Is Cash King Again?

Why attractive bank interest rates might not be all they seem.

For the first time in 15 years UK savers can now park their money with a high street bank and earn circa 5% interest.

On the face of it, this appears to make investing in cash right now attractive. Yet, our money is only worth what it can purchase and with inflation soaring it's right to ask if those interest rates are really as attractive as they seem.

Why have interest rates risen so much?

The rapid rise of UK inflation has pushed up interest rates at their fastest pace since the 1990s.

This has occurred because the Bank of England has been raising the costs for borrowers in order to slow demand in the economy and bring down rampant UK inflation.

So, should we now move our assets into cash?

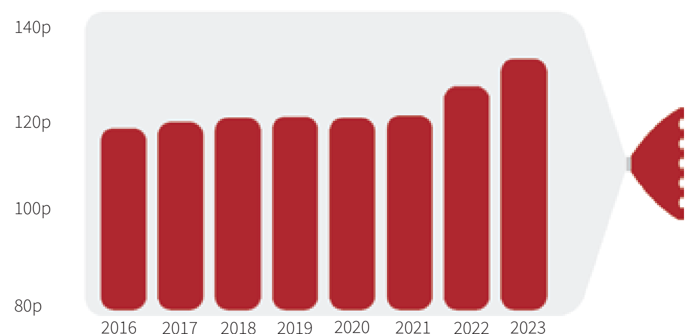
If someone requires access to their money soon, or if they need the money to fund a particular purchase in the short to medium-term cash may be the appropriate option. But for those seeking to invest for the medium to long-term, who can cope with changes in the value of their money, the key message is this: The real return on cash actually has not got better.

Why is this?

Inflation is a measure of the rising cost of things we use in our day to day lives. It is a measure of how likely it is for a fixed sum of money to last a household until the end of the week. Every time inflation rises by 1% the pound in our pocket is worth 1p less. We call this the 'real' rate of return on an investment.

For example, the current inflation rate in the UK was stuck in June at 8.7%. This means that a cash rate of 5% in the bank is losing 3.7% of its buying power over the next year. When the inflation rate is higher than the interest rate it is almost certain that your money will fall in value in real terms.

Bread prices and inflation:



Source: ONS at June 2023

What about if inflation falls?

The government and the Bank of England are determined to make inflation fall and the Prime Minister Rishi Sunak has pledged it will halve by the end of the year. Now it is important to note that at the moment the market does not believe he will be successful.

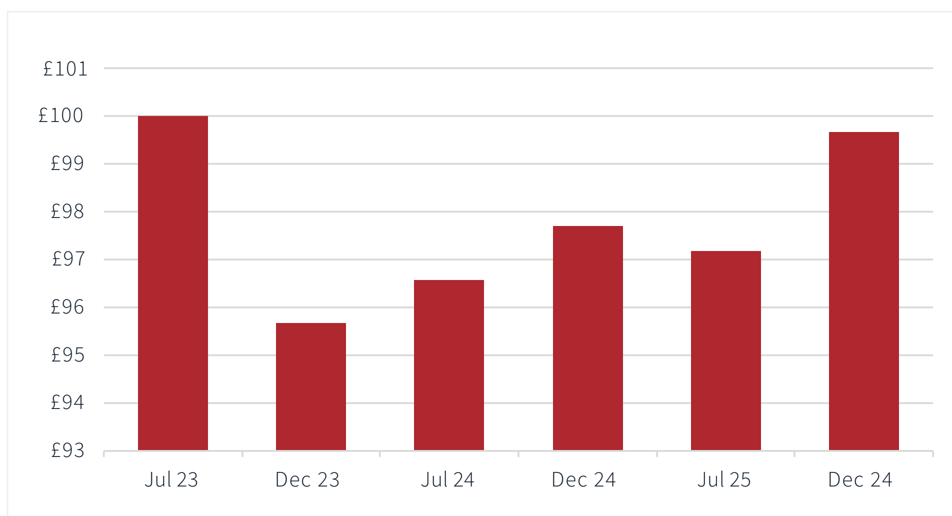
But let's give him the benefit of the doubt. Let's say that interest rates follow the path that the market believes they will over the next three years, and that Sunak is able to halve inflation by the end of 2023 to 4.8%, and then carry on and halve it again by the end of 2024 to 2.4%.

How much would money in the bank make us in real terms over that time?

We have to make a lot of assumptions to get to an estimate and should be clear that we cannot perfectly predict the future. But if we assume the government reaches its goal, and the market is right about interest rates then by July 2025 the actual buying power of £100 put into a bank account earning the current interest rate, reset every six months, would be worth £97 in terms of its real buying power.

On this basis we can see that actually the real buying power of your money isn't any better than it was when inflation was close to zero and so were interest rates, indeed if the government is unable to fulfil its promises it could be a little worse.

Real buying power of £100:



Source: Capital Economics/Chatham Financial. Assumes interest rate of 3-month forward SONIA reset at six-month intervals and inflation which halves every six months until reaching 2% Bank of England target. This is for illustration purposes only and must be understood as a simulation rather than a forecast.

How do I know remaining invested in a diversified portfolio will be any better for me?

Well, the short answer is you don't. Nobody can tell you what stock markets will return over the short-term, and anyone who claims to is being misleading.

However, what we can say is that over the long-term being invested in a diversified portfolio of shares, bonds and other assets has been the key step that investors have needed to take to beat inflation.

The real return of an investment in shares compared to the bank over the long-term has proved powerful.

After all, if shares fall in value there remains the possibility that they will recover in the next period. However, with an investment in cash as inflation begins to fall, the enemy we are trying to beat, so too does the return on cash because the Bank of England must start reducing interest rates to keep pace with inflation.

This means that the potential for a portfolio to bounce back from a period when it has fallen in real terms does not exist with a bank account.

Importantly, we can note that once interest rates reach their peak the return of shares in the following period has generally been good. We cannot guarantee this will be the case in future but interest rates generally start to fall because economic growth is falling. Once economic growth has fallen the stockmarket is able to recover.

The real return of shares versus cash:

Source: ASPIM and Bloomberg, 05/1994 to 05/2023

Shall I wait until things improve and then buy into the stock market later?

Trying to time the market is almost always impossible to do. It is also true that much of the recovery that is often seen in stock markets following recessions happens quickly – in the year or so after the bottom and equally in the year or so after interest rates hit their peak. It is this initial recovery that can be vital to restoring the buying power of your investments. Missing it means permanently locking in real losses.

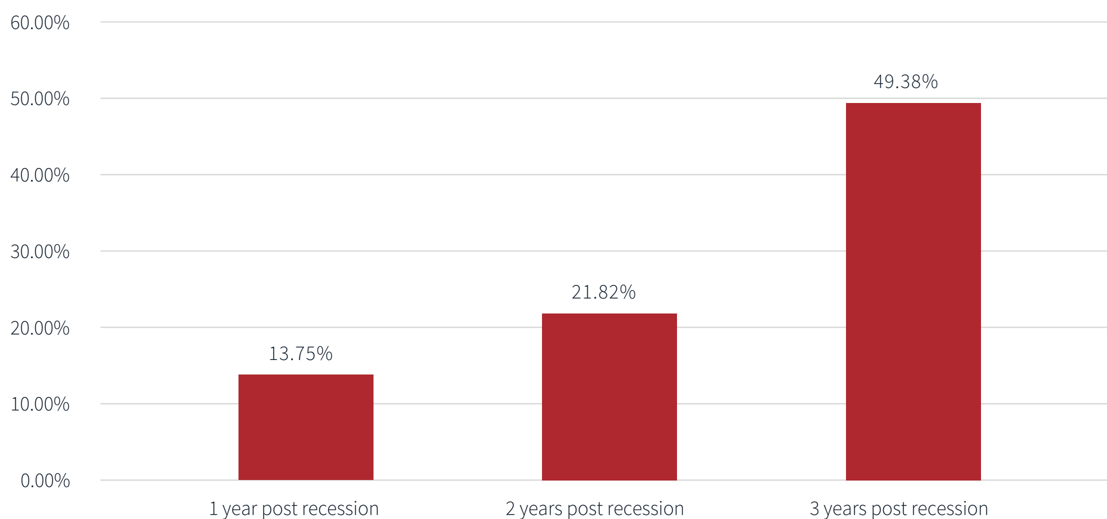
Are investments other than cash good value now?

It is human nature that we tend to want to invest in things that have gone up, and sell things that have gone down. In reality of course this is a sure-fire way to buy high and sell low. The past year has seen the price of many shares and bonds fall substantially. This is the market adjusting for the fact that the companies within the stock market may make less profit in a recession. However, a change like this does mean that investors are now being asked to pay less money for the same amount of a company. In the long-term, investing when shares are cheaper can be a good investment strategy.

So, should I stay invested?

The decision about where best to invest is one to be made between you and your financial adviser when all your circumstances have been considered. However, if you are invested for the long-term and can tolerate short-term movements in the value of your investments then the lesson of history is that these big numbers on adverts for cash accounts can look attractive but ultimately, they are a mirage that can rob our money of its real buying power.

The average return on shares from the start of the last three recessions:



Source: Bloomberg modelling MSCI World Net TR at 11/07/2023. Based on 1990, 2008 and 2020 recessions.

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