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Markets in a Minute

Guy Foster, Chief Strategist, discusses recent central bank decisions on interest rates, and key highlights from Chancellor Rachel Reeve's speech at the Labour Party conference.



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Last week was a central bank week for September, with the Federal Reserve (the “Fed”), the Bank of England (BoE) and the Bank of Japan (BoJ) all setting rates as the week wore on.

There were few surprises with the Fed cutting rates, and the BoE and the BoJ remaining on hold. The nuance was in the size of the moves, detail of any forecasts and the tone of the commentary.

Powell goes large

The Fed cut rates by 0.5%, which was technically a surprise. Less than 10% of respondents to Bloomberg's poll expected such a large cut.

Why was this? Well, September's jobs report was mixed, and since then, the inflation data had been marginally hot.

The Fed doesn't hold speeches during the week and a half before its meeting and the market wasn't prepared for a

0.5% cut. But you may recall from our update a couple of weeks ago, that our sense was that conditions justified a 0.5% cut, given there's now evidence to support the Fed's assertion that interest rates are restrictive.

Therefore, there was an opportunity for the Fed to take a meaningful step towards reducing the restrictiveness of rates, and to do so without suggesting that the economy is in dire trouble or implying that we can expect a series of sharp interest rate cuts from here on.

In fact, Fed Chairman Jerome Powell made these points explicitly when he referenced the weak tone of the 'Beige Book' (which we discussed a few weeks ago). He said that “nobody should look at 50 basis points and say this is the new pace”.

How has the decision landed?

Powell's message has been received. The market has now gone from expecting a quarter point in September and a half point in November, to getting a half point in September and only expecting a quarter point in November. Beyond that, there's been very little change in interest rate expectations. However, longer-term bond yields are actually a little bit higher than they were prior to the announcement.

This shows that the Fed's stance hasn't changed very much, despite the significant change in rates. Its rough assessment of long-term interest rates (communicated through the so-called 'dot plot') spans a range from 2.4% to around 3.8%. This suggests rates will be coming down over the coming months, but it's hard to know exactly how much they'll fall.

(1) The beige book is the slang name given to a report compiled by the regional Federal Reserve banks based upon anecdotal interviews with economic actors in their regions. It's a bit like the Bank of England's Agents' reports in the UK.

Equities sold off on the day of the announcement. Were investors disappointed? Not really. Where there's so much anticipation around a data release, we often see volatility over the next day or so as an elaborate dance of position taking and profit taking takes place.

Is the U.S. economy sliding into recession?

The consumer activity slowdown that took place in July and August was tangible and although it was first flagged by consumer-facing companies, it eventually became evident in the economic data. But the current tone of companies suggests that activity levels have stabilised, and no longer continue to slide. The latest example came from the payment companies at some of the conferences held a couple of weeks ago – Goldman Sachs held a technology conference and Barclays held a financial services conference. The overall message is that consumer spending is also very consistent.

What about the UK?

In the UK, last week saw the BoE keep interest rates unchanged. It did so off the back of the latest inflation data, which was pretty uneventful. So, is inflation under control in the UK?

The consumer price index (CPI) recently declined to the BoE's target rate but has been picking back up a little, while CPI including owner occupier's housing costs (CPIH), which is arguably a fairer measure of inflation because it includes housing costs, is still running around 3%. Forward indicators of housing costs suggest that spread should narrow, but the main issue remains whether services inflation and wages slow.

Like the Fed, the BoE will want to do enough to restrain economic activity without completely strangling the economy. A sign they might be winning that battle was the decline in median inflation, which suggests that, aside from the very volatile anomalies, general price growth has started to slow.

Meanwhile, retail sales data released on Friday morning painted a picture of consumer strength. A significant element of this will be driven by the catch-up spending of consumers stuck indoors by the dreadful weather in May and June. However, a backdrop of tax cuts, rising benefits, a rising national living wage and increasing pay settlements will also be helping on the spending front.

A slight concern is the consumer sentiment survey from market research company GfK, which was released on Friday morning. This suggests there has been quite a sharp slowdown in confidence among shoppers. So far, this is not corroborated by other sources but it's worth monitoring. The last month, in particular, has seen a lot of briefing and speculation around possible budget changes, none of which paint a particularly upbeat picture. However, clothing retailer Next reported that consumer activity is very stable at the moment, which struck a similar tone to the American payment companies.



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