Markets in a Minute

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Guy Foster, Chief Strategist, discusses expectations around interest rates settling down, while Janet Mui, Head of Market Analysis, explores the reasons for weak underlying demand in the Chinese economy.

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Markets were kind last week, marrying with the sentiment of the previous week's round-up, where we discussed how the U.S. employment report added credibility to a dovish tone from Federal Reserve Chairman, Jay Powell.

We've seen a bit of push and pull with investors of late. At the start of the year, there were expectations of deep interest rate cuts (which seemed excessive), but some investors have now reached the point where they are entertaining the possibility of an interest rate increase.

However, markets now seem more realistic about the future trajectory of interest rates and the yield curve implies that rates will gradually fall over the next few years. Assuming that we see a recession within that period, bonds may outperform, but a repeat of the post-financial crisis bull market for bonds seems unlikely.

A quick recap of earnings season

The very recent stabilisation of interest rate expectations has been a supportive feature for equity investors, who'd started to become much more concerned about possible rate increases than economic growth. However, they've also had a raft of earnings results to sift through over the last few weeks.

Regular readers will know that some oft-quoted statistics regarding earnings season are meaningless. It's of no consequence that 80% of companies beat estimates for earnings and 50% beat estimates for sales, because this happens every quarter. Generally, the important thing is the guidance companies give to inform these estimates, and how they evolve over time.

Usually, estimates are set and are influenced by whatever guidance companies offer, after which they gradually decline as the year progresses. My colleague Kelly Bogdanova from our RBC Wealth Management U.S. team has observed this phenomenon over time and notes that full-year estimates for 2024 company profits are holding up well, where usually they tend to slide downwards over the year (around 5% by this stage).

No change from the Bank of England

In the UK, the Bank of England (BoE) announced its latest monetary policy decision. Unsurprisingly, there was no change to the actual policy rates, but this was a meeting in which the BoE updates its forecasts.

It raised its growth forecast, albeit marginally, and reduced its inflation forecasts, even more marginally. The significance of this is that the BoE makes its forecasts based upon the path of interest rates implied by the markets. So, despite markets expecting fewer interest rate cuts, the BoE still expects growth to be a touch better.

To me, the most striking comments from Governor Andrew Bailey were that the committee would likely "need to cut bank rates over the coming quarters and make monetary policy somewhat less restrictive over the forecast period, possibly more so than currently priced into market rates." That last phrase signals that he's happy to guide interest rate expectations downwards. Doing so is effectively changing monetary policy, because the interest rate expectations he guides downwards will feed into mortgage rates. Those mortgage rates will then trigger housing market activity, support house prices and will likely make homeowners feel wealthier as a result.

This is also important because Bailey's comments were couched in language which made clear that incoming data will need to support the idea of inflation moderating. Goods inflation is quite subdued at the moment, but services inflation remains high. A big part of high services inflation is housing and particularly high rental inflation. Expectations are for rental inflation to slow over the year. According to some studies, rents forming a record level of household earnings would seem likely to restrain the pace of rent increases to some extent.

The UK economic recovery arrives

I've talked about the signs of a cyclical recovery in the UK economy for the past few months, bouncing back from the "technical recession" of last year. Well, last week's Q1 GDP report seemed to reflect that, with the economy expanding 0.6%. This was much stronger than expected.

The strength was across a broad range of sectors, but services consumption was a key area of strength. Any further recovery in house prices would likely drive more growth in consumption now that households have rebuilt their savings and are beginning to acclimatise to the higher prices.

So, the recovery of growth should be able to continue, particularly if the BoE is right and inflation continues to moderate, but there are some things to watch out for.

In the UK, the labour market seems to have slackened off from the post-pandemic labour shortage. The question is how much further will it weaken?

Provisional data has suggested that April saw the sharpest drop in employment outside of the pandemic period (records only go back ten years or so). These data are quite erratic and usually substantially revised (similar estimated declines from last month have been largely wiped out by revisions) so we shouldn't be too hasty to extrapolate them into a sharp recession, they're more likely to reflect a gradual ebbing of labour demand. In fact, the more worrying trend data, from the BoE's perspective, would be the apparent resumed pick up in wages that is evident in the official figures and also some survey data.

Despite all the emphasis on the UK last week, it's also worth mentioning that initial jobless claims ticked higher in the U.S., which will add to the softer labour market data from last week and give fuel to the argument that interest rates will indeed be cut this year.

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