TOO HOT?

The US economy has not slowed down, despite months of tight monetary policy. Continued growth is good for jobs. Employers added an astonishing 303,000 to payrolls in March. Unemployment has defied expectations, staying below 4% for the past two years. The potential costs of this robust growth were brought home this week with the consumer price release for March. For the third month in a row, US consumer inflation was higher than expected, with the 12-month headline rate up 3.5% over a year earlier and the three-month rate at 4.5%. Could this be a turning point for market sentiment?

Global equities ended the week 1.9% lower. Japan was a top performer rising 1.1% while the US fell 1.7%. European equities were flat in local terms but fell by 2.0% in USD due to Euro weakness against the Dollar. Canadian equities fell by 3.1%.

Until this week, US equity investors remained sanguine even as fixed income markets gradually gave up earlier – unrealistic – hopes for six or even seven interest rate cuts in 2024. After inflation came in above forecast in January and February and the labor market remained strong, bond markets repriced. But as they moved into line with the Federal Reserve expectation of three 25 basis point reductions this year, equities stayed strong. The Fed reaffirmed that expectation just three weeks ago, implicitly discounting the early months' hotter price data.

The inflation surprise for March is harder to wish away. Importantly for interest rate policy, underlying inflation seems to have plateaued in early 2024 after declining gradually during the second half of last year. Better than expected producer prices softened the blow by the end of this week. But those prices are heavily weighted towards goods rather than services. And it is in services – a bigger portion of the US economy, and more heavily influenced by wage costs – where inflation worries are concentrated.

DIVERGENT RATE PATHS?

Monetary policy tightened around most of the world as inflation took off post-pandemic. Hopes for a global easing this year that would spur growth worldwide have centered on a June cut in rates, by both of the world's major central banks. But the likely paths in the US and Europe may now diverge. And, unusually, the Federal Reserve is unlikely to take the lead. That divergence has good reason.

As expectations of Fed easing were scaled back after the latest CPI report, the President of the European Central Bank (ECB) Christine Lagarde reaffirmed that a June cut in interest rates is likely in Europe. Some of her colleagues even favored an immediate cut in the 4% policy rate. That is appropriate, given weak growth and better inflation performance this year. Inflation in Europe's major economies has continued to decline in 2024. For the euro area as a whole, consumer prices undershot expectations in March with a 2.4% rise from a year earlier. And although unemployment has also been relatively contained, European GDP growth has hovered close to zero. That contrasts with the robust growth experienced on this side of the Atlantic, powered by consumer spending and investment.

In the US, some are now calling for monetary tightening rather than easing, expecting a move up rather than down in the 5.3% Fed Funds rate over the course of coming months. They are likely wrong. But a cautious and data-dependent Federal Reserve will be looking for better inflation news before easing, with some market participants questioning whether there will be any easing at all in 2024. The recent data shows consumer prices rising at a rate above the Federal Reserve's 2% price stability goal, however the numbers are sliced. A June rate cut is not impossible. But the odds went down this week.

When will we know? The Federal Reserve next meets at the end of this month, with its rate decision to be announced on May 1. There will be little new data to guide its decisions between now and then. The two reports of most interest – the Fed's preferred inflation measure, or PCE, and the JOLTS metric of labor tightness, comparing job openings with job seekers – will both be for March. What the central bank says in May will be more important than what it does.

As investors look for easing in Europe and the US, the Japanese central bank is being watched for a move in the opposite direction after its historic interest rate rise last month. The next Bank of Japan (BOJ) meeting will be April 26. A growing concern in Tokyo is the weakening yen against the dollar, but as of now markets are not expecting a response in the form of an additional rate hike until at least July. The rush into equities continues.

DIVERGENT GROWTH PATHS

An unfortunate feature of the pandemic was that the long-running convergence of living standards between poorer countries – emerging market and low income – with the richer world stopped. In many cases, the gap even widened as International Monetary Fund (IMF) Managing Director Kristalina Georgieva has pointed out in speeches this week and last.

Finance Ministers and Central Bank Governors from around the world will be in Washington, DC next week for the Spring Meetings of the World Bank and the IMF. New growth projections will show a better outlook for the world than seemed likely at the turn of the year. The IMF chief celebrated the fact that the world had avoided the recession that many feared last year. But she warned of a risk that growing protectionism and fragmentation could lead to a "Tepid Twenties" decade.

SO WHAT IS R* AND WHY DOES IT MATTER?

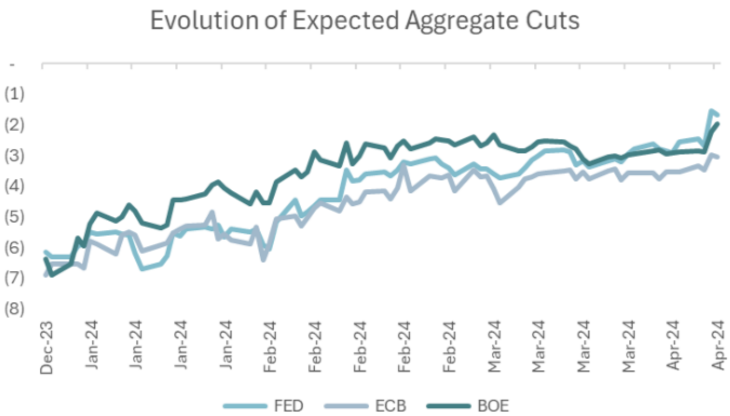
Investors wonder whether "higher for longer" interest rates are here to stay. Economists talk about whether "r star" – written as r* – has risen, and if so why. The questions are connected. The interest rate which balances supply and demand – without accelerating or decelerating inflation – is the one that the Fed and fellow central banks would like to land on, for the medium-term.

That equilibrium exchange rate can only be inferred by what is happening in the economy and not calculated or observed directly. But it matters. If the central bank holds rates lower than equilibrium, the economy will overheat. If rates are too high, the restrictive stance of monetary policy will hold back jobs, profits and growth unnecessarily. Many believe that r* may be higher now than it was pre-pandemic when interest rates were kept close to zero but inflation was contained.

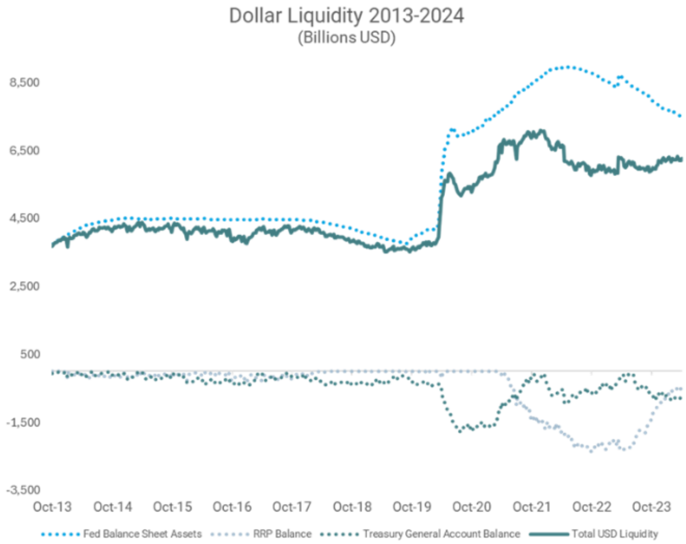
The US economy has withstood tight money so far. That could mean that today's monetary stance is not as restrictive as the Fed believes. If so, interest rates would need to be higher than expected in the future to curb inflation and balance the economy, while growth and jobs continue. There is an alternative view: that the impact on economic activity of monetary tightening is less direct and slower than before. On this view, current rates are high enough to slow the economy and push inflation down further. But this may come with unemployment rising above 4%.

RATES

US rates markets experienced significant fireworks. The impact on interest rate markets of the CPI disappointment reverberated across asset classes, particularly those most sensitive to monetary easing. In bond markets, the curve shifted upward, led by 2-5yr points which backed up by more than 20bps in a single day. In April those tenors are approximately 40bps higher, and roughly 75bps higher than where they started the year. Short-term interest rate (STIR) derivative markets also saw significant moves. Standalone probabilities for a Fed rate cut in June fell from nearly 60% to less than 20% and are currently at 25%. Even more striking, the most likely date for the first reduction in the Fed Funds rate is now September.



Another development worth watching in rate markets over the coming weeks and months is the evolution of the Fed's balance sheet and its impact on liquidity. Slowing the pace of quantitative tightening was discussed in both the press conference and minutes of the March FOMC meeting. While the discussion was positive for risk assets, with the committee looking to start easing the pace of taper relatively soon and to reduce by a meaningful half, the exact progression of this plan will be meaningful to markets. To begin with, it is unclear how the recent economic and inflation data will impact these plans. In addition, the QT process has been softened thus far by ample US Treasury bill issuance, which has lightened the usage of the Fed's reverse repo facility, allowing an offsetting amount of liquidity back into the system for the assets that have rolled off the balance sheet. As such, variables out of the FOMCs control (i.e., Treasury funding plans) could create a renewed uptake in the RRP – potentially more than offsetting any positive effects from reduced balance sheet runoff.



CURRENCIES

The repricing in rates in the US led to a significant strengthening of the dollar. DXY, a measure of the US Dollar against major peers, rose 1% on the day of the CPI print – a nearly 3 std. deviation move based on a one-year lookback period. While the Greenback strengthened against the Pound, Franc, and Euro, its most notable move was against the Japanese Yen, which broke through the 152 level vs. the dollar – a level not seen for many decades but one that, over the past month, the currency pair had been testing frequently. Traders had been watching the line intently, wondering if and when the BOJ and/or Ministry of Finance would intervene. As of writing the JPY is above 153, and there is as of yet no sign of intervention. Time will tell if policy makers step in, but for now a marginally weaker currency should be beneficial to Japan's exporters.

EQUITIES

Japanese equities remain some of the best performing stocks YTD despite a softer start to the month of April. On a total return basis, the Topix is up 7.6% YTD, just behind the S&P 500's 9.1% return while global equities are up 7.0%. Even while Japan has performed well, it remains attractively priced vs. the rest of the world as well. Japan's forward P/E of 14.7 still compares favorably to the world (15.9) and US (18.7), although slightly more expensive than Europe (12.8) and Canada (13.4). In addition, despite recent monetary easing, interest rates in Japan are still effectively zero and, as RockCreek has written about in the past, there is still a significant portion of $14 trillion worth of domestic savings looking to earn a more attractive yield than that offered by cash. All the while, corporate governance reforms are starting to make a meaningful difference. For example, corporate cross-shareholdings, numbers of independent directors, and acceptance levels of takeover offers have all improved. For example, last year, outside directors occupied 44% of the board seats of companies listed on the TSE's Prime section, up from 28% five years ago.

Elsewhere in equity markets, mega-cap tech continued to outperform as AI and AI-related themes continue to proxy as modern defensives in equity markets. Apple, for example, jumped 4.3% on April 11th following news that it was revamping its Mac line with new AI focused chips. More generally, large cap tech as proxied by the Nasdaq and even the Magnificent 7 (despite Tesla's woes) continue to outperform global equities and the S&P 500. A Goldman Sachs constructed basket of AI beneficiaries is up 3.4% this month and 25.1% YTD.

COMMODITIES

Other top performers, perhaps surprisingly given the repricing in rates, have been global copper producers. A basket of 23 different copper producers is up 9.0% in April and 20.4% YTD. This strong performance has also propelled certain emerging markets higher, including those in Latin America. Peruvian Southern Copper Corp and Mexican Grupo Mexico are up 35.9% and 12.2% respectively in 2024. So, what has been driving copper's price higher amid monetary policy uncertainty? In essence there are two main drivers keeping the price of the red metal well bid: a nascent global manufacturing recovery and a structural demand increase from the ongoing energy transition. While early on, manufacturing data around the globe has begun to point to a turnaround in manufacturing. This data includes ISM Manufacturing reports in the US, German Industrial Production, and even Chinese PMIs. These traditional sources of demand for copper are certainly helping to drive the price higher, but perhaps most interesting is the continued demand from the energy transition. Copper demand for solar and wind, for example, have increased 80% and 69%, respectively, year over year according to data compiled by Goldman Sachs.