Weekly round up (Week 35)

Our weekly view of key developments in financial markets and economies asks whether the slowdown in the US jobs market could prompt the Fed to take more radical action.

Despite the turbulence that characterized most of August, the balance sheet will be favorable for investors, particularly those investing in fixed-income securities. Government bond yields fell, led by short-term bonds, as the easing of monetary policy in the US was all but confirmed on August 23 at the Jackson Hole Economic Policy Symposium.

The spread between 2- and 10-year US government bonds is now just -5 basis points (bp), narrowing from a -50 bp inversion in June. Corporate credit markets benefited from lower government bond yields, capital inflows and seasonally low supply, resulting in tighter spreads. Emerging-market high-yield credit now yields +9.6% year-to-date.

Oil prices remained range-bound, with geopolitical risk and global economic activity offsetting each other. Meanwhile, gold hit new highs in August, reminding us that not everything in the world is balanced.

Most stock markets are in positive territory, with Hong Kong's Hang Seng Index the best performer, buoyed by speculation that the Chinese authorities may allow homeowners to refinance up to US$5.4 trillion in mortgages to reduce borrowing costs, which could boost domestic consumption, but at the expense of state-owned banks' profitability.

In Japan, the benchmark Nikkei index was the epicenter of market volatility in early August. But after dropping 17% at one point, it ended the month just 1% down on its starting level. In Europe, Spanish equities led the way, while in the Americas, Brazil's Ibovespa outperformed.

Dependence on data

Throughout the year, central banks around the world insisted that policy decisions depended on data. Thus, consumer price updates released in the last week of each month were closely watched by investors for clues to possible policy changes.

Having spooked the markets with a surprise rate hike at the end of July, the Bank of Japan (BoJ) will want to avoid causing further clouds in the months ahead. However, the latest inflation data released last week put this assumption to the test, with Tokyo's consumer price index rising by 2.6% year-on-year in August, compared with 2.2% in July, above consensus expectations.

A base effect due to lower energy prices 12 months ago contributed to this increase, but the report also showed that a weak yen and rising labor costs are behind a generalized rise in prices. Speculation is mounting that the BoJ may be forced to tighten policy further in October if these trends continue.

The situation is clearer in the eurozone, where inflation has fallen to its lowest level since mid-2021. Consumer prices rose by 2.2% year-on-year in August, well below the 2.6% recorded in July and in line with consensus. This should give the European Central Bank (ECB) the green light for a further 25 basis point cut in key rates in September. The question now on investors' minds is whether the ECB will cut rates twice or three times this year, with the overnight interest rate swap market currently pricing in a 62 basis point easing.

Markets are looking for a major move from the Fed

In the United States, two other conclusions can be drawn from the Jackson Hole conference, in addition to Mr. Powell's announcement of a key rate cut at the September meeting of the Federal Open Market Committee (FOMC). The first is that the Fed's priorities have shifted from maintaining price stability to promoting maximum employment, as illustrated by Powell's statement: "We are not looking for and do not welcome a further cooling of labor market conditions”.

Growing concerns about the labor market could reduce attention to the Fed's preferred inflation indicator, the Personal Consumption Expenditure (PCE) price index. Despite this, the Fed will have been encouraged by July's data, as headline and core inflation held steady at 2.5% and 2.6% year-on-year, respectively[6] On a three-month annualized basis, the core PCE index, which many economists consider the most accurate reflection of inflation's trajectory, slowed to 1.7%, down from 2.1% in June. This was the slowest price rise of the year .

The second conclusion is that the door appears to have been left open for a 50bp rate cut in September, with the overnight interest rate swap market currently pricing in a 61% probability of such a move. While the Fed has announced a 25bp cut, a weaker non-farm payrolls report on September 6 could prompt investors to consider a 50bp cut at the FOMC meeting on September 17-18. Whatever the Fed's decision, the market's reaction will speak volumes about investor sentiment.

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