Weekly round up (Week 37)

Our weekly take on key developments in financial markets and economies examines why last week's worrying calm may not last long.

Last week was a disappointing one for thrill-seeking investors. Volatility eased, government bond yields fell slightly and credit markets delivered positive returns, with investment-grade US bonds the best performers.

The US dollar remained stable, industrial metals and energy prices recovered from their recent falls, and gold reached a new high of over $2,560 an ounce. Meanwhile, equity markets posted solid performances, driven by technology stocks, with the "Magnificent Seven" gaining 7%.

China benefits from a rebound in exports, but growth fears remain

Chinese trade data for August suggest that global consumption remains robust, with exports up 8.7% year-on-year. Vehicle exports hit a new high and trade with almost all markets increased, with double-digit growth in shipments to the European Union, India and Brazil.

Despite renewed concerns about trade wars, Chinese exports to the USA grew at their fastest rate for two years. China is once again exporting deflationary goods, with companies cutting prices to secure sales, as evidenced by shipment volumes that have risen faster than export values in recent months.

Buoyant exports are acting as a buffer to weak domestic demand in China, as shown by the disappointing import data. Imports rose by just 0.5% year-on-year, a sharp decline on the 7.2% rise recorded the previous month and well below consensus estimates.

Fears about the loss of growth momentum since the end of the second quarter have reached the highest levels of the Chinese Communist Party. On September 12, President Xi Jinping called on officials to do their utmost to ensure that the country reaches its official 5% growth target: All regions and departments must carefully implement the major economic initiatives and measures introduced by the Central Committee and complete the economic tasks for the third and fourth quarters."

The ECB keeps its promises

There were no surprises from the European Central Bank (ECB): at its monetary policy meeting on September 12, it made the expected 25 basis point (bp) reduction in the interest rate. The deposit rate was thus reduced to 3.5%. The ECB adopted a balanced tone in its policy statement, with growth projections slightly lowered by 0.1% over the entire forecast horizon and headline inflation left unchanged.

At the post-meeting press conference, ECB President Christine Lagarde reaffirmed that future cuts would be data-driven. For the markets, the policy direction is clear; the debate is more about timing.

The overnight interest rate swap market is leaning slightly towards a pause at the next ECB policy meeting in October, implying only a 44% chance of a further 25bp cut. However, the swap curve currently puts the probability of a 50bp cut in December at 82%.

Fed cut: 25 or 50?

Similarly, US investors continue to wonder whether the Federal Reserve will begin its easing cycle with a 25 or 50 basis point cut at the Federal Open Market Committee (FOMC) meeting on September 17-18. August consumer price data, released on September 11, was the last key variable likely to influence the decision.

When the data was released, it may have raised a few eyebrows among FOMC members. On the positive side, consumer prices rose by 0.19%, bringing the year-on-year increase to 2.5%, in line with expectations and the smallest rise in almost three years.

However, core prices unexpectedly rose by 0.28% month-on-month, compared with July's 0.17% increase and the consensus of 0.2%, leaving the year-on-year increase in core prices unchanged at 3.2%. The surprise in core prices came from the strength of homeowners' equivalent rent, which accelerated to 0.5% month-on-month, which could strengthen the argument for a cautious approach to rate cuts.

Whatever the FOMC's decision, interest-rate markets are expecting cuts of 100 basis points by the end of the year (see this week's chart). If the 50bp cut does not take place in September, the market believes such a move is highly likely in November, and another 50bp cut is expected in December.

Interest rate volatility is likely to continue until the end of the year, and any weak data could lead to a reaction in risk asset prices. Last week may have been quiet, but it could be full of twists and turns.

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