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Investment Research

Get ready for further rate cuts as inflation pressures ebb

Weekly Global

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Deeper Dive

Higher-than-expected US inflation data released on 10 October added fuel to some investors' concerns that the US economy's strength may stay the Federal Reserve's hand in cutting interest rates.

The core consumer price index for September, which excludes volatile food and energy prices, rose 0.3% for the second consecutive month, slightly above consensus estimates of 0.2%, and bringing year-over-year core inflation to 3.3%, up from 3.2% in August.

This followed a stronger-than-expected September employment report in which unemployment fell one-tenth to 4.1%, the US generated a net 254,000 jobs over the month (above the consensus forecast of 150,000 and the strongest monthly increase since January), and the annual rate of average hourly earnings grew 4%, from 3.8% in August. In combination, these signs of robust US economic activity led to a scaling back in the likelihood of another Fed 50-basis-point cut and an increase in the chances the Fed leaves rates unchanged in November—with markets now implying a roughly 10% chance that no cut will occur at the upcoming policy meeting, up from 0% last week.

But investors should not interpret a single US inflation print as reason for the global rate-cutting cycle to end:

Price pressures continue to subside, despite monthly fluctuations. While US consumer price inflation was slightly higher than expected, there were also some positive developments. Headline inflation eased to 2.4%, marking the lowest rate since 2021. The most recent reading of the personal consumption expenditure index (PCE), the Fed's preferred measure of inflation, came in below expectations and showed annual inflation slowing to the lowest level since February 2021. It is possible this divergence between the two main inflation measures could occur again in September. And last week's flat reading for producer price inflation, with declines in goods prices balancing out modest service cost increases, looks consistent with US inflation falling back into ranges consistent with the Fed's 2% target.

The minutes of the Fed's last meeting underline a desire by top officials to move rates down from current restrictive levels.

From the studio

Podcast: Jump start — China's stimulus message leaves investors wanting more (5:16)

How large is China's growth gap? The main economic event over the weekend was a press conference by China's finance ministry. But this is unlikely to be the Chinese government's last word on the subject. And this week we will get a clearer view of the task ahead. Data this week includes economic growth, retail sales, industrial production, urban unemployment, and investment.

Will the ECB keep the global rate cycle turning? The European Central Bank has cut rates twice this year, including just five weeks ago. So, after such a recent easing, it had seemed likely that the ECB might stay on hold at its meeting this week. But recent soft economic data has changed this. Eurozone inflation slowed to 1.8% in September, from 2.2% in the prior month. We now think the ECB is likely to cut at this week's meeting. In fact, we now expect rate reductions at every policy meeting until the middle of next year.

Will consumer data add to confidence over the strength of the US economy? The recent strength of data has raised the possibility that there will be no landing at all—with US growth staying close to the long-term average. One key source of this strength has been American shoppers—historically among the most resilient in the

In discussing the outlook for monetary policy last month, Fed officials anticipated a "move toward a more neutral stance of policy over time" if economic data continue to come in about as expected, according to the minutes released Wednesday. While policymakers may not see the urgency to move as quickly as they did in September, as some "would have preferred a 25-basis-point reduction," they acknowledged the restrictiveness of monetary policy.

The case for other major central banks to cut rates is even more clear-cut. Eurozone activity and inflation data may prompt the European Central Bank (ECB) to cut rates again this week. September headline inflation of the bloc printed 1.8% year over year, below the 2.2% rate in August and putting the central bank's 2.3% forecast of third-quarter inflation at risk of looking over-optimistic. Combined with weak activity, we think the ECB will cut rates every meeting from this month until next June, for 150bps of total rate reductions. The Swiss National Bank (SNB) recently cut interest rates by 25bps to 1% but indicated there may be additional easing to prevent inflation from slowing further. We now expect two further rate cuts from the SNB to 0.5% by March 2025.

So, we believe investors should keep positioning for lower rates. Further global rate cuts will likely erode returns on cash, money-market holdings, and expiring fixed-term deposits. A combination of bond ladders, medium-duration investment grade bonds, diversified fixed income strategies, and equity income strategies can all play a role in sustaining portfolio income as interest rates decline. We favor 1-10 year bonds and an average 5-year portfolio duration.

In equities, we believe US third-quarter earnings season will conclude with S&P 500 earnings per share (EPS) growth of 5-7%, lower than the 11% posted in the second quarter as a result of lower oil and gasoline prices, but consistent with our 2024 full-year earnings growth forecast of 11%. With large-cap corporate profit growth likely to remain solid against a constructive macro backdrop, we reiterate our S&P 500 price target of 6,200 by June 2025.

We continue to see opportunities in the AI value chain. Investors looking to add AI positions can turn volatility into an opportunity to build positions at lower prices, using structured strategies. Within tech, we prefer AI-linked semiconductors, US megacaps, and select Chinese internet leaders. Capital preservation strategies may shield existing positions from market swings. Broadening earnings growth may also support select areas of the US market beyond technology like financials and utilities.

With the Fed having more room to cut rates than other central banks to move policy back toward neutral, we think the US dollar should weaken further. Investors should reduce USD exposure, including hedging assets, diversifying internationally, or using options. We expect a stronger Swiss franc (CHF), as the Swiss National Bank is likely closer to the end of its rate-cutting cycle than peers. Investors that borrowed in francs can consider hedging against CHF appreciation. Gold should rise on firmer central bank and investor demand, lower rates, and USD weakening, in our view.

world. As a result, investors will be keenly awaiting the retail sales data for September. The consensus forecast is for a solid increase in the headline measure.

Key Messages

China's government leaves market guessing on scale of stimulus

China's Ministry of Finance over the weekend outlined plans to "significantly increase" central government debt issuance to support the economy. Finance Minister Lan Fo'an said he sees "relatively large room" for China to increase both its deficit and debt.

Investors have become impatient for more detail over the specifics of the government stimulus measures, as outlined late last month. Last week the CSI 300 index fell 3.2%, after rallies of 8.5% and 15.7% in the prior two weeks.

But while markets would have welcomed a more concrete announcement, our view is that the outcome of the weekend press conference was a modest upside surprise. China is launching more tools to stabilize property—a persistent source of economic weakness in recent years. Efforts appear to be on the way to help alleviate the heavy debt burden on local governments, which has made it harder for them to support the economy. Finally, the press conference confirmed a program to assist six large state banks to rebuild core tier-one capital, putting them in a better position to lend.

Takeaway: So, while we wouldn't chase the rally higher in the near term given this volatile backdrop, the outlook for Chinese stocks has improved. Investors under-allocated to China equities may consider using any dips to add exposure via select internet and consumer stocks. We would also recommend building some defensive exposure.

Despite mixed inflation data, Fed remains on track for rate cuts

Higher-than-expected consumer price index data released on Thursday added to recent concerns that the Federal Reserve may be more hesitant in cutting rates. The core consumer price index (CPI) rose by 0.3% in September, above the consensus forecast and unchanged on the prior month. The annual core rate even accelerated to 3.3% for September, from 3.2% in August. That follows stronger employment data from the prior week.

But whether the Fed decides to reduce rates at a faster or more gradual pace, the direction of travel remains unchanged, in our view. Price pressures continue to subside. Despite some disappointments, last week's inflation data did show headline inflation easing to 2.4%, its lowest level since 2021.

Top Fed officials have also signaled confidence in the trend toward moderating inflation, with New York Fed President John Williams saying there had been "pretty steady" progress. The Fed's favorite measure of inflation—the personal consumption expenditure index—was also more reassuring than the CPI in August. A repeat of this also looks possible for September. Finally, the minutes of the Fed's last meeting underlined a desire by top officials to move rates down from current restrictive levels.

Takeaway: A combination of Fed rate cuts and continued economic growth should support equities into next year.

Fundamentals to support higher oil, gold prices

The recent rallies in both oil and gold appeared to lose momentum last week, amid news of a possible ceasefire between Hezbollah and Israel. However, elevated geopolitical tensions are likely to support hedging demand for both commodities from investors. Over the weekend the US government said it was sending an advanced anti-missile system to Israel, along with troops to operate it.

But we also expect fundamental forces to underpin gold and oil in coming months. Starting with oil, we expect modest supply growth to keep the market in deficit. The International Energy Agency estimates that the oil output rose just 0.3% in the first half of 2024. Demand growth continues to outstrip supply and energy demand looks likely to be bolstered into 2025 by solid economic growth as central banks cut rates.

The outlook for gold demand is also positive, in our view. Gold has historically rallied by as much as 10% in the six months after the first Fed rate cut, and investor appetite for gold exchange traded funds is continuing to pick up. Central bank purchases for gold have been strong and we believe that uncertainty around the upcoming US election should support bullion.

Takeaway: We continue to see value in exposure to oil and gold in a well-diversified portfolio and believe that both commodities can serve as effective portfolio hedges to help investors navigate an uncertain market environment.

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