Weekly round up (Week 33)

Our weekly review of key developments in financial markets and economies looks back on a much calmer week after a hectic start to the month.

Order was restored to the financial markets last week. Most major equity markets continued their recovery from the sharp fall at the start of the month, while our preferred measure of volatility, the VIX, fell back below 16, having reached 38.6 on August 5.

Government bonds played their usual safe-haven role during the turbulence of the first week of August, but yields remained relatively stable last week, perhaps indicating that a drastic policy response from central banks may not be necessary. Meanwhile, in corporate credit, all asset subclasses continued to record positive returns, with the US slightly outperforming Europe and emerging markets in both investment grade and high yield.

The final piece of the puzzle?

After a series of disappointing economic data and evidence that inflation is edging closer to the 2% target, the US Federal Reserve is expected to announce a long-awaited key rate cut at the September meeting of the Federal Open Market Committee (FOMC).

The Fed has always maintained that it will be guided by the data; last week's Consumer Price Index (CPI) and Producer Price Index (PPI) should have dispelled any lingering doubts about a September interest rate cut.

Core PPI (excluding food and energy) was flat month-on-month in July against expectations of a 0.2% rise, while core CPI components have been negative for 7 consecutive months year-on-year. As a result, Goldman Sachs has lowered its estimate of core personal consumption expenditure (PCE) for July to 0.14% month-on-month (from 0.17%).

PCE is a key indicator for the Fed; the next PCE release, on August 30, could be the final piece of the data puzzle needed for the Fed to finally begin its next round of monetary easing (see this week's chart).

The big question is whether it will opt for a 25 or 50 basis point cut in September. This week's Jackson Hole economic policy symposium is likely to reveal much about the Fed's thinking, with Chairman Jerome Powell scheduled to deliver a keynote speech on August 23. For the time being, the overnight interest rate swap market seems undecided about a 25 or 50 basis point cut, and is instead counting on a 35 basis point drop.

Bad news (for) the bears

After the bearish market reaction to July's non-farm payrolls and gloomy projections for consumer spending, the latest retail sales and jobless claims figures indicate that the US labor market and consumers may not be as fragile as some had feared.

Preliminary estimates for July retail sales and restaurant services rose by 1% month-on-month and 2.7% year-on-year. Meanwhile, initial jobless claims for the week ending August 10 were 227,000, down 7,000 on the previous week and below the 235,000 expected.

The July NFP report may be a seasonal error. Assuming good weather for the rest of the month, the September 6 NFP report could hold an upside surprise, with workers returning from weather-related events and after the modest increase in employment reported in July.

Big miss in Europe

Economic data in Europe have generally been disappointing of late. This trend continued last week, with industrial production being the most notable figure. In June, year-on-year industrial production in the Eurozone came in at -3.9%, well below market expectations (-2.9%). This sign of weakness was compounded by a downward revision of May's figures (from -2.9% to -3.3%).

With inflation moving closer to the European Central Bank's 2% target, investor attention, as in the US, is shifting from inflation to growth, with data such as industrial production prompting calls for a faster, more meaningful response from the central bank.

Fifth time lucky?

The big news in Japan this week was the decision on August 14 by the Prime Minister and Chairman of the Liberal Democratic Party (LDP), Fumio Kishida, to resign, following a funding scandal within his party and public discontent with the rising cost of living.

Next month, the LDP will hold a leadership contest to replace Kishida. So far, only one candidate has declared his intention to run: former defense minister Shigeru Ishiba, who will attempt to lead the party for the fifth time. Other potential candidates include those who ran against Mr. Kishida in 2021, such as Taro Kono, current Minister of Digital Transformation, and Sanae Takaichi, Minister of State for Economic Security.

However, with the next general election scheduled for October 2025 and support for the current administration dwindling, it's possible that new talent will emerge. Among the names mooted are Shinjiro Koizumi, son of Junichiro Koizumi, former

Prime Minister and Elvis Presley fan, and Yōko Kamikawa, current Foreign Minister.

Despite the uncertainty generated by the leadership race, the winner is expected to continue Kishida's political approach. The market brushed off the news of Kishida's departure - the benchmark Nikkei 225 index rose by 0.8% the day after the announcement and by almost 9% over the week.

The market is more focused on the Bank of Japan's next moves, following the surprise interest rate hike on July 31, which contributed strongly to global market volatility earlier this month, as we explained in our latest weekly market commentary.

A crisis in China?

If the media are to be believed, the latest economic data released by China last week point to an extension of its “economic malaise”. However, we find it hard to see how the data revealed anything we didn't know or that was out of step with the consensus. While second-quarter GDP growth (4.7% year-on-year) was slightly below the official target of around 5%, first-half growth was right on target.

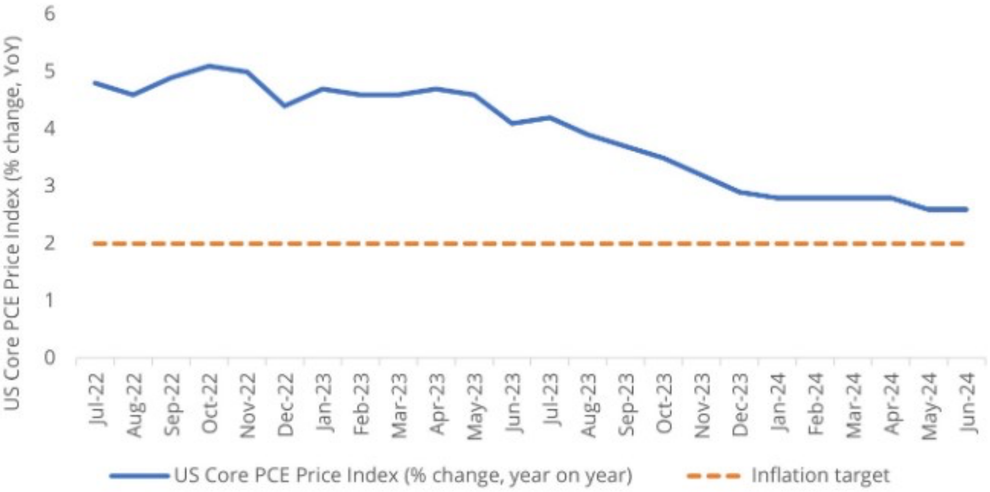
Nor should we forget the measures announced by the government this year to support the economy. This theme was reinforced on Thursday by the Governor of the Bank of China, Pan Gongsheng. In an interview with China Central Television, he confirmed that the central bank's supportive monetary policy will continue, and declared that further measures “will be taken in accordance with the requirements of the State Council”[10].

The government is undertaking a multi-year reorientation of the economy, away from the moribund real estate sector and towards high-tech industry and higher consumption. In our view, this period will not be without friction, and adjustments will probably be necessary along the way. Ultimately, however, economic change is essential to China's long-term prosperity, and investors would be well advised not to obsess over point-in-time data.

Elsewhere in Asia, on August 14, Srettha Thavisin became the fourth Thai prime minister in the last 16 years to be removed from office by the Constitutional Court. The decision followed widespread outrage at the appointment of a convicted criminal to his cabinet[11], when Thavsin had been in power for less than a year.

Political upheavals are nothing new in this Southeast Asian country, but this latest episode of uncertainty is likely to be a further headwind. The Thai economy is already lagging behind other countries in the region, while the benchmark SET stock market is down 9.5% year-to-date, making it one of Asia's worst performers.

Chart of the week: US inflation moves closer to target



Source: US Bureau of Economic Analysis, 'Personal Consumption Expenditures Price Index,' as of July 26, 2024