Weekly round up (Week 15)

After several years in which financial markets were largely dominated by a "risk on" or "risk off" sentiment, the current trend of divergence between asset classes may take some time for many investors to adjust.

Last week, gold was one of the winners. Spot prices rose by over 3%, continuing the trend of the last six months in which gold has risen by almost 23%. Gold is often used as a hedge against escalating geopolitical risk or rising inflation, as investors fear that fiat currencies will depreciate. Although we are not so sure that this was the main driver (China?)

The other big winner was the US dollar, which appreciated against the other G10 currencies. Variables that generally cause the greenback to appreciate include its status as the world's reserve currency; increased uncertainty can also lead to capital inflows, as US investors send money home and many non-US investors seek to increase their exposure to the dollar. Currently, **and most importantly**, interest rate differentials favor the US over many other markets, with global savers paying more, in relative terms, to hold US assets.

A weaker yen

At first glance, one might conclude that this was a risk-free week, but the details reveal a more nuanced picture. A closer look at the dollar reveals that it appreciated mainly against developed-market currencies, and not against higher-beta emerging-market currencies. The Japanese yen, meanwhile, belied its usual "safe-haven" status by depreciating to over 153 points against the dollar. The last time the yen reached such levels was in 1990. However, the euro's underperformance was even more marked, weakening by over 1.5% against the US dollar.

Equity indices across all regions were mostly range-bound (+/- 1%), while corporate credit spreads remained stable or narrowed slightly over the week, with high-yield bonds outperforming. The biggest divergences were in government bonds. For example, five-year US Treasury yields rose by 14 basis points (bps) compared to German bund yields, which fell by 3 bps.

U.S. and euro interest rate expectations diverge

Perhaps more importantly for investors, the overnight interest rate swap market is now only forecasting a 25bp cut in 2024 by the US Federal Reserve at its September Federal Open Market Committee (FOMC) meeting. The European Central Bank (ECB) is expected to make its first cut in over eight years at its June meeting, and three 25bp cuts are planned for this year. [See chart below].

The Fed's reluctance to act quickly on rates is due to inflation data. In the US, headline and core consumer prices rose by 0.4% in March, against expectations of 0.3%, bringing headline inflation to 3.5% and core inflation to 3.8% over the past 12 months.

Two aspects of this data will be of particular concern to the FOMC. In March, core inflation exceeded economists' expectations for the third consecutive month, suggesting a loss of momentum in the disinflation trend. In addition, the "super core" component of consumer prices - prices for basic services excluding rents - rose by 0.65% month-on-month, with car insurance, personal services and medical services increasing by 2.6%, 0.76% and 0.56%

respectively. Other macro-economic factors, like employment and industrial activity, add to the bullish view for US growth.

European inflation (and the EU economy) is moving in the opposite direction. Core inflation fell to 2.9% in March, from 3.1% in February, its lowest level for two years. At the ECB meeting on April 11, investors sought confirmation that policy restrictions would begin to be lifted in June. Although the ECB kept key rates unchanged as expected, it said: "If the Governing Council's updated assessment of the inflation outlook, underlying inflation dynamics and the strength of monetary policy transmission were to reinforce its conviction that inflation is converging sustainably towards the target, it would be appropriate to reduce the current level of monetary policy restrictions."

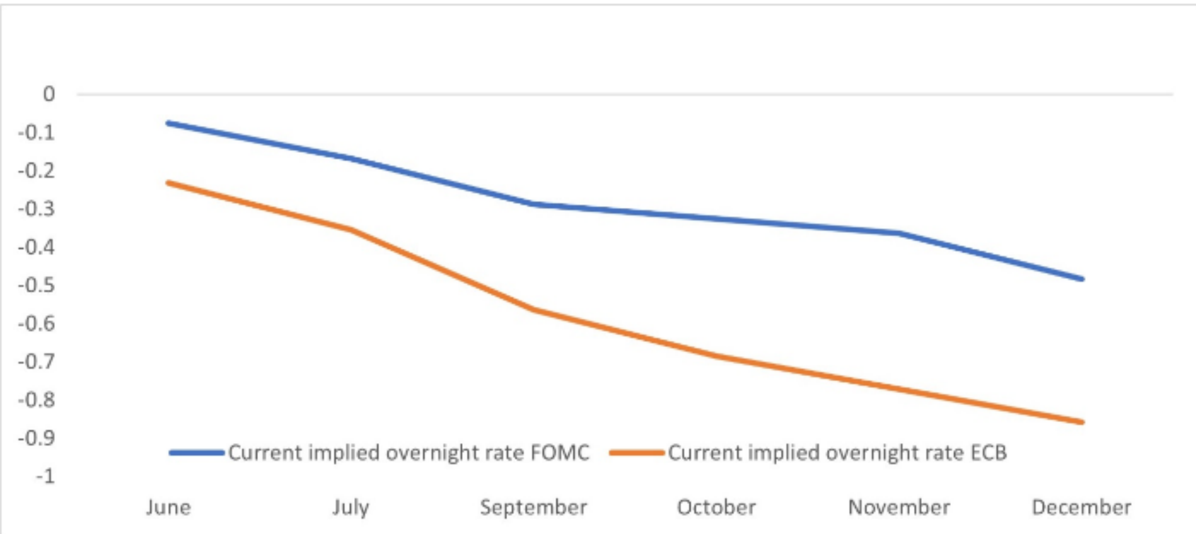
Hotter for longer?

In short, the US economy has not yet bottomed out and could stay hotter for longer. In our view, this should benefit risk assets, particularly those less sensitive to interest rates, such as US and European high-yield and short-term bonds. Conversely, Europe is already on the runway, which should benefit more interest-rate-sensitive assets, such as full-maturity investment-grade European credits.

At the same time, investors must bear in mind persistent geopolitical uncertainties. This argues in favor of further diversifying portfolios and building up capital reserves in the event of price disruptions.

This weeks graph

ECB to cut rates faster than FED



2024.04.16.ECB
Source: Bloomberg, as of April 11, 2024.

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