RATHBONES

IS THE DOOR OPENING TO US RATE CUTS?

REVIEW OF THE WEEK
15 JULY 2024

POLITICAL VIOLENCE IN THE US IS OVERSHADOWING LAST WEEK'S BIG MOVES IN THE BIGGEST US STOCKS, AND WIDESPREAD GAINS FOR SMALLER STOCKS TOO.

Last week seemed like a fairly normal one in financial markets… until Thursday, when all sorts of extraordinary things happened in US stocks. The ostensible trigger for some hefty rotations within the S&P 500 was a benign US inflation report that seemed to bring hopes for a US rate cut forward to as early as September.

US headline inflation slowed from 3.3% to 3.0% in June, the third month in a row of slower than expected inflation, with the consumer price index (CPI) actually declining 0.1% month on month. This was the first outright drop in the CPI since May 2020.

If you just looked at the overall move in the main US index, you would have had the impression that stock investors weren't impressed. But you would've missed some fairly seismic moves. The S&P 500 fell 0.9%, but four out of five of the underlying companies in the index made gains. The index was dragged lower, despite this, by big declines in the 'mega-cap' tech stocks which have by far the largest weighting. It's dangerous to post-rationalise a one-day move, but it's possible this was due to some large-scale profit taking in these erstwhile outperformers, now that the prospects for many other companies seemed to be turning up as well amid hoped-for cuts in interest rates. Meanwhile, the Russell 2000 Index of smaller US companies outperformed the S&P 500 by 5.6 percentage points on the day the inflation data was released – companies in the small cap index have a five times higher proportion of floating rate debt than large caps. This was one of the biggest one-day outperformances in history (you have to go back to 1979 to find another move larger than 3%). At the start of the day the valuation gap between small and large companies was near historic highs, and in our view there is still plenty of room for smaller companies to close this gap.

From a global perspective, of course, the major news was the narrowly failed attempt to assassinate former US president Donald Trump at a campaign rally in Pennsylvania over the weekend. Although the former president escaped largely unharmed, one spectator was killed and two others were injured.

As always with these sorts of events, it's uncomfortable to discuss how they may affect financial markets, but we do have an obligation to consider the potential impacts on our clients' investments and to share our thoughts in this regard. It's too early to say for sure, but the incident seems to have bolstered support for the Republican candidate ahead of this week's National Convention, particularly as his response has been described as 'presidential'. In an interview with the Washington Examiner the day after the assassination attempt, Trump said he's rewritten his keynote speech to focus on national unity rather than President Joe Biden.

However, there are still almost four months until election day, and it's likely to remain a highly uncertain election – in stark contrast to the foregone conclusion and relative calm of the UK general election just over a week ago. As we note in our special election edition of **Investment Insights** , there are big differences between the Republicans and Democrats in consequential policy areas, and no clear view on which outcome markets would prefer. At this stage, it still doesn't make sense to premise investment decisions on a particular outcome – we need to be prepared for a range of possibilities.

A big step in US inflation's last mile?

As we've explained, ahead of the shocking events in Pennsylvania over the weekend, it was US inflation that took centre stage last week. After June's CPI print delivered more positive news on the inflation front, investors are again ramping up hopes of US Federal Reserve (Fed) interest rate cuts after sticky inflation in most of the first half of this year drove a massive dial-back in their expectations.

After strong monthly increases in the CPI for the first four months of the year, it was flat between April and May, which was better than consensus expectations. May's inflation data, released last month, brought more encouraging news. With June's data again showing inflation trending lower, this strengthens the case that May's data was more than just noise and that inflationary pressures in the US eased in the second quarter.

It is worth cautioning that the decline in headline CPI in June was driven in part by a chunky 3.8% monthly drop in fuel prices. However, core CPI (which excludes energy and food prices) inflation still slowed from 3.4% to 3.3% year-on-year and rose just 0.1% on the month. That's the smallest monthly rise in core prices since April 2021.

If the disinflation in CPI overall is good news, then the slowdown in the services part of the CPI basket (especially so-called 'supercore' services which basically comprise everything apart from housing costs) was even more positive. Since the start of the year, labour-intensive supercore service prices (things like haircuts, gym memberships and plumbing bills) have been running hot. Price increases in this category were back at eye-watering >6% run rates in the first quarter of this year. They are now virtually unchanged for two months (May and June). Federal Reserve Chair Powell repeatedly refers to this cohort of prices as the key part of the inflation basket to watch.

The Fed looks almost certain to keep rates on hold at its next meeting on 31 July, but investors now seem nearly 100% confident of a rate cut at its mid-September meeting. Regular readers will know that we have repeatedly disagreed with market interest rate expectations over the last two years: they have been variously too high and too low. Unusually, we broadly agree with the market's current assessment of this year, although we expect a few more rate cuts than is currently priced into next year.

Here in the UK, this week will deliver more fodder for the Bank of England to consume in its rate deliberations. The first will be Wednesday's UK CPI data for June and then Thursday's employment and wage numbers for May. Just as in the US, core UK inflation is being elevated by high services inflation, with the respective figures expected to be 3.5% and 5.6%. The latter, in turn, is being kept up by strong wage growth, which is forecast to be running at 5.7%, though down from 6% in April. This data will be followed by June retail sales on Friday, which are expected to be lower than May's, mainly due to the dismal weather. And there will be more focus on the new Labour government's policies at the state opening of parliament and the King's speech on Wednesday.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.