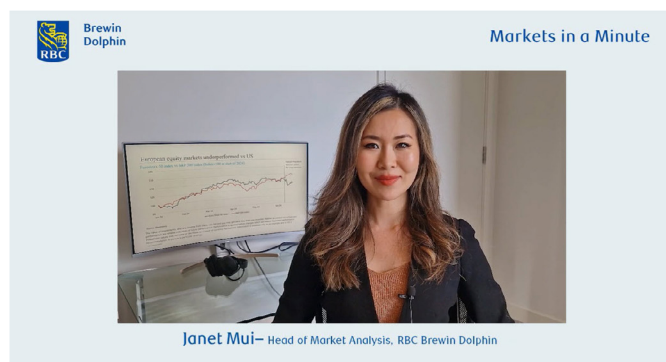
28 August 2024

Brewin
Dolphin

Markets in a Minute

Janet Mui, Head of Market Analysis, discusses the Federal Reserve's signal that U.S. interest rate cuts are coming, weighs the possibility of similar moves in the UK, and examines the reasons behind the recent gold price rally.



To view the latest Markets in a Minute video click here.

Equity markets globally continued to rebound last week, and the U.S. S&P 500 index was a whisker away from its all-time high. Recent economic data helped ease recession fears while Federal Reserve (the "Fed") Chair Jay Powell announced on Friday, at a speech at the Jackson Hole Economic Symposium, that the time has come for the Fed to cut interest rates.

This is music to the ears of traders, households and businesses. There has been a lot of speculation and expectation (resulting in disappointment and confusion) over interest rates in the past year, so to hear such clarity of impending rate cuts from the Fed Chair is both pivotal and a relief. Despite the revelation, Powell fell short of suggesting how the Fed may proceed. Again, there's an emphasis on data dependency and the assessment of the balance of risk. There's no doubt that incoming economic data will continue to be scrutinised.

Does a downward revision in U.S. jobs growth matter?

Last week, the revisions to U.S. jobs growth data gained a lot of attention, though market impact was rather muted. Usually, these statistical revisions are a non-event, but any data release related to the labour market is heavily scrutinised by traders.

According to the U.S. Bureau of Labour Statistics, the number of nonfarm payroll positions (which exclude farm workers, private household employees, unpaid volunteers, business owners and some self-employed) will likely be revised down by 818,000 for the 12 months through March. That's a bumper figure, and the biggest revision since 2009. It translates to about 68,000 fewer jobs created each month than previously thought.

I remember how stunning it was to see several nonfarm payroll releases announce gains of 300,000 jobs over the past year. It turns out the actual state of the U.S. labour market is much less robust.

Does that matter? Yes and no.

Yes, because it adds to the evidence of a cooling U.S. labour market and really seals the deal for a rate cut in September. We don't know the distribution of this downward revision in job numbers – could it be more concentrated in more recent months? If that's the case, the lagged impact of higher interest rates could be gathering pace (think of the 'boiling frog' syndrome). In this scenario, the Fed could be expected to end the current restrictive monetary stance as soon as possible to avert a recession.

Some economists may argue that no, the revisions don't matter too much (even after sizeable downward revisions) because the job data was so robust, and the monthly pace of job gains was still a whopping 174,000 on average. This is still a healthy pace of hiring and a picture of economic resilience. The muted market reaction suggests the rate cuts are well priced in, and markets decided the data wasn't too bad.

How low can the Fed go?

Beyond September, the question is: how much further can the Fed cut? Perhaps even the Fed has no idea given its dependence on data. We think barring a recession, the pace of rate cuts is likely to be measured.

The aggressive rate cuts priced in by the bond market appear to be overdone if the economy continues to expand. For instance, the Fed's median interest rate projections (the so-called 'dot plot') suggest the Fed funds rate will be just above 4% by the end of 2025. That compares with about 3% currently implied by the Fed funds futures. While the next dot plot may see downward revisions, the current 100-basis point disconnect seems big.

If the U.S. economy continues to hold up, are the 100-basis point interest rate cuts priced in by markets for the end of 2024 and 2025 warranted? We think probably not. What we can learn from the past two years is that the market pricing of interest rates can change drastically. What is significant is that we're moving into the next phase of the interest rate cycle. While we don't know the exact quantum, the direction of travel of interest rates is highly likely to be south over the next 12 to 18 months – important information to consider for both businesses and households, for example if you're holding a lot of cash or if you're looking to buy a property.

The price of gold soars

As a result of the intensifying expectations of interest rate cuts by the Fed, the U.S. dollar has weakened notably across a basket of major currencies. Meanwhile, gold prices blasted past $2,500 to an all-time high last week.

Gold prices, which are denominated in U.S. dollars, tend to strengthen with a weaker dollar. They've been on a tear of late, having risen around 21% this year. Prices have been supported by increased central bank purchases, as emerging market central banks look to increase gold as a percentage of their reserves.

Gold, an asset traditionally expected to retain or even increase in value during times of market turbulence, has been a beneficiary of the ongoing geopolitical and economic uncertainty. It served as an effective hedge in the recent bout of equity market volatility, for example. Furthermore, gold prices have recently re-aligned with their fundamental driver: real interest rates. Gold prices tend to move in the opposite direction to real interest rates (for example, the higher the interest rates, the lower the gold prices) because gold generates no income.

With global central banks likely to cut rates simultaneously over the next six to 12 months, and U.S. growth moderating, the stars are aligned for gold to perform well and deliver as a portfolio diversifier.

The UK is recovering – but some fears of inflation remain

Turning to the UK, and there are more signs the economy is recovering. The latest purchasing manager indices (PMI) for manufacturing and services show both expanded more than expected in August. This is rather special, because manufacturing PMIs in the U.S. and the Eurozone both contracted in August. This sets a good backdrop for Q3 gross domestic product (GDP) growth – and don't forget, GDP was already expanding at +0.6% in Q2 and +0.7% in Q1, respectively.

However, there are concerns that higher inflation will return. The large wage increases given to train drivers and junior doctors raise concerns on further public sector and labour union wage demands.

In addition, on Friday, energy regulator Ofgem announced an increase of 10% to the energy price cap from October. While expected, this risks feeding into consumers' inflation expectations. The Bank of England (BoE) already expects UK CPI to re-accelerate to 2.7% in Q4 from the current 2.2%. As a result, markets are no longer betting that the BoE will cut interest rates again in September, with the next cut more likely to be in November.

Overall, the markets have priced in higher UK interest rates compared to those in the U.S. for at least the next 12 to 18 months. For instance, U.S. interest rates are expected to be at about 3% by the end of 2025, versus about 3.7% in the UK. This has contributed to the recent strength in sterling, which surged past 1.32 versus the U.S. dollar last week, meaning £1 now buys $1.32.

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy. Information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness. Forecasts are not a reliable indicator of future performance. We or a connected person may have positions in or options on the securities mentioned herein or may buy, sell or offer to make a purchase or sale of such securities from time to time. For further information, please refer to our conflicts policy which is available on request or can be accessed via our website at www.brewin.co.uk.

RBC Brewin Dolphin is a trading name of Brewin Dolphin Limited. Brewin Dolphin Limited is authorised and regulated by the Financial Conduct Authority (Financial Services Register reference number 124444) and regulated in Jersey by the Financial Services Commission. Registered Office; 12 Smithfield Street, London, EC1A 9BD. Registered in England and Wales company number: 2135876.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.

RBCBDM1809_2408