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## Market View

# A sterling performance

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Author Jeremy Sterngold



### At a glance

- The British pound has reached its highest level against the dollar since March 2022, benefiting travelers, but it's uncertain if this gain will last.

- UK Prime Minister Keir Starmer hinted at potential tax hikes in October's budget, though key taxes like income tax, VAT and National Insurance are likely to remain unchanged.
- The pound's strength against the dollar is influenced by the Fed's focus on employment over inflation and the Bank of England's cautious approach to rate cuts.

News that the pound has strengthened to its highest value against the dollar since March 2022 will be welcome to those enjoying the last of the summer holidays, as those pounds stretch further.

Since the UK's decision to leave the European Union, the value of the pound has fluctuated – at times gaining strength only to lose it again soon after. This begs the question: will this increase in value last, or will it fade like before?



Source: Bloomberg

## Tax rises on the menu

On Tuesday, Prime Minister Keir Starmer gave a speech warning that October's budget "is going to be painful", as he reiterated the claim that Labour inherited a £22 billion black hole from the previous Conservative government. When pressed, Starmer repeated his electoral pledge that there will be no increases on income tax, VAT or National Insurance, but did say those with "the broadest shoulders should bear the heavier burden".<sup>1</sup> Chancellor Rachel Reeves has not ruled

out an increase on inheritance tax, capital gains tax, or reforming tax relief on pensions. The government also announced cost-cutting measures such as scrapping a cap on social-care payments and withdrawing the winter-fuel allowance for 10 million pensioners.

While speculation is mounting on what taxes will most likely rise, from a broader economic perspective, we are unlikely to see a stimulative fiscal policy stance any time soon. This likely means a lower of supply of UK government bonds, or Gilts, providing support to the pound. Furthermore, news of a better economic partnership between Germany and the UK highlights the potential for less trade friction which could boost long-term prospects.

## Setting the scene

The Federal Reserve's (Fed) annual meeting in Jackson Hole has also had an impact on the value of the pound and the dollar. Last week, Chairman Jerome Powell laid the groundwork for a cut in interest rates at the Fed's September meeting. Powell highlighted that inflation has been steadily declining since it peaked in 2022, and expressed confidence that it is on track to reach the Fed's 2% target. He spent most of his speech reiterating the two-sided impacts of monetary policy, focusing on weaker labour market dynamics rather than inflation. The August Consumer Price Index reading came in at 2.9% for the year up to July, but more pertinently, shorter-term indicators showed a meaningful cooling of price pressures.<sup>2</sup> The Fed's mandate is for stable prices and maximum employment. Powell's latest speech shows a clear shift of focus from the former to the latter.

## Rate cut expectations down

In addition to keeping fiscal policy tight by raising taxes, the number of expected rate cuts by the Bank of England (BoE) has remained moderate. Earlier this month, members delivered a 0.25% cut. However, the UK's inflation rate came in slightly higher than expected in August, with overall prices increasing by 2.2% this year through July, according to the Office for National Statistics (ONS).<sup>3</sup> The BoE is now forecasting inflation will tick up to 2.75% over the coming months, before falling below 2% next year as favourable base effect diminish.

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Last week, we covered the US presidential election and Kamala Harris's and Donald Trump's economic plans. While some Democrats initially expressed reservations about Harris, her popularity has grown more than expected. However, the race remains close, with FiveThirtyEight giving Harris a slight advantage over Trump as November approaches.

The closeness of the race increases the chances of a divided Congress, which could limit government spending and make it difficult to pass new policies. Despite this, the current US fiscal approach remains more flexible than that of the UK, largely due to significant military and healthcare expenditures.

There are deeper factors contributing to sterling's recent strength, but it is too early to say if these will fade over time. We continue to monitor the dollar/pound relationship very closely, but given the sharp, recent strength, we expect a breather until investors gain more confidence about the direction. For the moment, the interest rate differentials move in the UK's favour, and the fiscal situation broadly favours the pound.

[1] BBC, <https://www.bbc.com/news/articles/clyn01p5npgo>

[2] Bureau for Labor Statistics

[3] Office for National Statistics, <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/july2024>

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