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Markets in a Minute

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Janet Mui, Head of Market Analysis, takes a closer look at U.S. inflation data and what this could mean for both markets and consumers. Plus, Guy Foster, Chief Strategist, discusses interest rate decisions by the Federal Reserve and the Bank of England.

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Last week was eventful on many fronts – from macroeconomics and central bank interest rate decisions to corporate news and politics. There were plenty of things to digest for investors, but there has been a clear divergence in U.S. and eurozone market performances.

The S&P 500 and the Nasdaq Composite reached new record highs last week, as investors continued piling into U.S. tech stocks and other equities, bolstered by multiple good news reports. To summarise, the positive drivers are disinflation trends, the Federal Reserve signalling it's willing to cut interest rates, and supportive corporate developments relating to artificial intelligence (AI).

U.S. inflation data lower than expected

Let's first look at the trigger moment for last week's U.S. equity rally, which was the lower-than-expected U.S. consumer price index inflation (CPI) data for May. Both U.S. headline and core CPI (which excludes food and energy) slowed more than expected in May – from 3.4% to 3.3% year-on-year and from 3.6% to 3.4% year-on-year, respectively. This is the lowest figure for core CPI since April 2021.

The fall in gasoline prices was a key driver of CPI being flat month-on-month, which helps offset the ongoing strength in shelter inflation. There are a few positive reads in the report, such as a big drop in airfares and modest falls in new vehicle prices and car insurance.

The elephant in the room remains the elevated shelter inflation, which is taking longer to slow, but leading indicators suggest it will eventually.

Overall, the latest U.S. CPI reports have provided more evidence of disinflation and removed some concern from earlier in the year that inflation has re-accelerated. We've a way to go with U.S. disinflation, but there is progress despite some bumps along the way.

Adding to the enthusiasm is that U.S. producer prices contracted in May on a month-on-month basis, driven by the fall in gasoline prices. Core producer prices inflation (which excludes food and energy) slowed from 2.3% to 2.2%, which was below estimates.

While producer price releases don't tend to move markets, the idea is that the lower inflation experienced by manufacturers will trickle down and help ease the price pressures consumers are experiencing – every little helps with the disinflation narrative.

U.S. disinflation has important implications for both Wall Street and the main street. Real wage growth (wage growth adjusted for inflation) accelerated from 0.5% to 0.8% in May, meaning the average household is benefitting from a resilient labour market and lower inflation. This supports the soft-landing thesis.

U.S. inflation reports provide support to our baseline macro view of ongoing disinflation and a soft-landing, with an overweight position in U.S. stocks.

U.S. interest rates, and a revised 'dot plot'

On the same day U.S. CPI data were released, the Federal Reserve announced its interest rate decision and released its updated summary of economic projections. It was widely expected that the Fed would hold rates unchanged, so all eyes were on its macro projections – particularly the 'dot plot', which is a summary of rate expectations gathered from the Federal Open Market Committee's members.

Since the Fed has revised up its near-term inflation forecasts, it is perhaps no surprise that the dot plot now only indicates one rate cut by the end of 2024, down from the three cuts expected previously. However, the dot plot now shows that four rate cuts are expected in 2025, up from a previous three.

Meanwhile, the Fed expects the U.S. unemployment rate to rise only modestly to a peak of 4.2% in 2025, from 4.0% currently. Inflation is expected to trend to 2% by 2026 as real gross domestic product growth is expected to be sustained at 2%. In short, this is as goldilocks as you can get – a soft landing is the main scenario for the Fed, with inflation coming down without any great damage to the labour market.

During the press conference, Fed chair Jay Powell was grilled by journalists' questions on the prospective policy path and the thought process of its decision making. The market's interpretation is that this is a Federal Reserve that is in no big rush to cut, but wants to and stands ready to do so, it just needs to see a few more inflation reports that are in line with the disinflation narrative.

Even though the Fed is flagging only one cut by 2024, markets are pricing in two, with an over 50% chance of the first cut happening in September, shortly before the U.S. election. As you can imagine, markets will remain very sensitive to any upcoming inflation data points.

Tech market rallies…

But the Federal Reserve isn't the only thing affecting markets at this juncture. As the strong year-to-date performance of large technology companies shows, corporate fundamentals matter more.

Last week, we saw Apple briefly regain its top spot in terms of market capitalisation, after temporarily falling into third place behind Nvidia. Microsoft reclaimed the top spot by the end of the week, but the battle of the big three is getting tight.

Analysts generally believe Apple has the tremendous opportunity to capitalise on a wave in the hardware upgrade cycle and get AI applications to mass-consumers at its fingertips. It's also in a prime position to capitalise on the budding AI-enabled software and apps ecosystem, given its dominance in consumer devices and wearables. Investors have turned hopeful, but the execution of its AI strategy will be key. There is immense competition, and the blistering pace of tech innovation means any near-term progress can't be taken for granted.

Semiconductor companies continued to rally against the backdrop of AI infrastructure build outs, anticipation of hardware upgrades, and cyclical recovery in the sector. The Philadelphia Stock Exchange Semiconductor index has risen by about 34% year-to-date, outpacing even the near 18% rally in the Nasdaq. We remain constructive on key companies in the semiconductor value chain.

… while European stocks take a turn for the worse

The mood in European markets couldn't be more different, with European stocks ending the week in the red. The epicentre of the downbeat sentiment is France, where its CAC 40 Index was down almost 6% last week, completely erasing the gains made so far this year.

The trigger is the uncertainty in French politics after President Macron called a legislative election to be held in two rounds on 30 June and 7 July, after the disastrous results from the European Parliamentary votes the week before last. It is widely regarded by markets as a huge political gamble with a high risk of scoring an own goal (no pun intended as the European Championship gets underway).

Currently, Marine Le Pen's National Rally party leads polls by a wide margin. But it is not just the far right that Macron's centrist Renaissance Party has to contend with. In a further blow to market sentiment, a coalition of left-wing parties has presented a manifesto ranging from reversing the government's pension reform and reinstating the right to retire at 60, to raising the minimum wage.

The polls show the far-right party leading with the coalition of left-wing parties being second. Either outcome is feared by financial markets as being more inflationary and detrimental to the state of France's public finances.

With so much uncertainty ahead, and a possibility of a shift in economic policy and weakened commitment to fiscal discipline, it is no wonder investors in French assets "sell first and ask later".

It is indeed a difficult period to endure before the market has more clarity. It is worth noting the sell-off in French equities has been indiscriminate this week and even spilled over to the broader European stock market. Market dislocation driven by political events tends to open opportunities for investors to pick up discounted quality stocks with solid fundamentals and international earnings exposure.

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