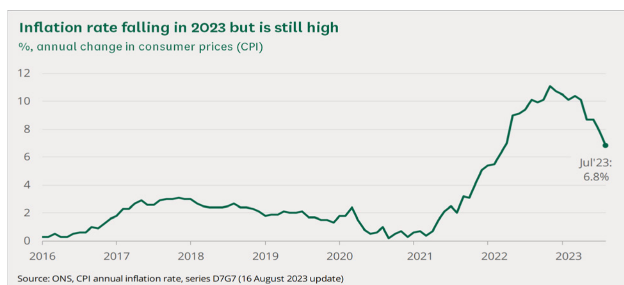


Figure 1: Annual Rate of Inflation – Jan 2016 – July 2023

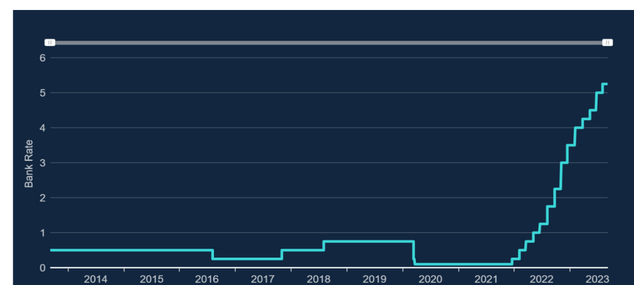


Figure 2: The Bank of England Base Rate – 2013 - Present

## Bond Yields and Interest Rates:

Bond yields and interest rates are closely linked. When interest rates rise, bond prices tend to fall, and consequently, bond yields increase. This relationship occurs because new bonds issued in a higher interest rate environment offer more attractive yields compared to existing bonds with lower coupon rates.

- Inverse Relationship: Bond prices and yields have an inverse relationship. When interest rates rise, the fixed coupon payments of existing bonds become less attractive in comparison to newly issued bonds with higher yields. As a result, investors may sell existing bonds with lower yields, causing their prices to fall. This is known as interest rate risk.
- Duration Sensitivity: The sensitivity of bond prices to changes in interest rates also depends on the bond's duration. Longer-duration bonds tend to be more sensitive to interest rate changes, meaning their prices can experience more significant fluctuations when interest rates move.

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### Effect of Falling Interest Rates on Equity and Bond Markets:

The Bank of England have stated that they expect inflation to drop significantly throughout the remainder of 2023, which could signal the end of rising rates, so what is the likely effect that this may have on equity and bond markets?

1. Equity Markets: Falling interest rates can generally be favourable for equity markets. Lower interest rates reduce the cost of borrowing for businesses, making it cheaper for them to finance expansion and investment. This can boost corporate earnings and stock prices. Additionally, lower interest rates can make stocks more attractive compared to fixed-income investments, potentially attracting more investors to the equity markets.

2. Bond Markets: Falling interest rates are typically positive for existing bond holders. As rates decline, the fixed coupon payments on bonds become more attractive, increasing the demand for existing bonds and driving up their prices. However, for investors seeking new bond purchases, lower interest rates mean lower yields, which may make it harder to find attractive investment opportunities.

### Executive Comments & Strategy:

As interest rates are estimated to taper in 2024, equities and government bonds may offer a golden opportunity for investment at relative bargain prices. Although the Bank of England is forecasting a looming recession, We reassess our business position regularly and will inform all clients when our strategy and overall outlook changes.

Kind regards,

**SIP Wealth Management**
Investment Committee

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