Weekly round up (Week 20)

Our weekly view of key developments in financial markets and economies examines what to make of a week rich in inflation data.

Consumer inflation data dominated the economic headlines last week. With "sticky" inflation still fresh in investors' minds, the data released was carefully analyzed for any signs that policymakers would backtrack on their commitment to loosen monetary policy over the summer.

Consumer prices in China rose for the third consecutive month in April, with a 0.3% year-on-year increase, ahead of economists' forecasts, mainly thanks to an increase in energy prices. However, the pricing power of food and products in general remains weak, and there is little sign of domestic demand gaining sufficient momentum to improve the imbalance between supply and demand within the Chinese economy.

China's demand problem

The subsequent release of data on total social financing (TSF), a broad measure of credit and liquidity in the economy, highlights the demand problem facing China. TSF contracted by RMB200 billion (US$27 billion) in April, the first decline since comparable data began in 2017.

Year-to-date, net issuance of government bonds totals RMB 1,300 billion, RMB 1,000 billion less than a year ago. Weak demand from businesses and households was reflected in year-on-year declines in lending, and policy banks repaid RMB 343 billion in additional loans pledged to the People's Bank of China (PBoC). Regulatory and statistical adjustments also had a significant one-off effect on the data, leading M2 money growth to fall to 7.2% year-on-year, the lowest figure on record.

The slow pace of government issuance led the Politburo of the Communist Party of China last month to explicitly call for faster execution. This, coupled with the lackluster credit data, led the Ministry of Finance to announce an early start date for the special RMB 1 trillion issuance program to support the economy, which will begin on May 17 and run until mid-November.

The PBoC's target for credit growth must be in line with real growth and expected price trends. In its latest quarterly monetary policy report, the central bank acknowledged that limited credit growth was not due to supply problems, but to weak demand.

Last week, the PBoC maintained the one-year medium-term lending rate at 2.5%. We expect a further 10 basis point (bp) cut in policy rates and a 50 bp reduction in the cash reserve ratio over the summer, but the PBoC is clearly emphasizing that the government must support the economy through bond issuance, property destocking initiatives and other supportive regulatory adjustments. A series of such policies were announced on Friday, including the abolition of nationwide mortgage floor rates, the introduction of a land buyback scheme and an initiative encouraging state-owned enterprises to purchase unsold housing stock.

Unsurprisingly, the announcement of Chinese stimulus measures was welcomed by investors, with Hong Kong's Hang Seng stock market and the Asian high-yield credit market rising.

The "Will they, won't they" saga continues in the UK

Meanwhile, the Bank of England (BoE) has published the latest data on regular private sector wages, a key indicator for measuring wage inflation. Wage growth fell slightly to 5.85% in the first quarter compared with the corresponding period last year, below the BoE's projection of 6%.There was also further evidence of a cooling job market, with a drop of 85,000 payroll jobs in April, a major surprise when the consensus of economists was forecasting the creation of 20,000 jobs. At the same time, the unemployment rate rose to 4.3%.

The overnight interest-rate swap market currently assesses the probability of a cut in June at 62%. The latest data on employment and wages could perhaps be enough to convince the BoE to take this decision.

In the Eurozone, there is less ambiguity as to when the European Central Bank (ECB) will act, with the latest inflation data pointing to a June cut. Although consumer prices remained stable at 2.4%, core inflation fell to 2.7% in April, from 2.9% in March, while service prices, about which the ECB had previously expressed concern, fell to 3.7%, after being stuck at 4% for five months.

Mixed U.S. data point to further postponement of rate cuts

After three consecutive months of 0.4% increases in US core consumer prices, investor expectations and the Federal Reserve's commitment to a summer rate cut have all but disappeared. Earlier this month, the overnight interest rate swap market pushed back expectations of a first full 25bp cut to December; some commentators suggested that further Fed tightening was not out of the question.(11)

This remains highly unlikely, in our view. Core consumer prices in April rose by 0.29% on the previous month, a sign that the high inflation seen in the first quarter has not continued. The Fed will be pleased to see lower housing inflation, with homeowners' equivalent rent falling to 0.42% month-on-month, while falls in car and furniture prices were also notable.

These figures helped April's year-on-year core consumer prices reach their lowest level in two years, with a year-on-year increase of 3.6%. Although bond critics may point out that super-core prices (basic services excluding housing) rose from 4.8% to 4.9% year-on-year, the overall price report favoured the resumption of the disinflationary trend after stalling in the first quarter. This is particularly the case when the inflation data is combined with the recent sudden slowdown in job growth, falling consumer spending and confidence, as well as weak industrial production and housing data.

The net result of the US data download enabled the swap market to bring forward the first full 25bp cut in key rates from December to November. If April's data weakness continues into May, expectations of a first cut by the Fed could be pushed back to September.

As we noted in last week's Market Comment, May has so far proved a positive month for financial markets. This trend continued last week. Government bond yields fell, with long-term bonds outperforming; credit spreads tightened, with emerging market credit outperforming both investment grade and high yield; and most commodities and major equity indices ended the week higher.

Chart of the week: Probability of a first rate cut of 25 basis points, according to the overnight interest rate swap market

	JUN	JUL	AUG	SEPT	OCT	NOV
US	4%	27%		82%		100%
CANADA	48%	100%				
EUROZONE	97%	100%				
UK	62%		100%			
SWEDEN	ALREADY CUT					
SWITZERLAND	ALREADY CUT					
NORWAY	NO CUT IN 2024					56%
AUSTRALIA	NO CUT IN 2024					
NEW ZEALAND		9%	51%		95%	100%
JAPAN - 10BPS HIKE	22%	87%		100%		

Source: Bloomberg, as of May 17, 2024

1.National Bureau of Statistics of China, as of May 13, 2024
2.RMB = renminbi
3.Reuters, ‘China stimulus starts with a bond, not a bang,’ as of May 17, 2024
4.M2 money supply = cash in circulation + short-term deposits
5.Reuters, ‘China to step up support for economy,’ as of April 30, 2024
6.Bloomberg, ‘China to Start $138 Billion Bond Sale on Friday to Boost Economy’, as of May 13, 2024
7.Xinhua, ‘China abolishes mortgage floor rates’, as of May 17, 2024
8.Reuters, ‘Mixed UK labour market signals leave BoE on rate cut alert,’ as of May 14, 2024
9.Office for National Statistics, as of May 14, 2024
10.Bloomberg, ‘ECB’s Villeroy Says Probability of June Rate Cut ‘Significant’, as of May 16, 2024
11.Investment News, ‘Fed could hike rates rather than cut them: UBS strategists’, as of April 15, 2024
12.Us Bureau of Labor Statistics, as of May 15, 2024

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