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Weekly Macro and Markets View

25 September 2023

Highlights and View

The Fed is on hold for now, but surprises with hawkish intent

Chair Powell makes it clear that the still remarkably robust labour market and elevated inflation mean the work of the policy committee is not yet over, with restrictive rates required for a protracted period.

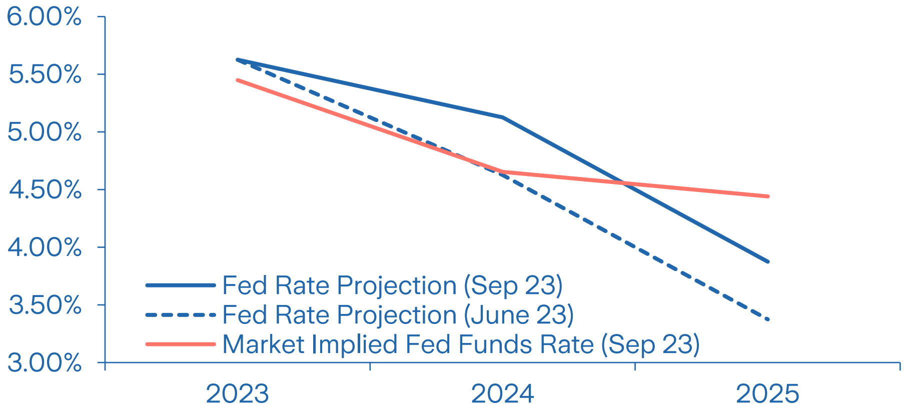
Bucking expectations, the Bank of England takes a pause in rate hikes

The sharp fall in inflation in August, with core CPI down to 6.2%, proved pivotal in the decision, though we suspect this a pause rather than an end to hikes.

Hawkish guidance from the Fed triggers a sharp rise in government bond yields

Further upside to yields is likely to be limited as the rate hiking cycle is nearing its end and growth and inflation are weakening.

Central banks become more cautious



Source: Bloomberg

Central banks were busy last week, with a plethora of policy meetings. Following on from the ECB's dovish hike in the prior week, the Fed delivered a hawkish hold, emphasising a higher for longer outlook for rates that triggered a sharp repricing in rates and yields. In Europe, by contrast, the Bank of England and the Swiss National Bank surprised markets by leaving rates unchanged. The SNB kept rates at 1.75% and cut its longer-term inflation forecast to below 2%. This was motivated by weakness in the global growth environment and marked a break from its hawkish guidance in the past. In a finely balanced decision, the BoE also moved against expectations by leaving rates unchanged at 5.25%. A sharp fall in inflation in August and weak growth appear to have swayed the committee. While it is encouraging that central banks are now able to proceed more cautiously, policy will remain tight until further progress on inflation has been achieved. Elsewhere, the Bank of Japan also left policy unchanged. This was expected and the focus was instead on Governor Ueda's statements during the press conference, where he pushed back on speculation that an end to the BoJ's Negative Interest Rate Policy (NIRP) and Yield Curve Control (YCC) will soon be announced. We do not expect a major change in monetary policy over the next few months.

US

The Fed pauses but signals rates will be higher for longer

In another week of ambiguous economic data the Fed was crystal clear in its hawkish messaging, refraining from an additional rate hike. The pause had been priced by markets, but the tone of the messaging and raising of the dot-plot, which shows the median FOMC member expects a further 25bp hike this year and now only two rate cuts next, unsettled global markets. We suspect that weakening economic data will likely temper the policy outlook, but there is no doubt that the labour market remains hot. Initial jobless claims ticked down once again to the lows of the start of the year, but other data point to an increasing economic vulnerability. In addition to further oil and gasoline prices gains, housing starts plunged in August and existing home sales show a market that is stagnating, also reflected in a five-month low for homebuilder sentiment. Despite the mixed data, Fed Chair Powell noted the inflation fight was not over and implied that the economic risks to win that fight are to the downside. It should be remembered that with inflation falling, real rates are rising and restricting activity.

LatAm

Economic activity remains solid in Brazil and Mexico

In Brazil, the economic activity indicator for July showed an increase of 0.44% MoM, up from 0.22% in June and above the market consensus of 0.4%. Conversely, year-on-year growth for July came in below market expectations of 1.0% at 0.66 %YoY, down from 2.37% the previous month. At the sector level the results were mixed. Services and retail sales showed gains of 3.42% and 7.12% respectively, while the industrial sector registered a drop of -1,51%. In this context, the data back the central bank's strategy to gradually ease monetary policy.

In Mexico, July data showed a further uptrend in activity, signalling robust domestic demand and strong Q3 growth prospects, though more moderate than in H1. The IGAE economic activity index showed an expansion of 0.15% MoM, up from 0.5% in June below the market consensus of 0.25%, and an increase of 3.19% YoY, below the market consensus of 3.6%. Manufacturing climbed 0.31% MoM, mining dropped 2.61% MoM, construction rose 1.96% MoM and 25.6% YoY, the highest since 1993, and services fell 0.08% from the month prior.

Bonds

The Fed's higher for longer guidance triggers a bond market sell-off

Bond markets sold off last week as the Fed's hawkish messaging unsettled investors. The 10yr Treasury yield snapped higher and rose above 4.50% intraday on Thursday for the first time since 2007. While the sell-off was initially driven by a reassessment of the near-term policy outlook, longer maturity bonds underperformed. Gilt yields, by contrast, continued to grind lower on the week as the BoE delivered a surprise hold. The 10yr gilt yield has fallen from a high of 4.75% in mid-August to a low of just above 4.2% last week, on weak growth and a downside surprise to inflation. By contrast, a more hawkish ECB in the prior week triggered a sell-off in Bund yields with the negative momentum continuing last week. The 10yr Bund yield is now trading above 2.75% and has hit new highs for the cycle despite the weak economic backdrop and falling inflation in many components. As policy tightening is now being felt across economies, further upside to yields is limited. That said, rising oil prices and the data dependent approach of central banks may well drive further volatility in bond markets near term.

Credit

Resilient amid broader volatility

In a week where both stocks and government bonds witnessed volatility following hawkish central bank rhetoric, corporate bonds were relatively resilient with decent demand seen in the primary market. However, credit derivative indices weakened and spreads widened in line with stocks. US High Yield supply remained solid for a second week, with strong oversubscription seen for the juicier deals. US IG and European High Yield supply remained muted, however, as several issuers stood down amid the volatility following the Fed meeting. European IG markets also saw strong demand and subscription levels. All in all, the higher yield environment is supporting demand for corporate bonds, causing technicals to remain strong despite increasing headwinds to credit worthiness from rising funding costs and weakening of economic growth. That said, High Yield in particular remains vulnerable given the low supply seen since beginning of 2022, which implies that there will be significant pressure to refinance bonds at much more expensive levels in coming quarters.

Equities

Volatility returns as investors take flight on surging bond yields

Equity investors were focused on the rates markets and the jump in bond yields that gave cause for concern. The more hawkish than expected Fed commentary drove a sell-off in US stocks into the close on Wednesday, which reverberated globally. By the week's close stocks had taken a meaningful hit, with the MSCI World index off 2.7%, and the more rate sensitive US Nasdaq index slipping 3.6%. As the VIX volatility index moved higher, there was a reminder for investors that both interest rate risk and indeed recessionary risks should warrant some form of risk premia, which we believe is currently not adequately priced in equities. Some markets are coming round to this, however, with the Russell 2000 small-cap index in the US off more than 10% from July's highs. While the battle between weakening fundamentals and momentum in key markets remains a close fight, we believe the balance of risk remains to the downside should technical support levels be breached and the buy-on-dip mentality falter.

What to Watch

- US consumer confidence and PCE inflation will be in focus, with confidence expected to slip modestly, while core inflation is forecast to fall to 3.9% YoY.
- Eurozone CPI for September will be closely watched, along with lending and consumer confidence data.
- This week the Central Bank of Mexico, Banxico, will hold its monetary policy meeting. We anticipate that it will leave the reference rate at 11.25% in the context of strong growth.
- In APAC, Japan will report a series of important economic indicators for August and September. On Saturday, China will release NBS PMIs for September. Australia will publish August CPI data, retail sales and private sector credit. In Thailand, we expect the BoT to hike its policy rate by 25bps, though it is a close call. Korea, Hong Kong and Thailand will release their latest foreign trade statistics. India will report its current account for Q2. Several markets will be closed on Thursday and/or Friday due to national holidays.

Disclaimer and cautionary statement

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