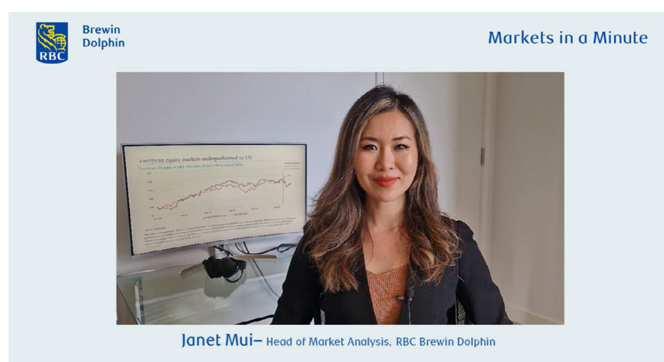
16 July 2024

Brewin Dolphin

Markets in a Minute

Janet Mui, Head of Market Analysis, discusses fresh U.S. and UK economic data and how the assassination attempt on Donald Trump has affected his chances of re-election.



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The major development over the weekend was the assassination attempt on former U.S. President Donald Trump. According to online prediction market PredictIt, the probability of Donald Trump winning the upcoming U.S. election has risen from 60% to about 66% since the event.

Market reactions have been relatively muted despite such a dramatic event, but there are some important observations as markets price in a higher chance of Trump being re-elected. Longer-term U.S. government bond yields have edged higher relative to shorter maturity bond yields. That is because a Trump re-election is expected to be more inflationary due to tariff threats.

Markets also believe there will be a bigger fiscal deficit and more supply of bonds because of Trump's pledge to extend tax cuts. U.S. equities reacted favourably, but that may also be due to higher hopes for rate cuts as soon as September.

Cuts come into view

The U.S. consumer price index was the most anticipated data last week and coincided with Federal Reserve (the "Fed") Chair, Jay Powell's semi-annual testimony at the Senate earlier in the week. The outcome of both events helped cement the market's view that U.S. interest rate cuts are coming soon.

Powell said the latest data shows that U.S. labour market conditions have cooled considerably from where they were two years ago. Indeed, we discussed the week before last how the U.S. unemployment rate has been steadily picking up and temporary help services jobs have fallen sharply. Because the labour market is no longer as tight, wage growth has slowed meaningfully. U.S. economic data indicated more of a soft patch recently, and Powell recognised that elevated inflation is not the only risk the Fed faces anymore.

The Fed's mandate has two objectives: 2% inflation and full employment. In the past two years, the priority has been on curbing inflation. But, as inflation has made great progress, the balance of priority is now shifting toward full employment.

Powell is perceived to be leaning on rate cuts, but he's keen not to commit to a specific timeline. The guidance is that more good data would strengthen the Fed's confidence that inflation is moving sustainably towards 2%.

U.S. inflation eases

The Fed and the markets did not have to wait long for that evidence. Last Wednesday, both U.S. headline and core consumer price index (CPI) inflation were reported at below estimates. U.S. headline inflation surprisingly contracted by 0.1% month-on-month (MoM) in June, which was the first time the CPI was negative since we started getting the high prints back in 2021. CPI slowed more than expected on a year-on-year (YoY) basis too, with headline CPI now at 3% and core CPI at 3.3%.

The slowdown in inflation is broad-based, which is welcome. The categories most responsible for driving the downturn in core inflation were the two big shelter categories – rent and

owners' equivalent rent, which together account for over 43% of the weight in the index. Both decelerated sharply, rising just under 0.3% MoM. This is finally starting to reflect the slowdown we've observed in new lets inflation.

Core goods inflation is now negative for the third consecutive month. Notably, durable goods prices fell sharply by 4.1% YoY in June, which could be a symptom of weaker demand. Airfares and new or used car prices were all falling in June. The Fed's preferred measure, so-called supercore CPI (core services excluding housing), contracted marginally for the second month in a row, a very different picture compared with the average +0.7% MoM pace in the first quarter of the year.

The satisfactory set of inflation data and cooling jobs data paves the way for the Fed to cut soon. Markets are now pricing in about 62 basis points of rate cuts by the end of 2024 and have fully priced in a 25-basis point cut in September. It feels like we really are finally inching towards a Fed interest rate cut, following wild fluctuations in expectations throughout the year.

The market reacts

Perhaps the most interesting aspect of the CPI release was the market reaction. Bond markets saw a marginal reduction in bond yields across maturities, while gold prices gained as real yields fell. The U.S. dollar weakened as real yields fell and interest rate differentials between the U.S. and other major economies are likely to narrow.

Lower bond yields and a dovish Fed tend to support growth stocks due to their sensitivity to interest rates, as their prospective profits are further out into the future. But mega-cap technology stocks, particularly the so-called "Magnificent Seven" (Microsoft, Apple, Alphabet, Tesla, Amazon, Meta and Nvidia), have plunged post-CPI, dragging the S&P 500 index down due to being heavyweights of the index.

Meanwhile, the S&P 500 Equal Weight Index and S&P 500 ex-Magnificient Seven posted gains. The most stunning move was the Russell 2000 (small cap) Index, which surged +3.6% on the day, the biggest outperformance versus the large-cap S&P 500 since 2020. While it's tempting to extrapolate a one-day move, the CPI report spurred excitement on the resurrection of small cap stocks via a rotation away from valuation-rich mega-cap stocks.

Time for the lightweights to shine?

The obvious reasons for being more bullish on small caps is the rate cuts argument; smaller businesses have struggled in the higher rates environment, whereas mega-cap companies have robust cash reserves that have shielded them.

Positioning is another argument. Given the extended rally in mega-cap tech stocks due to their embrace of artificial intelligence (AI), it's unsurprising that investors are taking profits on winners and seeking out laggards.

That said, it's not a foregone conclusion that small caps can persistently outperform. The conditions needed for small caps to outperform are low rates and a robust economic environment (usually at the recovery phase of the business cycle). Small caps tend to lead the markets when coming out of a downturn – but the U.S. economy is not coming out of a downturn, it's in late cycle. Also, a shallow rate cut cycle is expected, provided there's no recession.

All in all, lower inflation, rate cuts, and a soft landing are beneficial to the entire market backdrop. We may well be heading into an environment where both small and large caps can prosper. It's not a zero-sum game, as fresh capital can be deployed as investors become increasingly confident in the outlook.

Index concentration has been raising concerns amongst some investors, so a broadening of the rally is a welcome development and would support a more sustainable long-term rally for the broad indices.

A brighter outlook

Across the Atlantic in the UK, luck is in the air since a new government took office. The outlook for the UK has brightened despite the contentious weather this summer. One notable piece of data to be cheerful of is that the UK gross domestic product (GDP) growth in May (+0.4% MoM) was double that expected by economists.

This means not only did the UK come out of a shallow recession, but activity is recovering faster than expected, with second quarter growth likely to be around 0.6% to 0.7%. This will be a boost to the new Chancellor Rachel Reeves, who wants to make kickstarting economic growth a "national mission".

With stronger GDP data, a new government that is perceived to bring stability and a pushback on UK rate cut expectations, the pound traded at its strongest level in a year against the dollar, and in almost two years against the euro.

Investors are increasingly singing their praises for UK assets, a huge change from being one of the least popular regions since Brexit. Fundamentally, the pound remains cheap compared to its long-term average and purchasing power parity, whereas UK equities are trading at half the valuation of U.S. equities.

There is indeed room for UK equities to catch up if more international investors upgrade their allocation from negative to neutral or overweight. Our view is that some diversification into the value plays that the UK is so heavily weighted in makes sense at this stage. It can provide a relatively cheap hedge against inflation risks and growth-style equities in portfolios.

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