RATHBONES

THE COMFORT BLANKET OF LOWER INTEREST RATES

REVIEW OF THE WEEK
9 SEPTEMBER 2024

STOCKS ARE DOWN ON UNDERWHELMING US ECONOMIC NUMBERS, BUT THE CENTRAL BANK IS LIKELY TO RIDE TO THE RESCUE.

Equity markets fell around the world last week, as fears rose about the US economy – important enough to make the rest of the world catch cold when it sneezes.

The US S&P 500 index was down particularly sharply, buffeted by signs of a slowing economy, such as the closely watched ISM manufacturing survey for August and disappointing jobs numbers.

That said, we think fears of economic slowdown are overdone. Taken as a whole, data from the US have turned out more resilient than many feared. And most importantly, since our last Review of the Week, back in early August (the Review takes a summer break), the Fed has signalled that it will in September begin to cut its benchmark federal funds rate, currently at 5.25 to 5.50%.

This message came loud and clear from Fed Chairman Jay Powell during his speech at the annual shindig of central bankers held in Jackson Hole, Wyoming, sometimes described as the Woodstock for central bankers. Powell said the Fed's policy focus would now shift from suppressing inflation (which it sees as heading towards target) to supporting the labour market.

Against this backdrop, the yield on the benchmark 10-year US Treasury bond (which runs in the opposite direction to its price) continued its descent.

This is a sea change. Investors have spent much of the past couple of years fixated on high inflation, but the emphasis has now shifted decisively towards the sustainability of growth. Inflation is on a cyclical downward trend pretty much everywhere.

In the US, the Fed's preferred measure of core inflation, the snappily titled 'Personal Consumption Expenditures Price Index, Excluding Food and Energy', was 2.6% in August. This statistic, which strips out volatile food and energy prices, was admittedly still above the 2% target. But it was way down on a peak above 5% in 2022. We've written before about how the Fed has repeatedly called out a 'supercore' measure of inflation that looks at service sector inflation, excluding a few volatile and methodologically questionable prices. Monthly price rises of this key metric have slowed considerably, running at an annualised rate of just 2.0% between April and July. This all chimes with what we've seen from alternative measures of underlying inflation too.

The fact that central bankers are acknowledging the conquest of inflation is comforting. They've already cut interest rates in the euro area, UK, Canada and Australia, for example.

Falling interest rates support slowing economies by reducing the cost of borrowing for companies and consumers.

Holes in the blanket

But the comfort blanket of lower interest rates doesn't provide complete insulation.

The world's second largest economy, China, continues to grapple with the bursting of its real estate bubble, with forecasts for economic growth under continued downward pressure.

And if economies do slow markedly, there could be limits to governments' ability to invoke the moustachioed ghost of English economist John Maynard Keynes, who advocated supporting economies through higher spending or lower taxes. Many countries around the world racked up huge deficits during the covid pandemic (having never paid off the debts incurred during the Global Financial Crisis). This suggests less fiscal generosity to come – at least not without testing bond investors' patience. The short-lived 2022 UK premiership of Liz Truss, when yields on UK government bonds leapt on expectations of a ballooning fiscal deficit, suggests that this patience is limited. Having said that, the backdrop of far-from-tamed inflation during that episode is important, since it contributed to higher yields.

Moreover, geopolitics remains an ever-present threat. That could be political disruption or worse, such as an expansion of the conflict in Gaza into a full-fledged war between Israel and Iran.

But as we ponder threats to financial markets, it's important to remember not to panic. Early August tested investors' nerves. Those who'd taken on too much risk were forced to run for cover. But those with diversified portfolios and a longer-term perspective were able to ride out the storm. The short-lived Trussonomics experiment is one example,

with gilt yields easing back down again. Another is the March 2023 bankruptcy of the US' Silicon Valley Bank. This proved surprisingly non-contagious, in no small part due to forceful regulatory and monetary intervention. Markets can often weather shocks well when economies aren't already either in or heading towards recession.

We're not saying returns will be risk-free. But a background of subsiding inflation, steady but unspectacular economic growth and some space for central banks to cut interest rates should continue to offer inflation-beating returns for investors.

Jobs numbers no roadblock

Jobs data continue to indicate that any roadblocks the US labour market had erected to rate cuts have now been knocked down.

The benchmark Treasury 10-year dropped 6 basis points (hundredths of a percent) on Friday's news that the US economy added 142,000 jobs in August. Although this figure from the Bureau of Labor Statistics was above the July number of 89,000, it was below economists' expectations of 160,000. Moreover, Friday revisions put both June and July numbers lower.

This follows official data earlier in the week showing that in July US job openings sank to their lowest level in more than three years. At 7.7 million, the number was well below the 8.1 million average of a Reuters poll of economists. Strong jobs growth tends to push up inflation by giving workers greater bargaining power to wrest higher starter salaries or pay rises from employers. To borrow from Johnny Paycheck's 1977 country music hit, they're more able to say to employers: "Take this job and shove it." Central bankers are often particularly concerned about the inflationary pressures of higher wages because these effects are, to use their preferred adjective, "sticky". Once high wage growth starts to push up inflation this state of affairs often persists. That's because wages increase companies' costs, forcing them to push up prices. This prompts workers to demand still higher wages to cope with a higher cost of living. Weaker jobs growth has the converse effect, by reducing workers' bargaining power.

The low number of job openings shows, meanwhile, that companies are less desperate for workers. Looking at this another way, if employers are the buyers of labour and workers are the sellers, this is a buyer's market, where employers hold the best cards when haggling with workers over the price of labour.

A weakening jobs market does raise the risks to growth, but we don't think the jobs numbers portend recession as they stand. Not least because the unemployment rate, which can cause recession as it rises by depressing consumer confidence, was actually down a touch at 4.2%.

All in all, we still see plenty of opportunities in stock markets around the world. That includes the US, despite our concern that some valuations may be stretched, for the biggest stocks in particular.

*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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