Financial Markets Monitoring

July 2023

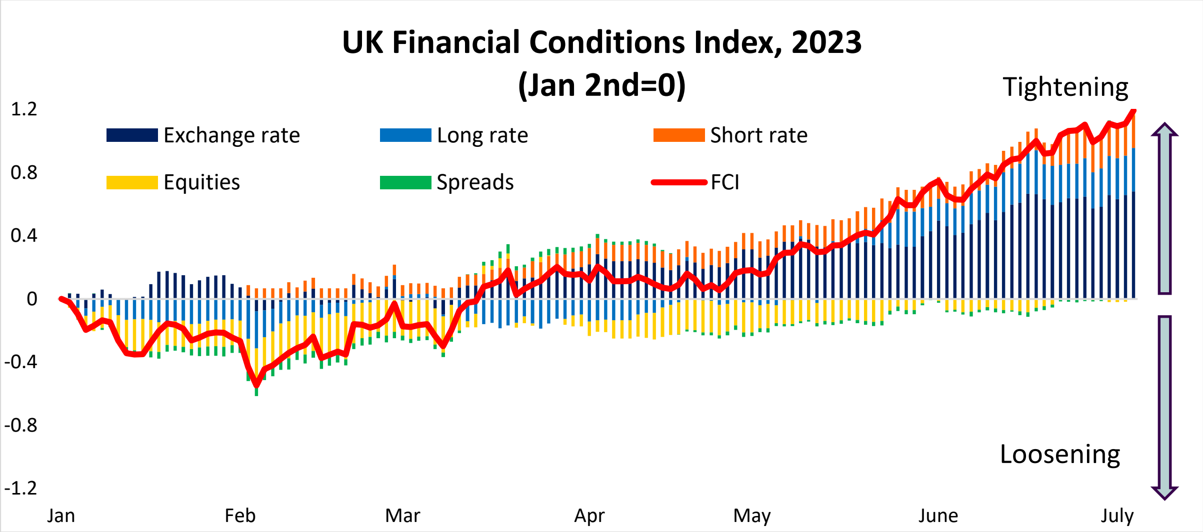
Financial conditions tightened over June, driven by an appreciation of the pound, rising interest rates and falling bond prices. A higher-than-expected inflation reading for May (8.7%), released the day before the June meeting of the Bank of England's Monetary Policy Committee, persuaded policymakers to step up the pace of monetary tightening, with the key policy rate rising by 50 basis points (to 5%) on June 21st. This led to a re-pricing of financial assets in late June, with market expectations for future interest rates strengthening and the cost of government borrowing rising further. The value of the pound lost some of its earlier strength as investors weighed the impact of further rate rises on economic growth, but it still ended the month higher and appreciated further in early July.

Financial conditions tightened have continuously over the past couple of months, amid signs that inflation in the UK was proving more persistent than expected. Headline inflation in May was unchanged from April at 8.7% – exceeding consensus estimates of an easing to 8.4%. Meanwhile, core inflation accelerated to 7.1% (up from 6.8%), its highest figure in 30 years. For more information on the latest inflation data, read our update here.

This triggered an immediate repricing of financial assets given anticipation of additional interest rates rises. By early July, interest rate futures were priced in an increase in Bank Rate to around 6.5% by the middle of the next year. Short-dated gilt yields rose to their highest since the aftermath of the "mini"-Budget in October of last year. The prospect of a much longer cycle of raising rates unsettled UK equity markets with the more domestically focused FTSE 250 losing ground through June (-1.6%) while the more internationally oriented FTSE 100 rose by 1.1%.

With interest rate expectations strengthening, mortgage rates have climbed to levels not seen since before the 2008 global financial crash. The average for a 2-year fixed rate mortgage (75% loan-to-value) has climbed from 4.7% at the end of May to 5.5% by the end of June, while the average for a 5-year fixed rate mortgage (75% loan-to-value has moved from 4.3% to 5%.

Recent analysis from the Resolution Foundation highlights the significant costs to households in the years ahead. Assuming a peak in Bank Rate of just below 6%, the analysis modelled the impact of an increase in the benchmark two-year mortgage rate to 6.25% later this year, with the rate not expected to fall below 4.5% until the end of 2027. Under this scenario, annual mortgage repayments could rise by £2,900 for the average household remortgaging in 2024, increasing total annual payments across the market by £15.8 billion in 2026, with three-fifths of the total impact yet to hit households. For more information on what this means for the housing market, see our publication here.



Note: The Financial Conditions Index above is a weighted average of changes in a variety of indices designed to capture broad movements across financial markets. It was constructed by the CBI, but based on research by Goldman Sachs.
Sources: CBI; Goldman Sachs; Macrobond.

Further details

The bullets below summarise developments over the month of June, since the opening of markets on Thursday 1st June and of to the close of markets on Friday 30th June.

The pound gained strength against the dollar and was unchanged against the euro

- June saw the pound gain strength against the dollar, as markets priced in additional interest rates by the Bank of England, with sterling appreciating 1.4% from $1.24 on 1st June to $1.26 on 30th June. Meanwhile, the pound stood at €1.16 on 30th June, unchanged from 1st June.

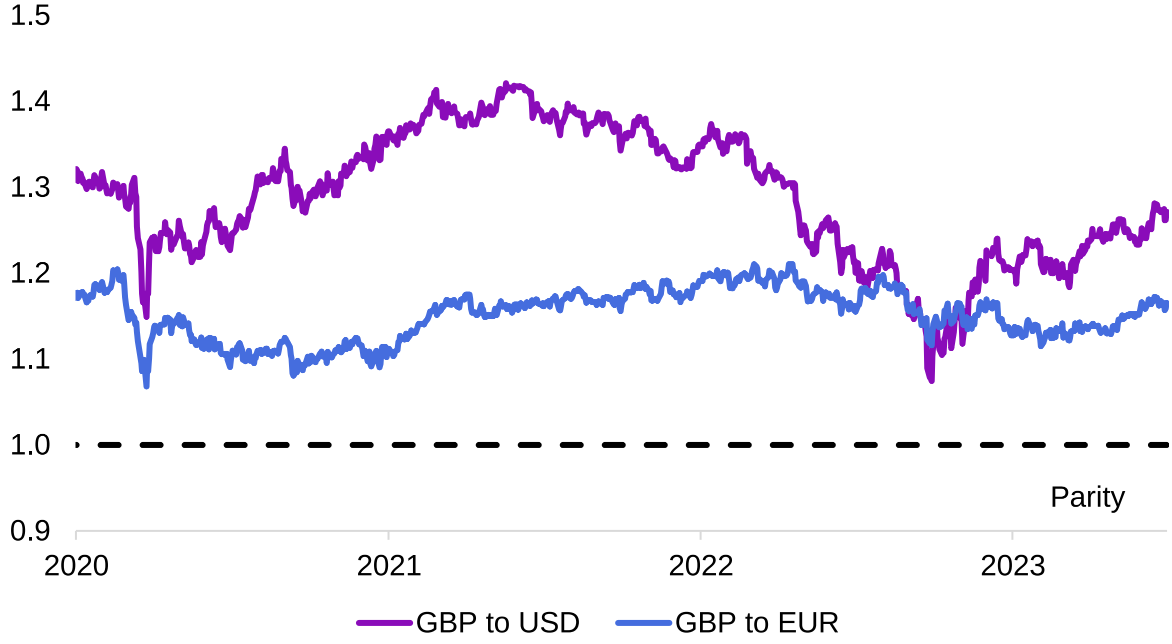
Government bond yields and mortgage rates jumped up in response to the Bank of England's rate hike

- The 2-year gilt yield stood at 5.3% as of 30th June, a full percentage point jump from 4.3% on 1st June. This left the 2-year gilt above the 4.8% high seen in the aftermath of the "mini"-Budget in October 2022.
- The performance of long-dated bonds was more mixed, with yields on the 10-year gilt rising slightly, to 4.4% from 4.2%, while the 30-year yield fell slightly from 4.5% to 4.4%.
- Benchmark mortgage rates have also risen with bond yields. Rates on 2-year and 5-year mortgages at a 75% loan-to-value (LTV) ratio rose to 5.5% (from 4.7%) and 5% (from 4.4%), respectively.

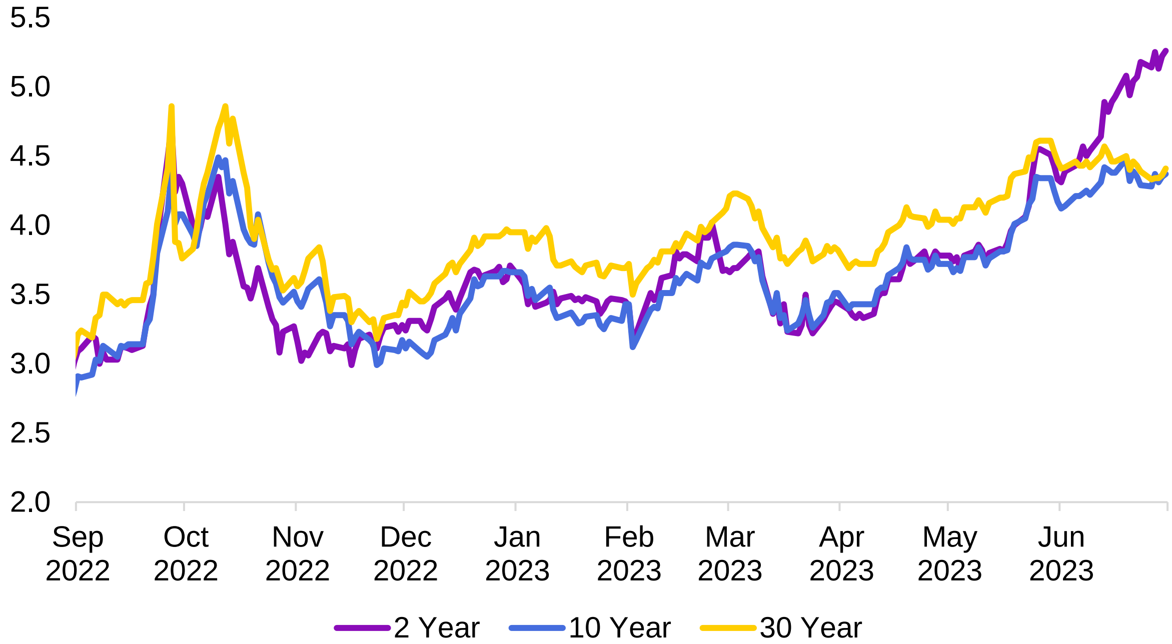
UK equity markets saw mixed results while international equities saw strong gains

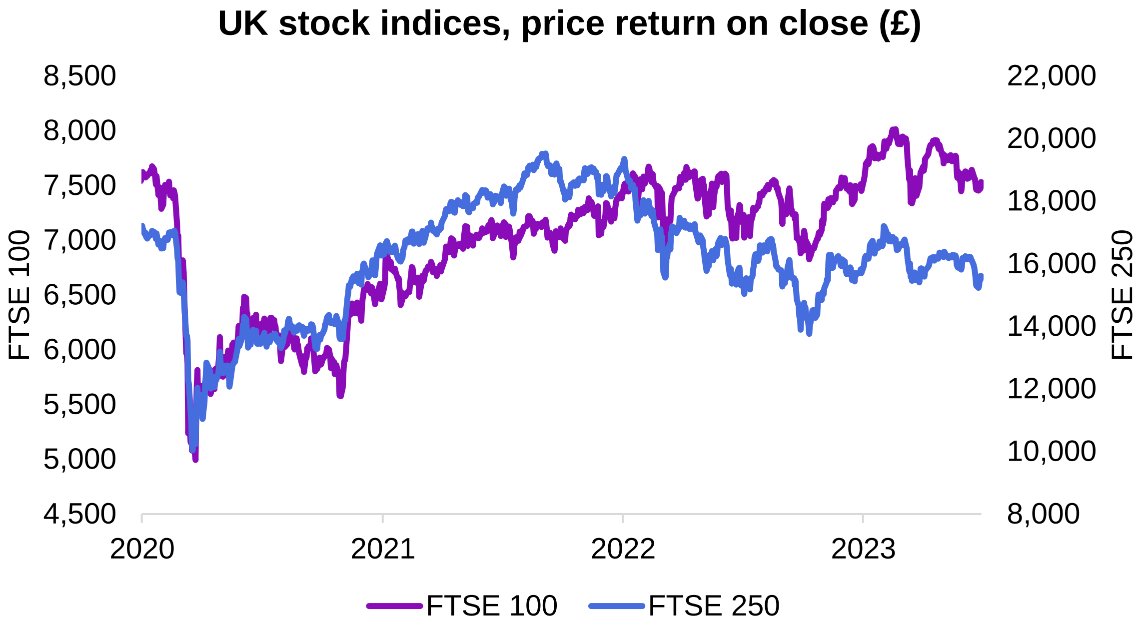
- The FTSE-100 gained 1.1% of its value through the month, but the more domestically focused FTSE 250 lost 1.6%.
- The headline European index (STOXX Europe 600) gained 2.1% in value, whereas the US S&P 500 gained 6.4%.

USD and EUR to GBP exchange rates



UK Gilts (Percentage Yield)





Sources: CBI; Macrobond

If you have any feedback on this article or would like to share any insights into the trading conditions currently facing your business, please contact us at:
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