RATHBONES

THE FEDERAL RESERVE RIDDLE

REVIEW OF THE WEEK
7 MAY 2024

Fading strength in the labour market and services businesses have increased hopes that interest rates can still be cut this year. Everybody is watching the Fed watch the data.

After a week or two of panic stations, a few cooler bits of economic US data have calmed bond markets – for now at least.

The notoriously volatile US nonfarm payrolls report (a monthly snapshot of job creation) delivered only 175,000 new jobs in April, the lowest in six months and well below the 240,000 that was forecast. The unemployment rate rose slightly to 3.9%; the rate has remained in the narrow range between 3.7% and 3.9% since last summer. Added to this, wage growth slowed, taking the year-on-year increase below 4% for the first time in almost three years.

The ISM Services PMI, which surveys businesses' hiring intentions, business activity and general mood, was noticeably weaker too. The index fell to 49.4 in April, down from 51.4. Generally, a figure above 50 means business is growing, while below means services businesses are shrinking. Although a reading in the low 40s has been consistent with past recessions, this was the first time the ISM Services PMI had dropped below 50 since December 2022. Within this ISM report, the employment index posted its fourth decline in five months, falling to 45.9.

Combined with **slower GDP growth in the first quarter**, the weaker economic signals encourage investors that inflation will start to decelerate once more. The next inflation report comes next week. Meanwhile, dimmer data casts softer shadows on the sphinx-like comments of the US Federal Reserve (Fed). The central bank admitted "lack of further progress toward the committee's 2% inflation objective" in recent months, yet its guidance was mostly unchanged. Regardless, the benchmark US 10-year government bond yield dropped 0.15 of a percentage point to 4.46%. The US Treasury bond maturing in two years, whose yield moves more in line with changes in forecast Fed rates, fell by almost 0.2 of a percentage point to 4.81%.

The Fed rate-setting committee still think that inflation should fall over 2024, albeit it will probably take longer for them to gain the "greater confidence" that it's on a sustainable downward path, which is required for them to cut rates. Powell didn't rule out rate cuts and some commentators believe he dismissed the suggestion that the next move in rates could actually be *higher* rather than lower. However, trying to unpick a riddle is a dangerous game. While Chair Jay Powell said he was confident that inflation would continue to fall from here and that that a rate hike was "unlikely", the idea of a rate hike wasn't exactly dispatched for six runs. Instead, he said that the Fed would need "persuasive evidence that our policy stance is not sufficiently restrictive to bring inflation sustainably down to 2% over time". While Powell and his committee believed their policy was sufficiently restrictive, he also noted that, at bottom, it all comes down to how the economy performs in the coming months: "That will be a question that the data will have to answer."

The UK recovers?

While economic data has taken a dip in the first quarter, company profits have strengthened. Four-fifths of S&P 500 businesses have reported earnings so far and the average 5% year-on-year growth is the highest since the second quarter of 2022. Almost 80% of the companies that reported so far beat their profit estimates, while around 60% beat sales expectations – both of these statistics are around the norm. Companies that are more exposed to the ebb and flow of economic cycles ('cyclicals') haven't been faring as well as more defensive companies – particularly consumer-facing ones and those that sell building materials. Based on reported and forecast earnings, analysts expect the S&P 500 to deliver earnings growth of 11% and sales growth of 4.9% this year.

Another area showing signs of improvement is the UK economy. The nation's PMI services report surprised to the upside, hitting 55 in April. That was the sixth consecutive month above the 50 growth/contraction level and the strongest result in a year. Construction was also strong, rising to 53, the highest level since February 2023. Even house prices have improved, with the Halifax House Price index rising by 1.1% year-on-year in April, accelerating from an upwardly revised 0.4% growth in March.

With the economy seemingly recovering well from last year's shallow recession and inflation still falling, hopes of a cut to interest rates in coming months are still alive. On Friday, the first-quarter UK GDP figure will be released.

It's forecast to bounce back from -0.3% in Q4 to 0.4% in Q1. The Bank of England meets the day after; will it set the scene for a quarter-percentage-point cut in June?

The British stock market has certainly got more of a spring in its step. The FTSE All-Share Index is trading at new all-time highs – no doubt **helped by a strong dollar**, which boosts the sterling value of profits earnt overseas. However, it's still not particularly loved. The average price of UK companies is less than 12 times the profit expected in the coming year. That is very low compared with its recent history and on a different planet to the US on 20 times. While some of this is due to greater exposure to companies and sectors that are growing more rapidly and operate more profitability, we still find a large valuation gap after statistically adjusting for such things – a gap that only appeared after 2015.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

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