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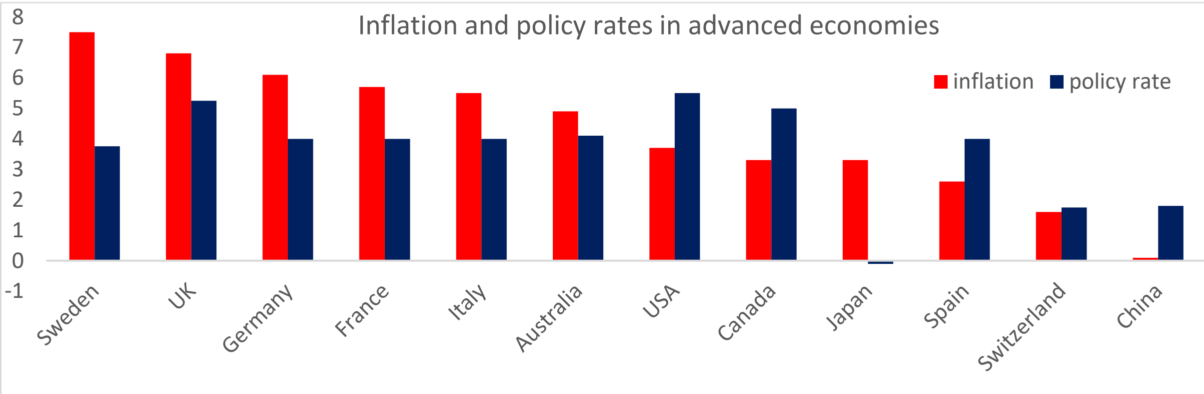
18th September 2023

"Temporarily right now, cash I think is good…..I don't want to own debt, you know, bonds and those kinds of things"
Ray Dalio at the 10th Milken Institute Asia Summit in Singapore

The ECB hiked its deposit rate to 4% last week and signalled the tightening cycle may be over while the Fed, the BoE and the BoJ are scheduled to meet this week, with only the BoE expected to hike. Policy rates are still below headline inflation in most of the advanced economies -especially Japan (see red bars below compared with blue) - but with the outlook for growth uncertain, labour markets easing, and policymakers fearful of overtightening, markets are pricing little chance of much further tightening after this week.



The supply shocks that were partly responsible for the surge of inflation have long since faded and disinflationary forces have been pulling inflation lower for the past year, giving an exaggerated impression of central bank success. Getting inflation fully to target is like running a marathon, with the central banks at the 20-mile mark and further progress getting tough.

In the US last week, the August monthly increase of .6% in the Consumer Price index was the largest in over a year and brought annual inflation up from 3.2% to 3.7%, while the core price index rose by the most since February. The major inflation components are showing different dynamics, leading to a wide range of possible future outcomes, and although services inflation – which is driven by wage increases – should by now have responded to tighter policy, it remains stubbornly high. Even the super-core measure of services inflation that excludes shelter costs has been stuck at roughly 4% for the past three months.

At Friday's close, crude was trading at roughly the same level as a year earlier but more than 20% above its level in December, and by the end of this year energy prices will almost certainly be adding to headline inflation rather than pulling it lower. Goods price inflation was close to zero after peaking at more than 12%, but new car prices have stabilised and used cars are no longer in freefall. Goods inflation was far higher and more volatile in the decades before Chinese imports were grabbing an ever-increasing market share and pressing down on prices, but that effect may have run its course. The decline of inflation from its peak last year is encouraging but was driven by three of the four major components excluding services, and with commodity prices now recovering, the prospects for continued progress at the same pace are dim.

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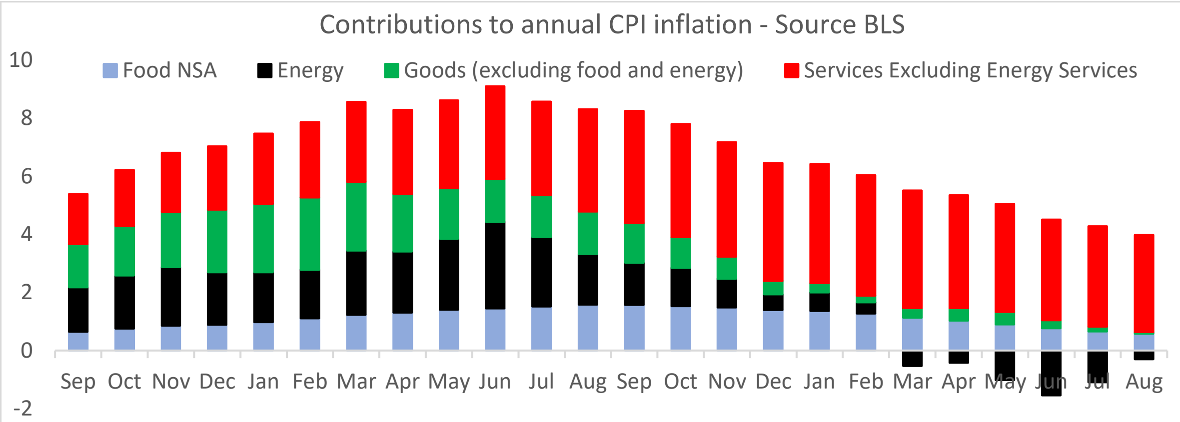

There were few other hard US economic data points last week, but a sharp slowdown in core retail sales growth to .1% in July following a jump of .7% in August pulled the Atlanta Fed GDPNow estimate for Q3 growth down to 4.9% from 5.5%. Retail represents roughly 40% of total real consumption in the US which jumped by .6% in July, and even with no further growth in August and September, a strong result for Q3 consumption is virtually baked in the cake.

The manufacturing sector is stabilising, with the August regional Fed surveys mostly pointing higher and the ratio of new orders to inventories in the nationwide ISM index signalling improvement. Friday's Empire manufacturing survey showed a strong bounce from -19 to +1.9, with the New Orders and Shipments indices each jumping roughly 25 points to 5.1 and 12.4 respectively and the index for future business conditions at its highest in over a year. This is the first of the volatile regional fed manufacturing surveys for September, and while the signs are encouraging, it is best to reserve judgement until several others are released.

The Fed meets this week after 525 basis points of hikes that have resulted in mixed economic signals, with inflation still far from target. Job growth is slowing, but the declining trend in claims suggests there is still more than enough demand for workers to prevent a significant rise in unemployment. Household wealth is at an all-time high, disposable income has been growing faster than inflation, and the continued strength of consumer spending will maintain demand for labour.

Europe

The ECB's rate hike was accompanied by an upward revision to the path of inflation expected over the next year, despite a lower growth forecast. The Deposit Rate is still more than one and a quarter percentage points below core inflation, but base effects from last year's temporary reduction in German travel prices should bring services inflation lower towards the end of the year. Unemployment is still at a record low in the eurozone, but Lagarde made clear the bar for any further hikes is high.

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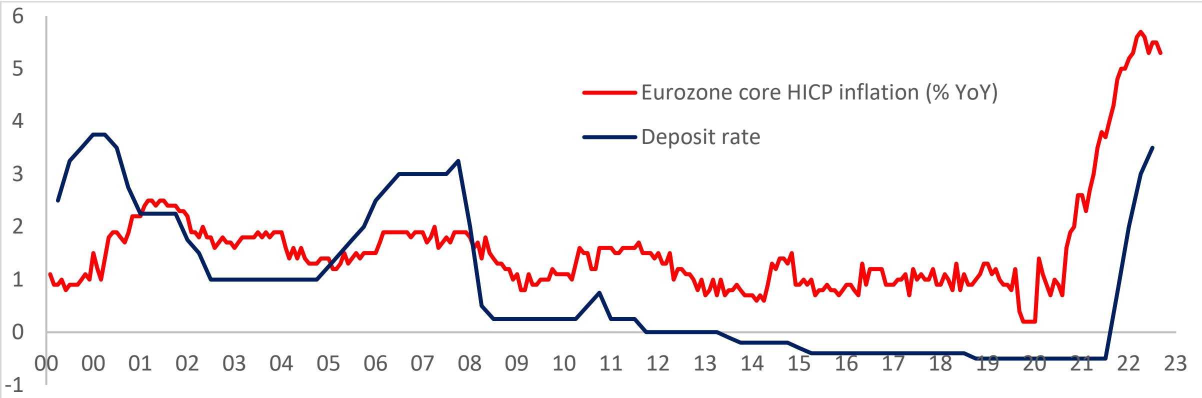

Markets are pricing the first cut by June of next year, but the ECB has a difficult task in lowering inflation while labour markets remain relatively tight, despite the ongoing slump in manufacturing.

UK

UK economic data last week showed that although the total number employed slipped by over 200K, pay growth remained at a record high in July. Vacancies fell in August but are still above the highest pre-pandemic level, and although the labour market may be cooling, it has not imploded. A half percent slump in July GDP reflected a rain-soaked month blighted by industrial action in the public sector which completely reversed the half percent GDP increase in June, but the prospects for August look brighter.

The BoE will meet this week with markets expecting a final 25bps hike for the cycle before rates start declining in the second half of next year. Friday's BoE survey showed public confidence in the Bank has sunk to a record low, but when inflation first exceeded 5% in late 2021 with its rate still at 10bps, the Bank failed to take the easy decisions. Mortgage rate resets are now hitting an increasing number of households and home prices are sliding, but inflation in August is likely to be reported higher on Wednesday and the Bank's future policy choices are far from straightforward.

China

China's monthly update of economic activity was released on Friday, showing better than expected increases in retail sales and industrial production - which rose 4.6% and 4.5% year over year respectively - while fixed asset growth was roughly in line, with an increase for the year to date of 3.2% against the same period last year. Unemployment ticked down a tenth to 5.2% but it is far too early to imply the piecemeal stimulus measures may be gaining traction.

Support for the construction and real estate sectors may have prevented an outright collapse as over-leveraged developers struggled to make coupon payments, but these sectors are not out the woods. The 70-cities index of new home prices resumed its slide in June and was down for a third consecutive month in August with a fall of .3%, pointing to a long period of stagnation before a sustained recovery in prices and any pickup in sales.

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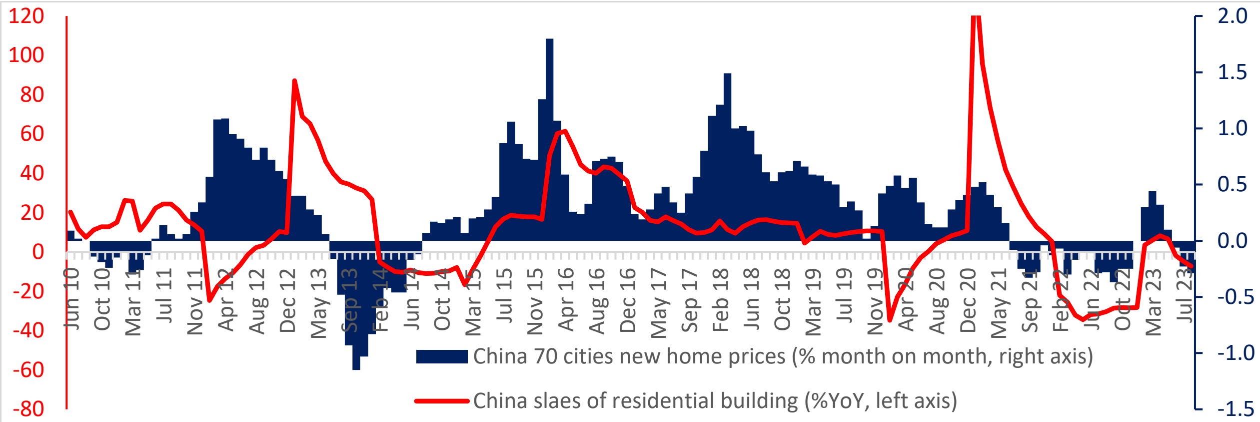
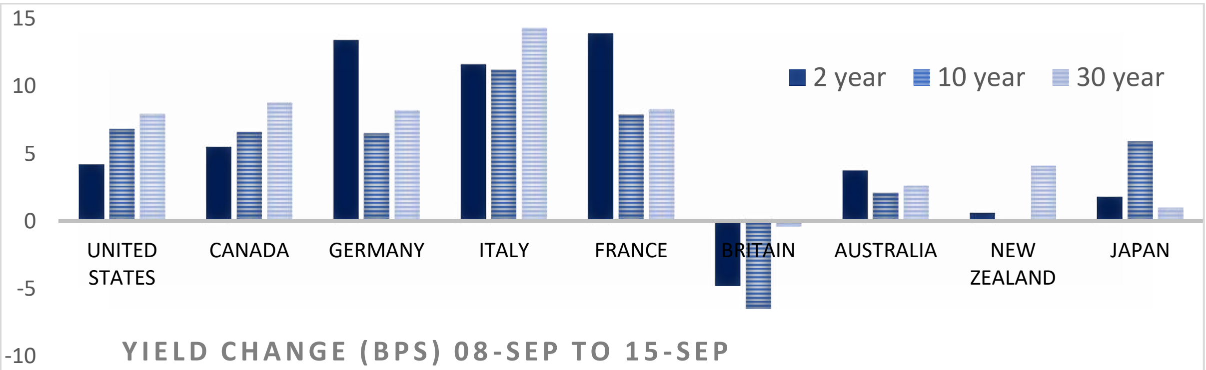


Markets
We warned of the risks to US CPI ahead of last week's release, but the treasury market initially just shrugged off the upside surprise. The ECB's dovish rate hike was also initially greeted with a decline in yields, but by Friday the market had a more sober assessment of the long-term path for policy, and yields closed the week higher across almost all the G7.



Japan's sovereign bonds have been the anchor for global yields, but the ten-year JGB yield ended the week at .72% - the highest since January of 2014. The August CPI will be published this Friday shortly before the BoJ meets and is expected to show little change, with core inflation remaining at 4.3%. Policymakers are trying to juggle too many balls with core inflation this high while they hope for a more sustained increase in wages. The overnight rate is still negative but yield curve control limits the rise in JGB yields, while the Finance Ministry threatens intervention to prevent the currency sinking. One-week dollar/yen implied volatility jumped to 11% on Friday, reflecting the BoJ risk falling within the 7-day window, but with the central bank's history of delivering surprises, the options probably represent good value.

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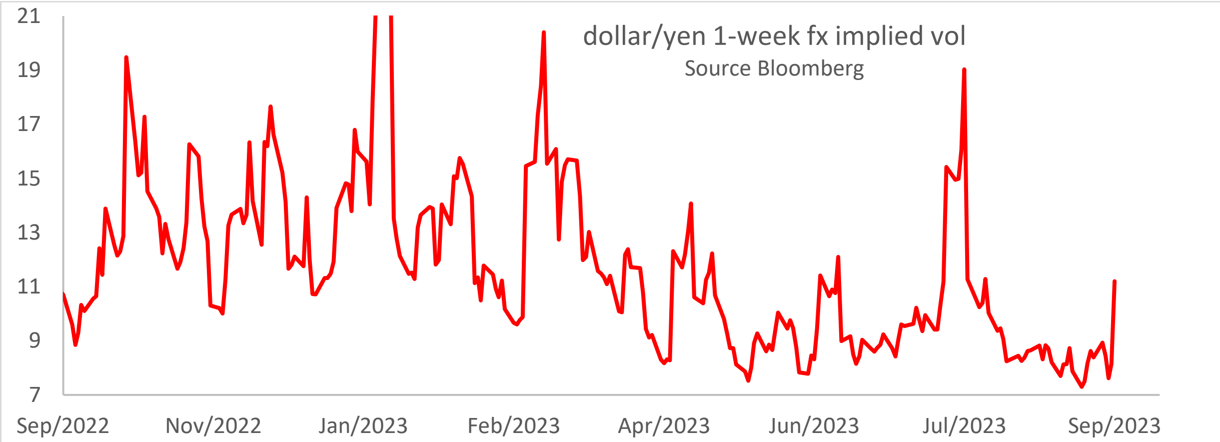
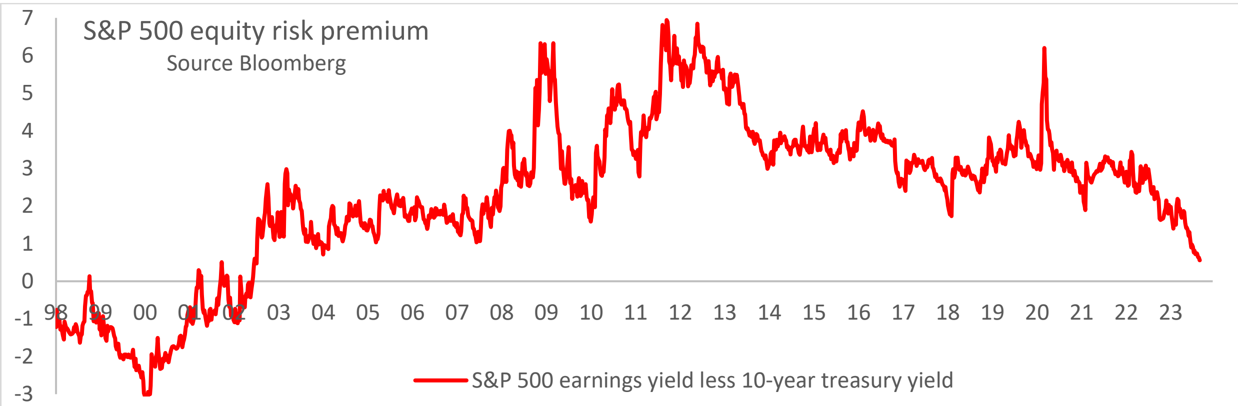


Hopes that China's stimulus measures will support the property market and lift infrastructure spending brought gains for most primary metals and a surge of 8.5% in iron futures over the week, with the Stoxx Basic Resources index jumping 7%. Brent crude futures climbed another 3.6% on the week and the FTSE-100 – which is roughly a quarter comprised of oil drillers and miners – was the best performing major index with a 3.1% gain.

Treasury yields rose last week and closed just below the year-to-date high while the S&P 500 sank 1.2% on Friday to close the week with a small loss. Earnings have stalled and valuations look stretched compared to fixed income yields, with a crude measure of the equity risk premium at the lowest in over 20 years.



The Fed currently has a target range for the fed funds of 5.25% to 5.5% and this is unlikely to change after this week's meeting. Since the previous Summary of Economic Projections in June, the labour market may have cooled, but growth has been stronger than expected and inflation is not yet convincingly heading to 2%. Powell and the rest of the FOMC want to avoid the mistakes of the 1970s, when each time the Fed took its foot off the brake, inflation surged, and main risk on Wednesday is a change to the forward guidance that drives the "higher for longer" message home in no uncertain terms. The prior set of projections showed one further hike this year followed by 100bps of cuts next year with more than 100bps to follow in 2025, and this rate path will almost certainly be revised.

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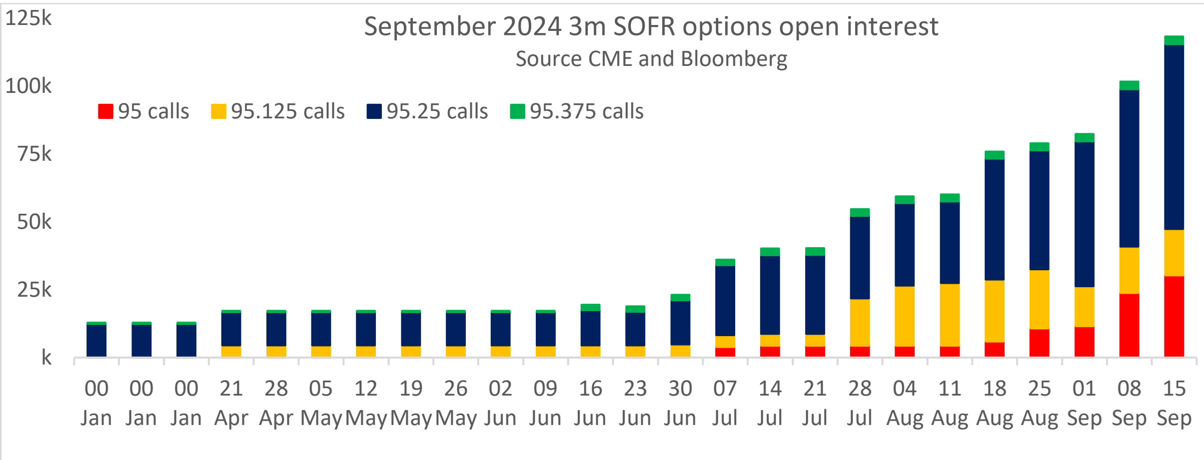
June Summary of Economic Projections	2023	2024	2025
Change in GDP	1	1.1	1.8
March projection	0.4	1.2	1.9
Unemployment rate	4.1	4.5	4.5
March projection	4.5	4.6	4.6
PCE inflation	3.2	2.5	2.1
March projection	3.3	2.5	2.1
Core PCE inflation	3.9	2.6	2.2
March projection	3.6	2.6	2.1
Fed funds projected rate	5.6	4.6	3.4
March projection	5.1	4.3	3.1

The current 3-month US Secured Overnight Funding Rate (SOFR) is 5.3%, but open interest in options on a rate below 4.75% by next September (95.25 calls) have been growing over the past month.



The fed funds futures market currently prices cuts of around 80bps next year and a rate of roughly 4% at the end of 2025, but these prospective rate cuts have been moving further into the future over the past 18 months, driving the upward drift in longer term treasury yields. If the short-term rate path gets a more significant reset, the ten-year yield could break to a new post-GFC high.

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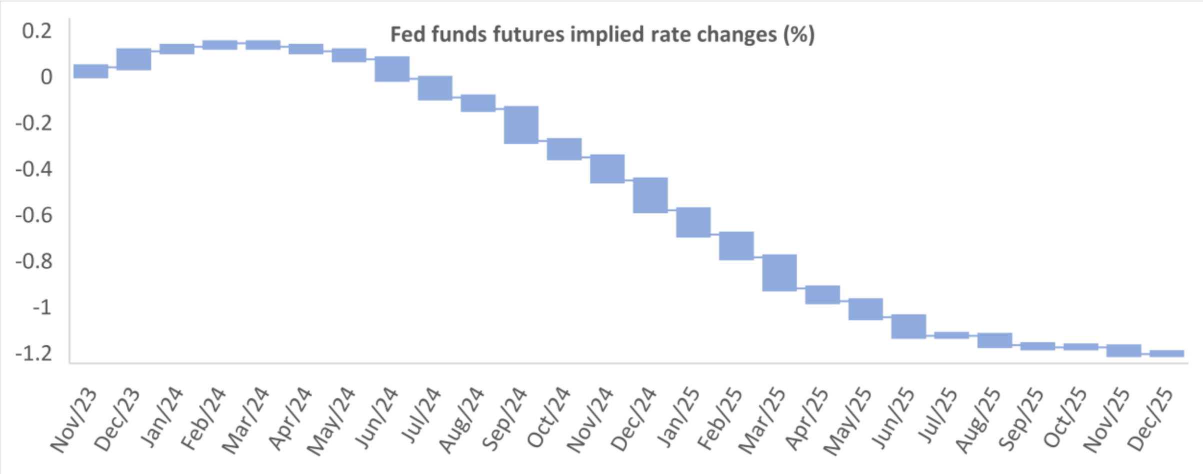

Portfolio Update

As made clear last week, we have scaled up the short position in treasury futures but are continuing to protect against a reversal with short-dated upside calls. This is not without cost, and although the futures declined almost ten thirty seconds, much of that profit was eaten by call premium. For the coming week, we have 110 calls to protect ¾ of the total trade size.

We still have the short position in S&P 500 futures, and the underperformance of US equities last week compared to rest of the developed market indices was encouraging. Short-dated implied volatility is still close to its post-pandemic low, and we will add puts or puts spreads expiring this Friday.

This week's macro agenda

Monday 18th Sep

UK Rightmove House Prices Sep
US NAHB housing market index Sep

Tuesday 19th Sep

US housing starts and permits August

Weds 20th Sep

Japan trade balance August
Germany PPI August, EU new car registrations August
UK CPI, RPI and PPI August, Land Registry house price index July
US FOMC rate decision, MBA weekly mortgage applications

Thurs 21st Sep

UK BoE rate decision, public sector finances August
France manufacturing and business confidence September, retail sales August, eurozone consumer confidence September

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US Philly Fed Business Outlook September, weekly initial and continuing claims, existing home sales August

Friday 22nd Sep
Japan BoJ policy rate and 10-yr yield target, nationwide CPI August, Jibun Bank PMIs September
S&P Global PMIs for US, eurozone, Germany, France and UK September
UK retail sales August