RATHBONES

IS THE DOOR SLAMMING ON EARLY RATE CUTS?

REVIEW OF THE WEEK
8 APRIL 2024

A BLOWOUT JOBS REPORT IS TIPPING BETS TOWARDS FEWER US INTEREST RATE CUTS THIS YEAR. WHAT HAPPENS IF INFLATION CONTINUES TO BOUNCE HIGHER THIS WEEK?

Investors are scaling back their expectations on just how much the US Federal Reserve (Fed) is likely to cut interest rates this year. Ahead of Friday's latest jobs report, the consensus was that the Fed was likely to deliver up to three 0.25% cuts this year, maybe starting around June. But those bets are being reined in following Friday's blockbuster jobs report. Nonfarm payrolls showed US employers added 303,000 new jobs in March. That's way higher than expectations of 200,000 and the most in almost a year.

Could that big upside surprise slam the door on three Fed rate cuts this year? More investors seem to be acknowledging that the Fed probably won't cut rates as early as June and they're swaying towards expectations of only two cuts.

Immediately after the release of the jobs report, Fed Reserve Bank of Dallas President Lorie Logan said "it's much too soon to be thinking about cutting rates". And on Thursday, Minneapolis Fed President Neel Kashkari even floated the possibility of no cuts at all this year if inflation keeps moving sideways. For his part, Fed Chair Jerome Powell remains insistent that rate cuts are still coming. Last week, he maintained that most Fed officials "see it as likely to be appropriate" to start cutting rates "at some point this year".

As we explained a couple of weeks ago, the Fed kept rates unchanged at its most recent rate-setting meeting, though it again pointed to three 0.25% rate cuts this year if inflation behaves and keeps falling toward its 2% target. But price rises since the autumn have not been consistent with continued progress.

The Fed came under a lot of fire for its insistence that the pressures that drove US inflation up to a peak of above 9% would prove "transitory". It will be acutely aware that cutting rates too much and too soon this year might risk inflation getting stuck at an uncomfortably high level – or even reaccelerating. That would damage its credibility badly.

As of this morning, investors are expecting the Fed to deliver less than 0.60% in rate cuts by December and believe there's only a roughly 50% chance that rates will get cut in June. That's driven a big surge in US treasury yields (which run in the opposite direction to their prices). Because we think there's a bigger chance of rates falling further and faster in Britain than in America, we prefer UK government bonds to US ones. Government bond prices tend to rise when rates in their home country fall.

Of course, the Fed doesn't need to see a weak labour market to start cutting. But its key goals are low unemployment and stable prices. So a cooling jobs market could have been the trigger for early rate cuts. Instead, the opposite has happened and Friday's report may have kiboshed those hopes. The unemployment rate fell to 3.8% from 3.9% in February. Once a commonly held view, expectations that high rates will result in an economic downturn that triggers big job losses are now vanishingly rare.

All eyes are now on Wednesday's Consumer Price Index (CPI) and Thursday's Producer Price Index (PPI) inflation prints. If they show that inflation is still hotter than expected, that could really dent confidence in whether the Fed can deliver rate cuts in the second half of this year.

A crude inflation problem?

Oil prices are retreating slightly after hitting a five-month high last week amid fears that flaring tensions in the Middle East could disrupt supplies. Brent crude, the international benchmark, traded as high as $91.71 on Friday. It hasn't been above $90 since last October.

Oil prices have been climbing for several weeks now as forecasts for global demand have begun to outstrip supply growth, and data have pointed to stronger-than-expected economic recoveries in the US, Europe and China. The price spike surged still higher last week amid fears that the conflict in the Middle East could widen after Iran claimed that Israel had attacked its consulate in Damascus. Iran has vowed to respond to the attack, which killed 13, including a prominent commander of Iran's Revolutionary Guards.

A big oil price rally would certainly complicate the inflation outlook. Central banks focus on so-called 'core' measures of inflation that strip out volatile energy and food prices. But businesses on the ground can't take crude prices out of the equation. That's why most stock markets got spooked last week by fears that a higher oil price might drive a big inflation resurgence.

If you'd like join our investment experts at our next Investment Insights webinar on Tuesday, 16 April, to hear more about the outlook for the global economy and markets, you can register **here**.

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