MORE WAR

The horrific Hamas attacks on Israel last weekend will reverberate for decades. Israelis had their sense of security shattered. The atrocities committed by Hamas roused the Israeli government to an immediate declaration of war.

The US, as President Joe Biden made clear this week, stands firmly behind Israel. At the same time, America does not want the conflict to expand into a more dangerous regional war, nor to trigger a humanitarian crisis. As noted by experts at the Council on Foreign Relations, in the first two of what is likely to become a series of discussions on the situation, the conflict could benefit America's opponents. The conflict could also serve the broad interests of Russia and China, distracting from the war in Ukraine and undermining diplomatic efforts to normalize Saudi-Israeli relations.

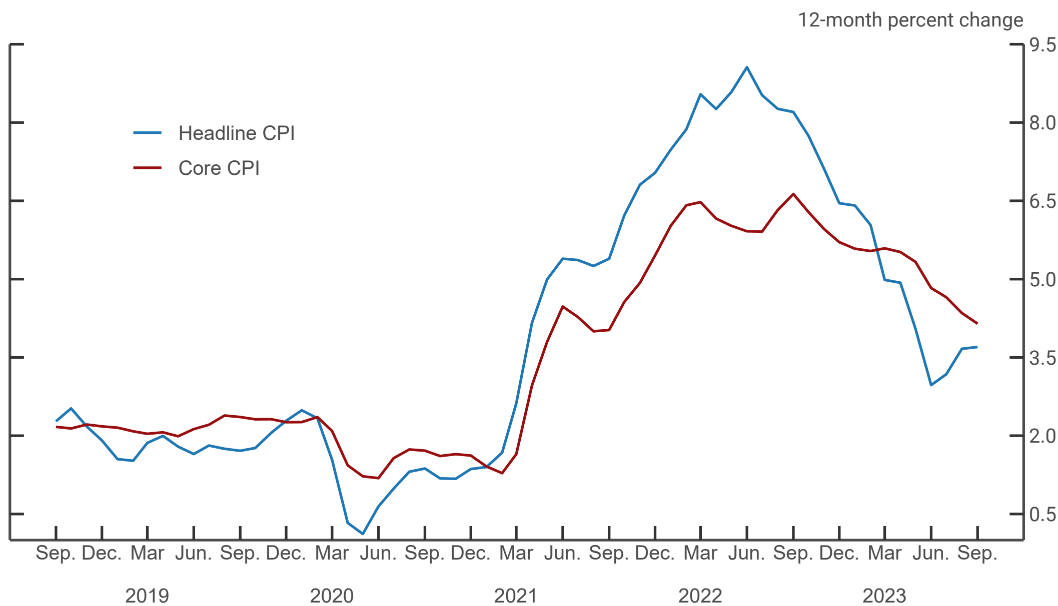
As is often the case with significant geopolitical events, the initial market response was muted. This reflects the difficulty in pricing the additional financial and economic risks from a changed political and security landscape. A bid for the safety of government bonds did lead to a drop in yields – partly exacerbated by technical buying. US 10yr yields fell 17 basis points on the week. It seems that a relatively minor bid for safe-haven assets triggered a larger unwind, reflecting a buildup of short positions as rates had risen 70 basis points from end-August through last Friday. Oil prices were up 3.5%, but the potential of a wider Middle East conflict could push them up further. EV stocks were up 2.2% on the week.

By the end of the week, markets had rebounded. But investors looking for guidance from this week's US price data did not have much to go on. Thursday's consumer price release was broadly in line with recent progress on bringing down inflation. But it came in a little firmer than expected, at 3.7% year-on-year on the headline rate and 4.1% excluding food and fuel.

This, together with more recent evidence that the labor market remains strong, kept investors wondering if the Federal Reserve might yet raise rates again this year. That is less likely after the sharp climb so far in October in longer-term rates, including mortgage rates. This week, senior Fed policy makers, including Vice-Chair Philip Jefferson and Dallas Fed President Lorie Logan, noted that tightening in financial conditions from higher Treasury yields, could reduce the need for further hikes in the Fed Funds rate. A December hike remains on the table.

What is also exercising the Fed is how long to keep rates up and money tight. The minutes released this week of their September meeting show Fed officials wrestling with the continued uncertainty about both inflation and the possible headwinds to the economy from rising market interest rates. Uncertainty – redoubled in the wake of this week's Middle East events – is likely to stay the Fed when it next meets, October 31-November 1. A December hike remains on the table. But getting the balance right between holding money too tight and risking progress against inflation is a difficult challenge at this delicate moment.

US Inflation numbers validate higher-for-longer



Source: RockCreek, Bureau of Labor Statistics.

THE BUMPY RIDE TO PRICE STABILITY

It has been clear for many months now that inflation has peaked and is on the way down. But the past two months' data support the view that there will not be a smooth glide path down to the Fed's 2% goal. That has implications for interest rate policy.

This week's CPI release for September showed the year-over-year rates of inflation of both headline and core prices – at 3.7% and 4.1% – are well below their 2022 peaks of 9.1% and 6.6% respectively. But the September increases were still considerably higher than the Fed's target. There is a similar picture in Europe.

Volatile prices that surged in 2022 followed by actual price declines, particularly for energy, have been the key driver of changes in headline inflation. Underlying, or core inflation, excluding energy and food, has moved in a different pattern. It was helped in 2022 by the exclusion of the sectors where prices were rising most rapidly. Now, while the fall in energy prices through September 2023 is helping to bring down the headline rate, stickier prices for services are stopping the core CPI from falling. The month-to-month data are noisy, making it hard to draw conclusions from just one month. In September, for example, a surprise increase in rent and rent equivalents, usually a lagging indicator in the CPI, accounted for much of the worsening in the core measure. This followed a low figure for rents in August.

The reason the Fed traditionally focuses on core inflation is that it has been a better predictor in normal times of future price changes. Since the pandemic, times have been anything but normal. Headline inflation is what hurts real incomes and pushes workers to demand higher wages and, as we have seen, to go on strike. Although other events have pushed it out of the headlines, the UAW strike continues. In these circumstances, central bank officials have worried that inflationary pressures could continue if the Fed eases up too soon on tight money.

SOFT LANDING IN SIGHT?

Support for a more optimistic view came this week from an unlikely source. The International Monetary Fund (IMF), holding its Annual Meetings with the World Bank in Marrakech (see more below), noted that developments were "increasingly consistent" with a soft landing for the global economy. Despite this, the IMF characterized the economy as "limping along" compared to previous recovery periods. The forecasts were finalized before the weekend attacks on Israel. Asked about the likely impact, Chief Economist Pierre-Olivier Gourinchas said that it was too soon to know how broad the conflict could become. He noted that both growth and inflation would worsen if energy prices were to rise on a sustained basis. The IMF rule of thumb is that every 10% increase in oil prices pushes up global inflation by 0.4% and knocks 0.15% off growth.

The latest World Economic Outlook pointed to US strength, revising the forecast for next year's US growth up 50 basis points to 1.5%, while lowering projections for Europe to 0.7%. The IMF warned nevertheless of downside risks. On the one hand, continued sticky inflation, which could also be pushed up by another spike in oil prices if the situation in the Middle East deteriorates, would lead to tighter money and job losses. Another risk is that of a further slowdown in China. A one percentage point drop in China's growth would feed through to reduce global growth by 0.3%, with very different impacts around the world depending on trade patterns, according to Gourinchas. This week's data for China was not encouraging.

LAYERS OF UNCERTAINTY

It is too soon to know the impact on the world of the Hamas attack and Israeli response. Many have pointed to the comparison with the terror attacks of 9/11, and the response that spiraled into a 20-year long war. As the Economist magazine asked this week "will Israel's agony and retribution end in chaos or stability?" One thing is clear: it adds yet another layer of uncertainty in a world already rocked by "black swan" events, including the global pandemic and the Russian invasion of Ukraine, and on edge as the two largest economies have faced off. A rising refugee crisis, as well as the threat of higher oil prices, is a possible outcome if the war broadens.

CALM HEADING INTO EARNINGS

Equity markets exhibited a surprising level of calm this week. The S&P 500 and Nasdaq gained 0.85% and 0.53%, respectively. European markets also finished higher for the week with the Stoxx Europe 600 gaining 0.98%. However, there were certainly some key pockets of weakness. For example, LVMH's report on Wednesday of a sharp slowdown in sales growth drove its shares as much as 8.5% lower and brought down the share prices of other luxury goods players like Richemont, Kering, and Hermes also.

On Friday morning, US banks JP Morgan, Citibank, and Wells Fargo boosted sentiment by reporting upbeat earnings that outperformed analysts' expectations. The S&P 500 Bank Index hit a three-week intraday high to end the week up 2.9%.

Investors seemed to grasp onto less hawkish comments from the Fed and reports of China weighing new stimulus measures. Clearly, developed market equities are not pricing in a likelihood of the war between Israel and Hamas spreading into a larger conflict that stresses the oil market and ultimately impacts company earnings.

Expectations for stronger Q3 earnings on the

horizon may be factoring into the market's current strength. In the US, the sell-side is forecasting S&P 500 earnings to improve by 1.3% in Q3 versus a year earlier. That would be a significant improvement over last quarter's 2.8% decline.

EMERGING MARKETS

Emerging markets had a strong run this week, led by China, Taiwan, and Latin America. In China, the ongoing troubles with real estate developer Evergrande, and news of Country Garden's missed bond payment wasn't enough to dampen animal spirits. Investors were buoyed by Beijing's message vowing to help commercial banks and financial institutions dispose of bad assets and loans while at the same replenishing their capital through multiple channels. Market participants also cheered the decision by the country's largest sovereign wealth fund to increase its stake in some of China's largest banks, including ICBC, Construction Bank, Bank of China, and Agricultural Bank. This type of state support has, in the past, acted as a catalyst for more upside in Chinese equities, but only time will tell if it's enough to maintain risk appetite high in the face of continuing foreign outflows.

Taiwan's strong week was a post-holiday catch-up move, with markets catching up to strong moves in US tech stocks. TSMC and other technology hardware stocks attracted strong buying throughout the week, with the financial sector also enjoying significant gains.

In Latin America, Brazilian markets led strong performance. Equities rallied on lower-than-expected inflation data and the prospect that Brazil's central bank would proceed as planned with a 50-basis point rate cut to 12.25% at its November 1 meeting.

UNDERSTANDING THE GENDER GAP LEADS TO A NOBEL PRIZE

Claudia Goldin, the author of seminal papers that have changed the way that orchestras conduct auditions for musicians and deepened understanding of how the labor market works to help or hinder women's participation and pay, won the Nobel prize for economics this week.

The first woman to win the Nobel in economics on her own, and only the third woman ever to be awarded the prize, Goldin has long been a trailblazer. She was the first woman to win tenure in Harvard's economics department, in 1989, and has been a mentor and guide to many others seeking to understand the interplay of societal norms and the labor market. Her recent work shows why, after dramatic changes in the 1970s, progress towards gender equity has more recently stalled. She noted that "we are never going to have gender equality" in the workplace "until we also have couple equality."

THE RHYMES OF HISTORY

Fifty years ago, Kenyan President Jomo Kenyatta welcomed delegates to Nairobi for the first World Bank-IMF meetings held on the African continent. "All countries, developed and developing alike," Kenyatta said, "have a common interest in your finding an early cure to the monetary sickness of inflation and instability that has afflicted the world." Ten days after Kenyatta's speech, the Yom Kippur War broke out, followed by the oil embargo and surging gas prices.

Delegates to the Bretton Woods institutions gathered in Marrakech, Morocco this week for the first Annual Meetings in Africa since 1973, just miles from a devastating earthquake that shattered the region last month. Twice postponed because of Covid, the gathering

hoped to focus on climate finance and Africa's economic development; instead, the shadow of inflation and instability, the war in Ukraine, and another attack on Israel hang over the proceedings.

"The scarring effects of successive crises are increasingly apparent," IMF Managing Director Kristalina Georgieva and new World Bank President Ajay Banga said in [a joint statement opening the meetings], "just as many countries are struggling to overcome high inflation, high debt, and significant financing shortfalls to provide basic services, support infrastructure and climate action, and address rising poverty, inequality, and fragility."

As the Bretton Woods institutions pledge to work together to reinvigorate growth and build resilience, the world must contend with geopolitics, conflict, and instability, much as it did half a century ago.