Rathbones
Look forward

Review of the week

3 April 2023

Back on track?

Stocks and bonds ended the month – and first quarter – nearing the top ends of the trading ranges in place since late last year. But there's still much uncertainty about the inflation and growth outlook, particularly if energy prices start rising again

After several weeks in which financial markets have been gripped by the fortunes of a few banks, a calmer narrative returned last week.

US and European stocks steadied, even as banking shares remained under pressure. Likewise, bond markets found a firmer footing after a chaotic first quarter, with 10-year US treasury and 10-year gilt yields hovering around 3.5%.

The last few weeks have seen significant volatility in investors' expectations of where interest rates are headed. Markets are currently pricing in about 0.5% in cuts from the US Federal Reserve (Fed) by the end of this year, following the possibility of one more rate rise in May. We still don't think rate cuts are coming soon.

Inflation just isn't falling back as fast as policymakers would like. Last week's preliminary Eurozone inflation reading showed the rate of headline inflation (which excludes energy and food prices) slowing to 6.9% in March, down from 8.5% in February. That is its sharpest monthly fall on record, according to Reuters. But the rate of core inflation, which strips out energy and food costs, actually increased, rising from 5.6% to 5.7%, a new all-time high for the monetary union.

Recent US inflation readings have been mixed too. Friday's US Personal Consumption Expenditures (PCE) index (an inflation gauge the Fed watches particularly closely as it charts the path of future rate hikes) showed core inflation up 0.3% month-on-month in February, better than the predicted 0.4% rise. But most of the moderation was attributable to weaker goods prices; the index showed service-sector inflation accelerating, rising by a concerning 5.7% year-on-year. The Fed has said many times that it needs to see this element slowing in order to change course.

Much of the stickiness in services sector inflation is down to high wage inflation. Labour costs account for a much bigger part of the prices we pay for services than they do for those of goods. Yes, wage growth is already falling a bit. And indicators that lead wage growth tell us that wage growth will probably slow further. These indicators include the rate at which people are quitting their jobs and a proxy for the rate at which laid-off workers are being rehired. But wage growth may well stay relatively high until the end of this year and that could stop core inflation rates from getting back to policymakers' targets of around 2%.

The bottom line is that while we still expect inflation to fade meaningfully this year (as long as we don't get another painful energy price shock, more on that later), services sector inflation is proving stubbornly resistant to the impact of higher rates. An awful lot must go right for inflation to subside to central banks' targets as rapidly as most investors seem to expect.

Meanwhile, there are tentative signs that still-rising rates, sticky inflation and the banking sector's troubles are weighing on US consumer confidence. The US March Conference Board consumer confidence index came in firmly above expectations at 104.2 as confidence in future business and labour market conditions rose. Looking into the details, the expectations index, the short-term outlook for income, business and labour market conditions, rose to 73 from 69.7 in February. But the present situation index, which reflects consumers' assessment of current business and labour market conditions, was less positive, falling from 152.8 to 151. In an alternative, and equally watched, survey run by the University of Michigan, consumer expectations fell. Both surveys are consistent with recession-level consumer spending, though their relationship with actual spending has been less authoritative since the pandemic.

As we explained in our InvestmentUpdate examining the bank stresses, if bank lending standards get even tighter, then monetary policy won't need to work so hard to slow the economy. So it makes sense that investors have reined in their expectations of where rates may peak, but we

think expectations of *cuts* for this year are an overreaction. We think that some more tightening is likely in the months ahead and that rates will stay higher for longer than markets currently expect.

And, as we explain in our quarter-end InvestmentUpdate, tighter credit conditions look likely to prove an additional headwind to economic activity. Further belt tightening will raise the already high probability of a US and global recession, though we continue to believe it will be a mild one.

Earnings season starts soon. It'll be critical in suggesting how much more company earnings are likely to correct to reflect the immediate inflation and growth outlook.

Another energy price shock?

Most of the drop in global inflation is due to lower energy prices compared with March last year, when they surged following Russia's invasion of Ukraine. So the news over the weekend that the OPEC+ group of oil-producing nations is planning to cut oil production by more than one million barrels a day risks worsening inflationary pressures significantly.

The announcement abandons previous assurances that OPEC+ would hold oil supplies steady. The group intends the move to shore up the oil price in the face of weaker demand amid growing fears of a broader global recession and a smaller rebound in Chinese demand than some had hoped (something we've warned for some time might happen). At the time of writing, the price of the international oil benchmark Brent crude was up by around 5% on the day. The share prices of UK and European energy companies have jumped on the news, driving up regional indices. But it is expected to weigh on key US indices, particularly the S&P 500.

If you want to hear more about the outlook for inflation and interest rates, recent banking sector stresses and a review of China, you can register for our 12 April Investment Insights webinar here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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