Market View
Central banks diverge as inflation pressures return

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At a glance

The Federal Reserve raised interest rates this week for the first time since 2023, while the Bank of England held.

Both economies face higher energy prices, but the US is also facing domestic pressures.

Yields have risen further and remain at multi-decade highs, which supports taking a longer-term view.

Six months after the Middle East conflict began, its effects are still working through the world's economies, and this week underscored how differently the central banks are responding. On Wednesday, the Federal Reserve (Fed) raised its benchmark rate by a quarter of a percentage point, to a range of 3.75% to 4%, its first increase in more than three years.[1] On Thursday, the Bank of England (BoE) held its Bank Rate at 3.75%, by six votes to three.[2] This morning the Bank of Japan (BoJ) raised rates, continuing a tightening cycle that began before the current energy shock. All three face oil back above $100 a barrel, but how it impacts their respective economies differs.

In this article, we look at how the Fed reached its decision, what separates the US inflation problem from the UK's, why Japan matters more to global bond markets than its size suggests, and what this means for investors.

The Fed acts, with more to come

As we discussed in an earlier article, July's split decision and the Treasury's intervention in the bond market had left the Fed's intentions unclear. Wednesday's unanimous vote showed investors that the Fed is determined to meet its stable prices mandate. The committee said inflation remains elevated, and its updated projections show inflation not returning to the 2% target until 2029, with one further increase pencilled in for this year.[1]

Energy costs have made the central bank's job harder. Renewed fighting in the Middle East has cut oil flows through the Strait of Hormuz, and Brent crude moved back above $100 a barrel last week for the first time since July.[3] European gas prices have risen for five consecutive weeks to their highest levels since the 2022 energy crisis.[4] Higher energy costs will push headline inflation higher in the months ahead on both sides of the Atlantic, whatever central banks opt to do. For each central bank, the critical issue will be identifying the other forces driving prices.

Beyond energy: the domestic sources of inflation

In the US, the answer is demand. Retail sales rose 1.2% in August, well ahead of expectations, with gains across almost every category and restaurant spending up nearly 6% on a year earlier.[5] The build-out of artificial intelligence infrastructure is adding a second, less familiar source of pressure. Memory chips are being diverted to data centres, and the cost of computers and related equipment in the US inflation basket rose 8.4% on a year earlier in August, the second-largest annual increase on record.[6] J.P. Morgan estimates that the shortage of memory chips alone has added between 0.2 and 0.4 percentage points to core inflation.[7] US consumer price inflation was 3.4% in August.[1] With demand this resilient and price pressures this broad, the Fed's decision was, in the end, an easy one.

In the UK, the picture beneath the surface is softer. Inflation rose to 3.1% in August, its highest for five months, but the BoE calculates that around 0.7 percentage points of the 1.1 point overshoot against its target came directly from energy prices, mostly motor fuels.[2] Services inflation, which the BoE watches most closely because it reflects domestic wage and price-setting rather than imported costs, held at 3.4%, down from 4.5% in March.[2]

The Bank of England can afford to wait, for now

That difference is why the BoE held. The Bank said there was little evidence so far of higher energy prices feeding into wages and prices more broadly. It also judged that a soft labour market and the higher borrowing costs already faced by households and businesses would bring inflation down over time.[2] Furthermore, the quoted rate on a two-year fixed mortgage is now almost a percentage point higher than before the conflict began.[2] This reinforces the view that rates are high enough to slow the economy, reducing the case for further rate rises, compared with the US where the case for hikes is stronger.

That does not mean the BoE is done. Three of its nine members voted for a rise, as they did in July, and the Bank now expects inflation to climb to slightly above 4% in early 2027, higher than it projected in July.[2] Governor Andrew Bailey has said that if the conflict persists, policy may have to tighten.[2] For now, the data gives the BoE room to wait; the longer energy prices stay high, the less room there will be.

Separately, the BoE set out a fixed plan to run down its remaining government bond holdings to zero by 2034, which removes a source of uncertainty for the gilt market at each annual review.[2]

Japan: a quiet driver of global yields

The BoJ raised rates this morning, as markets had expected. Japan's inflation has been persistent enough to keep the central bank tightening while others paused, and the yen has strengthened this month as a result.[8] Japanese 10-year government bond yields have risen to around 3%, a level not seen in three decades.[8]

These factors have impacts beyond Japan. Japanese institutions are the largest foreign holders of US government debt and significant buyers of gilts and European bonds. For years, negligible yields at home pushed that money abroad. With Japanese yields now at 3%, the incentive to look overseas has weakened, and a large, steady source of demand for other countries' bonds is becoming less reliable. That is one reason global yields have risen together this year, and why the BoJ's path deserves as much attention from sterling investors as the BoE's.

What this means for portfolios

At the start of the summer, markets were pricing in a quick resolution to the conflict in the Middle East and a return to subdued inflation, but this has since changed. Inflation has risen and the risk of stagflation, the combination of weak growth and persistent price pressures, has increased, particularly in economies such as the UK where the shock is imported. Central banks have begun to respond, but not in the same way or at the same pace. Bond yields have risen further in recent weeks as a result: US 10-year yields are around 5%, the 10-year gilt is at around 5.2%, its highest since the financial crisis, and Japanese yields are at levels not seen for a generation.

While volatility is likely to remain elevated, starting yields are now available are high enough to compensate investors for the associated risk. For investors willing to take a longer-term view, securing income at these levels remains appropriate, in our view.

Sources

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