

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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A Tale of Three Central Banks

- Fed, BoJ and the UK MPC meet this week with all meetings having scope surprise
- The Fed seems likely to leave rates unchanged but to give a clearer direction that the scope for rate cuts is opening up
- The BoJ and UK MPC have an opportunity to change rates in keeping with market hopes - the BoJ to increase rates and the UK to cut rates.
- A rate hike is needed in Japan to calm the currency market.
- A UK rate cut would reinforce the recent equity market rally

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Key Interest Rate Meetings this Week

This week, policymakers at three major central banks – the US Federal Reserve (Fed), the Bank of Japan (BOJ), and the Bank of England – will convene to decide on the future course of interest rates. Each of these meetings could have distinct impacts on their respective markets, and could signal a potential turning point in the banks' monetary policies.

United States and UK: Potential Rate Cuts?

For the Fed and the Bank of England, the prevailing expectation is for interest rates to move lower. The UK appears better positioned to cut rates this week. Meanwhile, the Fed is likely to hold off on any immediate cuts despite building market pressure – and what we have advocated for in our own analyses. However, we anticipate that post-meeting commentary will indicate a bias towards a potential rate cut in September. Money markets are already pricing in a 90% chance of a reduction in that meeting.

What's the trade?

Bond Market: We expect the 2-year US government bond to benefit most from eventual rate reductions. The market is likely to bet that the Fed will time the rate cuts to sustain economic growth and avoid a sharp slowdown. We are targeting a yield of 4.2% for the US 2-year bond.

Equity Market: Momentum in the equity market is currently with small-cap stocks, despite significant profit-taking in tech stocks, with the NASDAQ 100 down 8% from its highs. However, the Russell 2000, which has seen a sharp rise, continues to struggle with earnings support. Consensus earnings forecasts have been declining over recent months. We advise investors to exercise caution and not overpay for potential earnings turnarounds as the Fed stimulates the economy with rate cuts.

Chart 1: Russell 2000 Faces Earnings Forecast Slide

Russell 2000 price index and expected earnings index (rebased to Jan '23=100)



Source: Bloomberg

Japan: Tightening Monetary Policy

The Bank of Japan might finally tighten its monetary policy this week, reinforcing the yen's recent strength following a period of pronounced weakness. This shift, if it materialises, could mark a significant turning point for the Japanese market.

The outcome of the Bank of Japan's meeting is far from clear. Although 75% of economists surveyed by Reuters expect the BoJ to leave the rates unchanged, BoJ watchers have been particularly uncertain about taking any conclusive view on the meeting. Judging by the sharp rise in the yen's value in recent trading sessions, it does appear that there has been some shift in the monetary policy committee's view, which likely signals a risk of a policy tightening at this meeting. The BoJ could raise rates and/or signal its desire to reduce its bond buying. In some respects, the BoJ has achieved its stated policy of pushing inflation up to the target of 2%. Core inflation is at 2.6% and has been at around the 2% level for the past three months. However, some of the board members at the bank remain concerned about the persistence of inflation. Consumer spending and household confidence has slipped recently.

Whatever the BoJ does, it is likely to remain very measured. The bank ended negative rates in March, but any tightening episode is likely to be spread out over quarters and not months. Analysts see interest rates of around 0.5% to 1.5% as neutral – but that could take some time to achieve, particularly if global growth remains relatively benign. In essence, the BoJ is likely to continue to run relatively loose monetary policy for the foreseeable future, in our view.

The other element of monetary policy is bond buying, i.e., quantitative easing. The BoJ is due to release the details of a likely plan to slowly reduce its huge bond buying in the coming one to two years, and shrink its nearly \$5 trillion balance sheet. The bank remains keen to ensure that there is no significant spike in yields.

What's the trade?

Don't be deflected from buying the Japanese equity market

A hesitant BoJ and volatility in the currency market have turned out to be headwinds to an equity market that had done so well in the fiscal year to the end of March. An eventual rise in Japanese interest rates should not be seen as a negative, but a signal that the Japanese economy is normalising – something that should be taken very positively by Japanese domestic investors. Those investors have already reacted positively to the earlier changes in the individual savings accounts for which subscriptions tripled year-on-year. Meanwhile, volumes of share buybacks have continued to grow.

UK on a knife edge

The UK MPC meets on 1st August with a possible decision to cut interest rates on something of a knife edge. The market prices a virtual 50-50 chance of a rate cut at this week's meeting with a total of two cuts by the end of the year. At the meeting, the MPC will present the quarterly monetary policy report, which will be followed by a press conference. Official policy rates currently stand at 5.25%, which is where they have been since August 2023.

Inflation has returned to the 2% level and been there for two months in a row now. However, the last inflation report showed the service sector to have modestly re-accelerated to 5.7%. The Bank of England is also thought to be worried about the persistence of wage inflation. Those concerns have been further exacerbated by noise from the new UK government that it may award some quite substantial pay increases to public sector workers of up to twice the inflation rate.

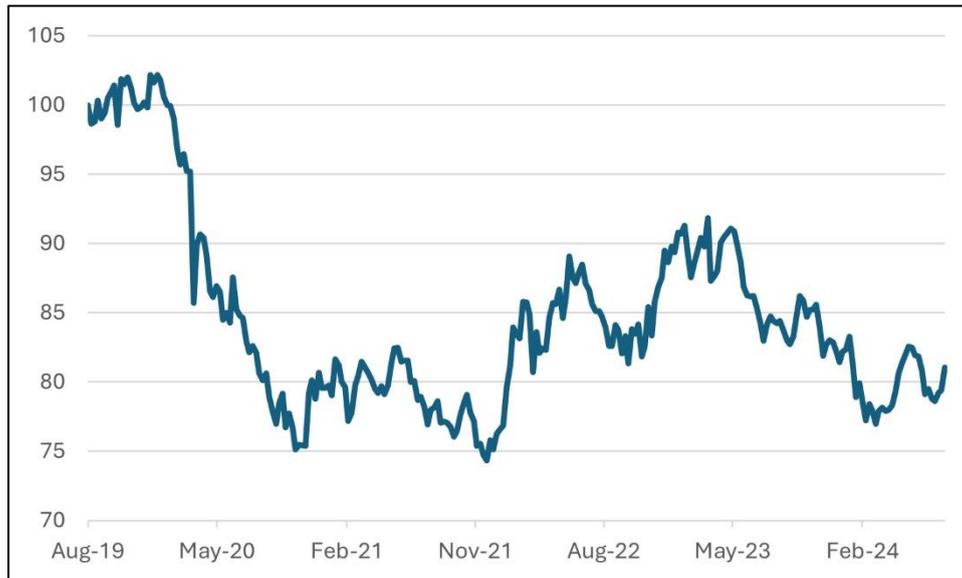
If there is no cut, the market will be looking to see if there is any change in the pattern of voting. At the last meeting seven members voted to hold rates unchanged while two voted for a cut. There is a good chance this time that more members will vote for a cut.

What's the trade?

UK equities to run further

Political stability and hopes for rate cuts could spur some further performance from UK equities in the coming months. The economy and the market are most sensitive to changes in short-term interest rates – a fact borne out by the recent spike in absolute and relative performance. The more socialist leaning policy shift expected with pay increases for the low paid and key support for housebuilding and infrastructure spend should enable the equity market to make further absolute and relative performance in the coming months.

Chart 2: UK Equities Have Rebounded – But Cuts in UK Rates Could Spur More Performance
Relative performance of UK equities Index to global equities in USD



Source: Bloomberg

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