Brewin Dolphin

Markets in a Minute

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Guy Foster, Chief Strategist, discusses Iran's attacks on Israel and what this means for markets. Plus, Janet Mui, Head of Market Analysis, analyses recent U.S. inflation data.

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The week before last saw stocks giving up some of their recent gains despite a late flourish following the U.S. employment report. The report showed strong jobs growth, substantially driven by increased immigration, which seems to be facilitating a renaissance in non-inflationary growth (what economists call a supply-side expansion).

Last week, however, they held their ground, lingering near their heights, but considering some of the news markets had to digest, that could be seen as a sign of strength.

U.S. inflation is high (again)

U.S. inflation data for March was released last week and was well above the rate consistent with hitting the inflation target. Sometimes, the inflation data is distorted by volatile food and energy prices, so we can look at core inflation instead, and if we are concerned about the distorting impact of shelter inflation then we can strip that out, too. The problem is that in all the various ways in which consumer price index (CPI) statistics are modified to make them seem more representative of underlying price pressures, they still seem to conclude that inflation during March was too high to be consistent with hitting the inflation target.

How has this impacted the markets? Well, over many weeks, we have been commentating on the market's slowly evolving views on the number and timing of interest rate cuts this year. Readers may recall there was a time when markets were discounting seven interest rate cuts by December 2024. This was difficult to comprehend and implied that a majority of investors foresaw a significant recession and a material undershoot in inflation. Instead, the economy has continued to grow, and inflation has proven stubborn. As of the week before last, the implied interest rate cuts by the end of this year have reduced to one or two.

Unlike the fickle market, the Federal Reserve members have remained consistent in their forecast of three interest rate cuts during the year. So, whilst the magnitude of the change in market expectations is significant, so is the fact that the markets saw the Fed as too hawkish and now see it as too dovish.

Various members of the Federal Reserve have spoken since the last Fed meeting, and most have acknowledged the persistence of inflationary data is a challenge to the current expected trajectory of rates. Some still believe they will happen while others are more circumspect. Fed chair Jay Powell seems more convinced than most that the Fed's economic projections make sense. Should he be?

How should the Fed set interest rates?

Broadly, the Fed is assumed to set its policy in either a restrictive or an expansive setting depending on whether the economy is operating above or below its potential capacity. A restrictive policy would mean interest rates above a neutral level, whereas an expansive policy would mean rates below neutral. The challenge, however, is that the neutral rate is uncertain and changes over time.

Jay Powell said a couple of weeks ago that the neutral rate "doesn't really matter" for policy today. Bloomberg ambushed former treasury secretary Larry Summers with this statement, and he pushed back against it, saying it was like driving a car by feel without looking at the speedometer. He didn't have the context of Powell's remark, which was that the neutral rate is unknowable, but the Fed is confident it is below the current rate. So, he just meant knowing exactly what the neutral rate was doesn't matter for policy today.

But to continue Summers' analogy, should the Fed be driving based upon a speedometer they believe is faulty (a neutral rate estimate they know is wrong) or by feel (taking other evidence that the economy is speeding up or slowing down)? Driving by feel can sound a lot like being data-dependent, and despite the enormous resources that go into trying to forecast the economy, given the well-known inexactness of economic forecasts, it could be wrong to place too much faith in the models and ignore other evidence that the economy might be operating above capacity.

Persistence in inflation would be one factor. Strong jobs growth is another, alongside the strength in consumer spending. There is evidence of banks loosening lending standards (slightly). Nothing is definitive but there seems to be enough to at least challenge the assumption that policy is restrictive.

So, are U.S. interest rates restrictive?

For what it's worth, there is a variety of estimates of the level of the neutral rate, with most being around 1%, but some are as high as 3%. At the same time, inflation itself is really an expectation rather than a known fact, and so this too could probably vary between say 1% and 3%. This may indicate that policy is restrictive, but it's certainly quite possible that it's not. The empirical evidence of a strong economy with high inflation might top the scale a bit in favour of the latter.

The counterargument is that policy is restrictive but operates with what economist Milton Friedman called long and variable lags, so even though the economy is strong now, it's likely to slow down in response to tightening that took place last year. This means what a central bank should do is change policy in anticipation of changes in the economy. Fortunately, most central bankers are self-aware enough to recognise their forecasts are not accurate enough to do this.

Bernanke and the Bank

Ironically, on Friday, former chair of the Federal Reserve Ben Bernanke's recommendations to the Bank of England were published. The Bank had asked him to review its forecasting approach. He has recommended abandoning fan charts, which show the range of possible outcomes for a variety of economic metrics. Fan charts can convey the inexactness of forecasts in a helpful way. They would highlight that while you expect the economy to weaken, there is a chance that it strengthens, and vice versa. It likely discourages central bankers from setting policy in anticipation of changes in the economy because very often, those forecasts are wrong.

To be fair, his suggested alternative is to have a central forecast and some alternative scenarios. This may work as well, but equally, may be open to criticism for being vague and inexact. The other specific change would be the nature of the forecasts, which are currently based upon the market's expectations of how policy will evolve. This can be confusing because sometimes, the central bank seems to be forecasting how the economy will evolve based upon interest rate changes it doesn't intend to make!

Enough eco-waffle – why does this matter?

Changes in expected interest rates drive changes in bond yields and prices. The U.S. CPI and strong data out of the UK have seen UK bonds underperform.

According to textbooks, they should also drive equity valuations, but often they don't. The textbooks would suggest that investors buy stocks based upon a valuation model that includes bond yields as an input – thus when yields go up, stock prices should come down. This should particularly affect stocks with longer-term growth prospects, as these are long-duration assets (as discussed last week).

This relationship is not very reliable though, as investors generally buy stocks because they have excess savings, and those savings contribute to a pool of global liquidity, which drives financial markets.

But interest rates will influence the returns earned by investing in certain industries. Banks earn more when interest rates are higher. It should add to their net interest margins (the difference between what they earn on loans and what they pay on deposits).

Another inflation hawk

Friday marked the real start of the first quarter earnings season, with a host of banks kicking things off. Focus as ever was on the sage words of Jamie Dimon of JPMorgan Chase. He cited inflation 21 times in his chairman's letter and named required investments in climate transition, restructured supply chains, more military spending, and higher healthcare costs as reasons to fear inflation will be "sticky" (persistent) and interest rates may stay higher than expected.

Another sector that is interest rate sensitive is real estate, which is likely to underperform if interest rates stay higher for longer because the sector is leveraged and will suffer an increased cost of debt.

Short duration assets are less impacted by changes in interest rates. Energy would be an example of a short duration asset (again discussed last week). That's not the reason it's performing well at the moment (which is of course the strength in the oil price), but it helps.

Changes in interest rates affect exchange rates too, and the dollar rose on the strength of the CPI report. In response, the Japanese Ministry of Finance employed vague threats of intervention to try and support the yen. These may not have been idle threats as the yen was rallying sharply at the time of writing on Friday.

The pound has been overshadowed by the inflation-boosted dollar and short-squeezed yen. Despite this, there was more evidence of a cyclical upturn in UK economic activity. The British Retail Consortium (BRC)'s retail sales survey suggests that March will see retail sales volumes expanding. The Royal Institution of Chartered Surveyors (RICS) house price balance suggests that house prices will continue to rise over the coming months. Friday's UK gross domestic product (GDP) report showed modest expansion, enough to confirm the recession (such as it was) is firmly behind us and that once March's data are confirmed, the first quarter of growth this year should be ahead of the Bank of England's forecasts.

The important rule when using forecasts is summed up in a brilliant piece of wisdom attributed to economist John Maynard Keynes:

"It's better to be roughly right than precisely wrong"

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