Weekly round up (Week 21)

Our weekly view of key developments in financial markets and economies considers the risk of monetary policy remaining too restrictive for too long.

Volatility remains suppressed, suggesting that all is calm on financial markets. On May 21, our preferred measure of volatility - the CBOE Volatility Index, or VIX - fell to 11.86, its lowest level since November 2019.

Back then, it took a global pandemic to cause a seismic spike in volatility - the VIX exceeded 80 on March 16, 2020, as much of the world locked in. Although nothing as dramatic as COVID-19 appears to be on the horizon, likely to tip volatility and trigger a downward spiral in financial markets, this is no time for complacency.

Taking it easy

After a good first half of the month for most asset classes, price action eased last week. Government bonds set the tone with yield curves steepening, with the front end underperforming, probably due to better-than-expected economic data on both the inflation and activity fronts.

High-yield corporate credit outperformed investment-grade bonds. European high yield generated a positive total return for the week, driven by emerging markets, which were the best performers in the investment grade category. In the commodities sector, gold fell by 4%, while oil and gas dropped by 2% and 4.3% respectively.

Most major stock market indices closed the week slightly down. The Nasdaq was the exception, buoyed by Nvidia's exceptional first-quarter results, which reported a 682% year-on-year increase in profits. In just five years, Nvidia's market capitalization has risen from US$82.5 billion to US$2.6 trillion, making it the third largest company in the world behind Microsoft and Apple.

In Japan, headline consumer price inflation fell to 2.5% in April, from 2.7% in March. Although core inflation slowed from 2.6% to 2.2%, it remains above the Bank of Japan's 2% target. Economists were surprised by the recovery in Japanese manufacturing, whose purchasing managers' index rose for the first time in twelve months, from 49.6 to 50.5.

These two data have enabled Japanese 10-year government bond yields to break through the 1% barrier, a level not seen since 2012. The market estimates a 90% probability that the next 10bp hike in key rates will take place in July.

Wet, wet, wet

British politics took center stage in Europe. Speaking at Number 10 Downing Street in the pouring rain, Prime Minister Rishi Sunak announced on May 22 that a general election would be held on July 4. His Conservative Party is well behind the Labour Party in the polls, and over 70 Conservative MPs have announced their intention to stand down at the polls.

In the UK, hopes that the Bank of England (BoE) would cut its key rates in June disappeared after the publication of higher-than-expected inflation data for April. While headline prices fell from 3.2% in March to 2.3% in April, driven by lower domestic energy prices, services inflation - a key indicator for the BoE - only rose from 6% to 5.9%, well below the BoE's forecast of 5.5% (see this week's chart).

Similarly, core consumer prices continued to fall, albeit at a slower pace than expected. With monetary policy remaining restrictive, and to the consternation of the UK government, retail sales (excluding motor fuel) fell by 2% month-on-month. While seasonal wet weather and an early Easter vacation may have affected the data, the current cost-of-living crisis seems a more plausible explanation, in our view. The current consensus is for the BoE to cut its interest rate in August.

Cutting rates to reduce inflation?

In early May, the US Federal Open Market Committee (FOMC) noted that private domestic demand was proving resilient, and suggested that it would take longer than expected for the committee to feel sufficiently confident that inflation was under control before cutting key rates.

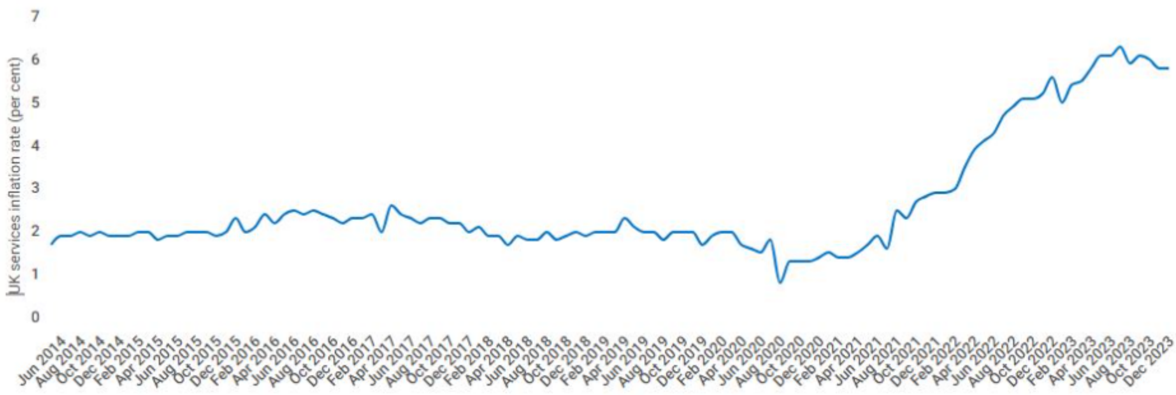
BlackRock offered some unconventional advice to the Fed, which could also apply to the BoE. He suggests that the best way for the FOMC to temper inflation is to lower rates, not keep them high any longer.

I believe that "sticky inflation" is a service sector phenomenon, which is not rate-sensitive, as prices remain supported by the elderly and the middle-to-high income cohort, who are earning more than ever from their fixed-income investments.

Conventional wisdom suggests that a restrictive monetary policy lowers an economy's immune system. As a result, over time, vulnerabilities and imbalances accumulate, leading to disease and, eventually, crisis.

If history is anything to go by, central banks often make the mistake of waiting too long before changing direction. The big question, then, is whether the BoE and FOMC are falling into this trap, trying to tame service inflation when the root cause of it is, in fact, restrictive policy.

Chart of the week: Stagnant UK services inflation reduces chances of a June rate cut



Source: Office for National Statistics, as of May 22, 2024

[1] CBOE Global Markets, as of May 24, 2024
[2] companiesmarketcap.com, as of May 24, 2024
[3] Bank of Japan, as of May 2024, 2024
[4] MacroMicro, as of May 23, 2024
[5] Electoral Commission, as of May 22, 2024
[6] BBC News, as of May 25, 2024
[7] Office for National Statistics, as of May 2024
[8] Federal Reserve, as of May 1, 2024
[9] Bloomberg, ‘BlackRock’s Rieder says cut, not hike, to tame US inflation, as of May 17, 2024