Markets in a Minute

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Guy Foster, Chief Strategist, discusses economic factors that may have an adverse effect on U.S. equity markets. Plus, Janet Mui, Head of Market Analysis, reviews fresh economic data from China.

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There is a well-known proverb that all roads lead to Rome. In the context of current market psychology, most market worries ultimately stem from uncertainty around inflation. The strong equity rally of the first quarter of the year has so far been met with a flurry of challenges in the second.

The “good” thing to worry about is the ongoing strength of the U.S. economy, which may keep inflation sticky, and in turn restrain the ability of the Federal Reserve (the Fed) to cut interest rates this year.

The “bad” thing to worry about is the direct confrontation between Israel and Iran, which keeps geopolitical tensions elevated, impacting oil prices, which are important variables affecting the outlook for inflation.

Iran-Israel conflict intensifies

The market has been arguably sanguine since the October 7 attack by Hamas on Israel. The Organization of the Petroleum Exporting Countries (OPEC+) even extended supply cuts to keep oil prices relatively high. However, things took a sharp turn the weekend before last, when Iran directed hundreds of drones and missiles at Israel. The attack was calibrated to cause minimal damage and there have been no casualties, but Israel has vowed to respond despite the U.S. urging restraint.

Overnight on Friday, Israel reportedly struck at Iran, causing a near 5% spike in oil prices to take it over $90 per barrel. However, as of Monday, oil prices have retreated to about $86 per barrel.

Overall, Israel's retaliation is perceived to be restrained in nature. Markets have, for the time being, assessed that both sides were trying to show strength in a way that is not intended to cause harm. Importantly, Iran has apparently already indicated that it will not respond to this attack. There is hope for a potential path of de-escalation.

There is little room for complacency, though, as tensions will remain high in the Middle East. The recent conflict has opened a new stage of direct warfare between Israel and Iran and the possibility of a cycle of retaliation is enough to keep markets on their toes.

Hence, oil prices will continue to trade with a high geopolitical risk premium, especially when global demand remains resilient. However, we don't see oil prices spiralling out of control. OPEC+ has the spare capacity to increase production, and it’s in its interest to not let oil prices get too restrictive.

The U.S. is now a reliable energy exporter, too. The uncertain dynamics of the ongoing geopolitical situation and inflation supports our positive view on global energy majors, which can act as a portfolio hedge.

Hope for rate cuts in the U.S. diminishes

The rise in geopolitical tensions and the uncertain outlook on energy prices further complicates the job of the Federal Reserve. There is more evidence that inflation in the U.S. is heating up again, and the Fed can no longer afford to lean on its dovish pivot.

In a week rather light in terms of U.S. data, a number of Fed speakers sounded more cautious on inflation. Fed chair, Jay Powell, pointed out it will likely take more time for officials to gain the necessary confidence that price growth is headed toward target before cutting rates. Fed vice chair, Philip Jefferson, said he expects inflation to continue to moderate, but persistent price pressures would warrant holding borrowing costs higher for longer.

There seems to be a sense of reckoning at the Fed that inflation is more stubborn than thought, and the risk of heating up is real. The likely outcome of this is the number of rate cuts signalled by the Fed's next Summary of Economic Projections, will be revised down. There is also a question of whether the current Fed funds rate level is indeed restrictive, which will impact the Fed's stance on the long-term Fed funds rate (the neutral rate, which is neither stimulative nor restrictive for the economy).

Bond markets have dialled back the number of rate cuts expected for 2024 to just one and a half, compared to about six at the start of 2024. U.S. benchmark ten-year treasury yields reached a 2024 high of 4.67% last week, whereas two-year treasury yields briefly touched 5%.

Global equity markets have navigated higher bond yields in Q1 this year but are currently hitting some resistance. There is only so much patience from investors on the disinflation and Fed cuts narrative. Add to the mix geopolitical tensions, stretched positionings, and disappointment from a few closely watched companies amid Q1 earnings season, and it's not surprising that risk assets took a hit last week.

Against this backdrop, safe havens such as the U.S. dollar and gold are well bid – a reminder of the importance of diversification in portfolios.

IMF growth upgrade highlights U.S. exceptionalism

We mentioned at the beginning that the "good" thing to worry about is the ongoing strength in the U.S. economy, which risks keeping inflation sticky. Last week, the latest quarterly forecasts from the International Monetary Fund (IMF) shed a light on how mind-blowing the relative strength of the U.S. economy is compared to its peers.

The IMF revised up U.S. 2024 gross domestic product (GDP) growth forecasts from 2.1% to 2.7%, after 2023 GDP growth of 2.5%. Meanwhile, UK and eurozone 2024 GDP growth forecasts were both revised down by 0.1% to 0.5% and 0.8%, respectively. Think about that for a second – these forecasts mean the U.S. economy is expected to grow at more than five times that of the UK and three times that of the eurozone in 2024. As such, it is reasonable to expect some differences in their respective pace of monetary policy adjustments.

The reasons why the U.S. economy is expected to do so much better than its peers are multi-faceted. When you think about growth, it is about labour, investment, and productivity. The U.S. has enjoyed better developments in all key drivers of growth due to high immigration and the CHIPS Act, which is stimulating a buildup of semiconductor infrastructure and superior tech innovation.

The U.S. has also weathered the higher interest rate environment better thanks to the dominance of 30-year fixed mortgages, rendering its economy relatively less interest rate sensitive. All these factors suggest the bar for the Fed to ease policy is high.

Yes, it is true that U.S. rate cuts will be pushed back to later in the year, and rates will likely remain higher for longer. From a positioning perspective, the significant repricing of the path of U.S. interest rates suggests the room for disappointment has reduced.

Our core view is that high-quality companies with a strong competitive advantage and sustainable earnings growth are less sensitive to fluctuations in rates and the economic cycle, so they can still do well in the long term. These stocks will still be subject to volatility depending on market mood and news flow, but the investment thesis is intact.

We think a resilient U.S. economy is a positive thing and should not be talked down as something dreadful. A stronger economy means higher nominal GDP growth, which is a macro driver for corporate profits.

Obviously, the earnings season will provide fresh catalysts on market direction. On that, lower inflation should help with corporate margins and resilient consumer and business investment should support the top line. The earnings recession should be over with more recovery in sight.

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