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WEEKLY DIGEST

WEAKENING US GROWTH COLLIDES WITH RISING INFLATION

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A drastic reduction to estimates of American jobs growth and the uncertain effect of a raft of political changes are clouding the outlook for the US central bank. Investors still believe the odds are good for a resumption of interest rate cuts regardless.

Stock markets continue to forge new highs, driven by hunger for US interest rate cuts that investors overwhelmingly believe will restart in earnest next month. A quarter-percentage-point cut is all but nailed on for the US Federal Reserve's (Fed) next rate-setting meeting in a month's time.

President Donald Trump has been growing increasingly impatient with the Fed's cautious stance on monetary policy since he took power. On the one hand, the Fed has a point. Trump has served up a conveyor belt of big-ticket polices and changes that could have big effects on inflation and economic growth. Massive tax cuts, swingeing increases to trade tariffs with all American trading partners and cuts to public sector jobs. US economic growth has been ticking along fine for several years now, albeit with two wild swings this year (first down and then up) as a wave of imports raced to beat Trump's tariffs. And job growth had continued at a decent clip, adding more than enough roles each month to suggest the economy was doing just fine regardless of relatively high interest rates.

The Fed was more concerned about making a mistake and cutting rates, making debt easier to come by and therefore increasing Americans' demand for stuff and services by more than it could actually deliver. That's what drives inflation: when more people have more cash, are willing to spend it, and there's not enough goods or services to go around. This risk is of course compounded when goods become harder to come by: say, by making it significantly more costly to import what the people want.

However, in the most recent jobs report, the US statistics office in charge of keeping tabs on employment drastically revised its numbers for this year. The number of jobs created in May and June was slashed by a combined 258,000, leaving less than 20,000 jobs each month as the final tally. July's increase in jobs was just 73,000 (two-thirds of what economists had expected). To put those numbers in context, researchers at the St Louis Fed estimate that 153,000 jobs are needed each month to keep the US at a 4.1% unemployment rate, which is slightly below its current 4.2%. That rate is low by historical standards.

QUICK TAKE

- American jobs growth is running well below what's needed to keep unemployment steady
- The US Treasury Secretary argues US interest rates should be cut by 0.5% next month
- Yet inflation has popped higher, particularly factory gate prices, muddying the waters
- Q2 UK growth was better than expected, but not great, leaving the government in a tough spot ahead of the Autumn Budget

US Treasury Secretary Scott Bessent argued that the Fed should slash its rate by half a percentage point – double the usual move – at its meeting in mid-September to cushion the economy and prevent it sliding into recession. While investors think a bumper cut is unlikely, they are taking it as a given that the political pressure and dampened economic data will force the Fed to restart its cuts.

And yet. Despite that, inflation is still a factor. The headline consumer measure is 2.7%, but the core gauge (which strips out energy and food costs that are seasonal/influenced by global commodity markets) is rising. It's now at 3.1%, up from 2.9%. Producer Prices inflation, which tracks inflation at the factory gate, last month soared almost a whole percentage point to 3.3%. Will retailers pass on these price increases to households? Will it be a one-off from tariffs, or will it fuel another surge in inflation?

Investors will be eager for further insight from the Fed about its view of all this. Minutes of the Fed's July meeting, which featured the first double dissent in 30-odd years will be released and pored over this week. Not only that, but the annual Jackson Hole global conference for central bankers kicks off this week. This year's theme is about labour markets in transition: changing demographics, productivity and how macroeconomic policy should react.

British muddle setting up trouble for Chancellor

The Bank of England (BoE) never really stopped its rate reductions. It has been steadily cutting by quarter-points every two or three months since last summer. The latest one, at the beginning of the month, took the rate to 4.0%.

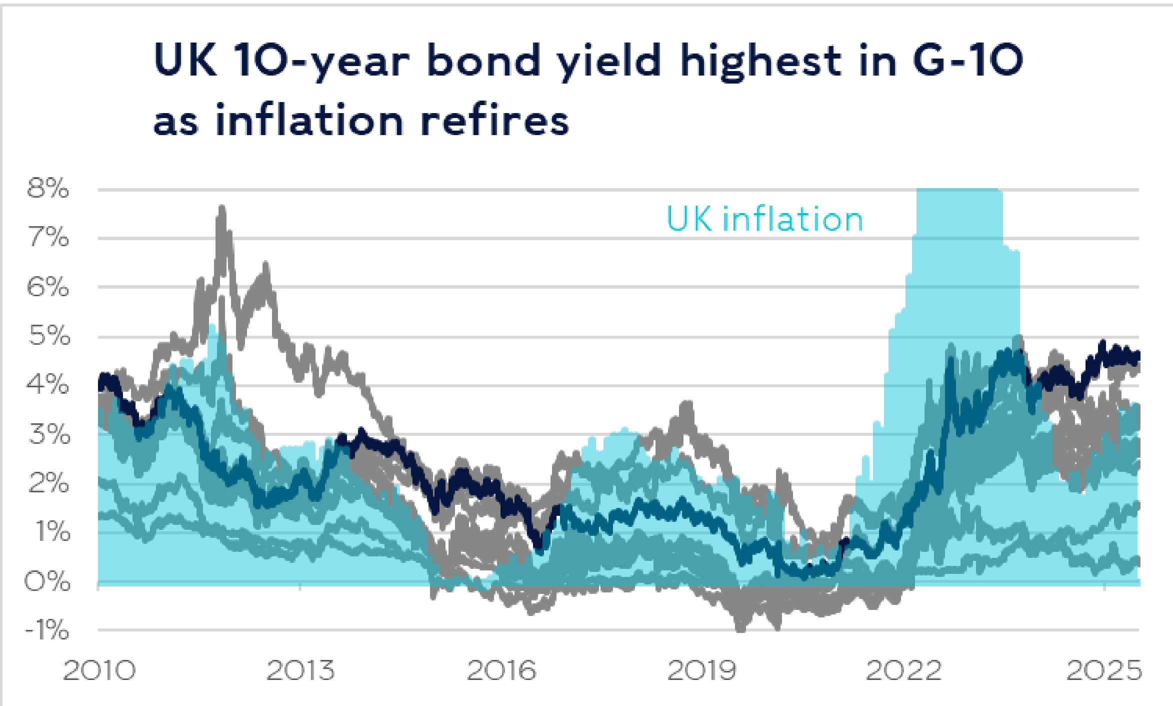
It was a close-run thing though. For the first time in its 28-year history, the bank's interest rate-setting committee needed a second round of voting to come to a decision. In the end, a quarter-percentage-point cut to 4.0% squeaked through 5-4 after one of the members scaled back his half-point suggestion get a majority for a cut rather than keeping rates where they were. Whether this downward trajectory continues at the next meeting in mid-September will likely be driven by the path of inflation.

It ticked up noticeably in the second quarter to 3.6%, while core inflation is even higher. If these figures continue to march higher, the BoE will find it harder to justify lower rates. While not great, second-quarter GDP growth wasn't as terrible as forecast, which injects doubt into the need to prop up the economy. At 0.3%, Q2 expansion was still a significant slowdown from Q1's 0.7%. The trend has been positive through the quarter after a very poor start, with April down 0.3% (the steepest decline since October 2023), May down 0.1% but then a return to growth with June up 0.4%.

The rumour wheel has already begun turning about the government's coming Autumn Budget, even before a date has been set for it. Too little is coming into the coffers from taxes and too much is flowing out for government spending. Government bondholders are getting edgy, leaving UK government bond yields among the highest in the developed world.

Chunky tax rises are required, according to most commentators and Westminster insiders. Doing that without breaking the electoral promise not to touch the big, broad taxes that would bring in real money means squeezing ever more from smaller-scale taxes that hit fewer people. Unfortunately, the people getting squeezed are increasingly the same set of people: the working middle class. Rumours in Westminster sound like this policy will continue, which is a bad sign for boosting British economic growth.

For recent economic highlights, see below on page 3.



Source: FactSet; data from 1 Jan 2010 to 31 Jul 2025

ECONOMIC HIGHLIGHTS

US – The University of Michigan Consumer Sentiment Survey fell once again in August, reinforcing concerns about the economy. At 58.6, the index is almost 15% lower than a year ago. A sub-index showed households expect inflation to be more than 0.4% higher both next year and over the long run. That assumes inflation of 4.5% next summer and 3.9% in five years' time. The Empire State Manufacturing Survey was better than expected, however, with new orders particularly strong. Although, the 'prices paid' data rose sharply as tariffs and other factors pushed up import costs. This chimes with recent inflation data showing a sharp rise in the cost of goods at the factory gate.

Record US tariff receipts haven't been enough to prevent the public sector deficit from increasing. Tariff receipts are almost double what they were at the same time last year, but the public deficit – which includes four months of President Joe Biden's term – is a fifth higher than at the same time in the previous year.

UK – Poor GDP growth and refired inflation complicate the picture for Britain. Most of the rise in inflation is coming from energy and food, which are global commodities that the central bank can't control. Poor-quality labour market data remains a major problem for policymakers: the margin of error on unemployment is very high. Some economists put the real rate at 5.5%, 80 basis points higher than the official measure. Meanwhile, the Rightmove House Price Index dropped 1.3% in August. Our own research shows that UK property has actually stalled in real (inflation-adjusted) terms over the past 10 years.

Europe – Mixed signals abound on the Continent. While some improvements in PMI business surveys and consumer sentiment suggest cautious optimism, German investor gloom and persistent inflation expectations highlight vulnerabilities. Germany's ZEW Economic Sentiment Index plunged from 52.7 in July to 34.7 in August after the bloc failed to secure favourable trade concessions with the US. Euro Area GDP growth decelerated noticeably in Q2 from 0.6% to 0.1%. Industrial production in July slumped 0.2% on a year earlier, down from the 3.1% growth of the previous month.

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