Will the Federal Reserve follow the Bank of Canada in cutting interest rates?

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Bank of Canada

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Federal Reserve

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Earnings season

One key takeaway from last week is that earnings season continues to give us indications of consumer weakness.

The Bank of Canada cut interest rates again last week. Given the similarities between Canada and the US in terms of past rate hikes and the current economic picture, could this be a sign of what's to come in the US? I also share my view of what to expect from the Bank of Japan and Bank of England as they meet this week.

Will the Federal Reserve follow in the Bank of Canada's footsteps?

Last week, the Bank of Canada (BOC) decided to enact another rate cut after its initial cut in early June. This begs the question of when the US Federal Reserve (Fed) will begin cutting since there are a number of similarities between the BOC and the Fed.

Like the Fed, the BOC went on a hiking spree starting in March 2022 and ending in July 2023. The BOC raised interest rates 10 times during that period, bringing its benchmark policy rate from 0.25% to 5% in a very aggressive tightening cycle.[1] Like the Fed, it held the policy rate steady at that terminal level for nearly a year — until its June 2024 meeting. We're now waiting to see if the Fed will follow suit soon after hiking 500 basis points over those same 15 or so months and holding steady at that terminal level since then.[2]

In addition to the similarities between these two central banks, there are also key similarities between the two economies.

Let's start with inflation. BOC Governor Tiff Macklem explained last week that a return to target inflation is "in sight." While he recognized that significant progress has been made, he acknowledged that the disinflationary path will be uneven. The BOC utilizes several different "preferred" measures of core inflation, and they have all fallen materially in the first half of the year. For example, median core inflation has fallen from 3.1% to 2.6% year over year in the first half of 2024.[3] Core inflation in the US, as measured by the core Personal Consumption Expenditures Price Index, has also experienced a significant decline — from 2.9% to 2.6% year over year in the first half of 2024.[4] It too has been an uneven, imperfect disinflationary path in the US, but what's important is that significant progress has been made.

Similar to US inflation, Canadian inflation has some sticky components such as elevated shelter inflation; however, that didn't prevent the BOC from cutting and should not be an obstacle for the Fed, in my view. BOC policymakers must have recognized that high interest rates are one reason for high shelter inflation, and that sticky components of inflation can be tolerated so long as overall inflation is moving downward, which is why they were comfortable cutting rates. Similarly in the US, shelter inflation has been a major obstacle to the Fed cutting rates. However, Fed policymakers such as Governor Adriana Kugler have said that they recognize that high shelter inflation is a very lagging indicator, and they anticipate it will fall materially in the near future.

Labor costs have also been sticky. In Canada, year-over-year wage growth recently ticked up from 5.2% in May to 5.6% in June.[5] However, that hasn't stopped the BOC from cutting. But given all the moderation in overall inflation, and a recognition that wage gains have been driven by public sector employees, the BOC has been comfortable cutting twice — and signaling more rate cuts will come. In the US, year-over-year wage growth has actually eased. While still elevated, it has fallen to 3.9% in June from 4.1% in May.[6]

In Canada, unemployment has risen significantly, from 5.7% to 6.4%, in the first half of the year.[7] The US's unemployment rate is substantially lower than Canada's, but it has also seen an increase in unemployment over the first half of 2024, from 3.7% to 4.1%.[8] Both countries have seen cracks forming in their economies. The BOC's Macklem explained it well, "I think what we really tried to signal is that the balance of worries is shifting."[9] The Fed should also be feeling the balance of worries shifting.

In fact, former NY Fed President William Dudley — who had heretofore been a "higher for longer" advocate — recently made a dramatic pivot because of his concerns about rising unemployment and weaker consumer spending in the US. In a piece last week, he argued that the Fed should cut this week, explaining, "The facts have changed, so I've changed my mind. The Fed should cut, preferably at next week's policy-making meeting."[10]

Now the Fed is unlikely to cut this week, in my view, but there is a small and rising chance it will — and I think a cut would be the right thing to do. I believe US monetary policy is far too restrictive given the progress made on disinflation and the state of the economy. The Fed Funds rate is at its widest spread over core Personal Consumption Expenditures (PCE) since 2007.[11] And the "proxy fed funds rate" — which offers the "real feel" of inflation when you factor in other monetary policy tools — is at 5.9%.[12] At this stage, I believe the Fed should be less worried about a resurgence in inflation and more worried that the long and variable lags of monetary policy could have a very negative impact on the US economy in coming months.

Bank of Japan seems poised for a rate hike

The Bank of Japan (BOJ) is also meeting this week. Markets are starting to anticipate a rate hike, and with good reason since rates and prices seem to be reinforcing each other. I too anticipate the BOJ will hike rates and reduce bond purchases as well. This would be an important — and justified — next step in the policy normalization path, in my view, and should also result in continued relative strength for the Japanese yen, especially if the Fed begins to cut rates soon.

Will the Bank of England join other central banks in cutting rates?

The Bank of England (BOE) is also meeting this week, and I do believe it will join other major central banks by beginning to cut rates. UK Chancellor Rachel Reeves' July 29 statement to Parliament may help the BOE make the decision to cut because, as the new Labour government has indicated, they have inherited some serious fiscal challenges that will result in reduced fiscal spending and the potential for tax increases. This could present real headwinds for the economy and gives the Bank of England another reason to cut rates. A rate cut could in turn be a positive catalyst for UK equities.

Earnings season: Companies discuss consumer weakness, AI spending

This will be a very big week for earnings reports. Overall, just 41% of the companies in the S&P 500 have reported earnings for Q2 2024 as of last Friday. The good news is that, of these companies, 78% have reported earnings that are higher than expected. The blended (i.e., forecasted and actual reported) earnings growth rate for the second quarter is currently 9.8% which, if it were to come to fruition, would be the highest we have seen in more than eight quarters. However, revenue beats have been much lower, at just 60% of S&P 500 companies, which is below the five-year average.[13]

One key takeaway from last week is that earnings season continues to give us indications of consumer weakness. For example, Whirlpool lowered its full-year earnings forecast, indicating that consumers are "weary" and are avoiding big-ticket appliance purchases.[14]

Another key takeaway from last week's earnings reports is that investors have suddenly grown impatient with companies' significant investments in artificial intelligence (AI). I think this is shortsighted as we should expect that it will take time for such investments to yield results. The comments made by Alphabet's CEO, Sundar Pichai, resonated with me, "When you go through a curve like this, the risk of underinvesting is dramatically greater than the risk of overinvesting for us here, even in scenarios where if it turns out that we are overinvesting."[15] He was quick to point out that their AI infrastructure has already driven significant revenues, and that technology infrastructure has a long useful life, improves efficiency, and has a broad and evolving set of applications, so overinvesting is not a significant concern.

Dates to watch

This week, we will get a large swath of companies reporting, including some mega-cap tech companies, such as Microsoft and Apple, major pharma companies such as Merck, and some bellwether consumer companies such as McDonalds and Procter & Gamble. As always, I care more about the guidance and the color provided on earnings calls, rather than the actual earnings results.

Date	Event	What it tells us
July 29	Japan Unemployment	Indicates the health of the job market
July 30	US Case Schiller Home Price Index	Indicates the health of the housing market
	US Consumer Confidence	Provides an indication of consumer sentiment
	US Job Openings and Labor Turnover Survey	Gathers data related to job openings, hires, and separations.
	China Manufacturing and Services Purchasing Managers Indexes	Provides an indication of the economic health of the manufacturing and services sectors
	Australia Consumer Price Index	Tracks the path of inflation
	Bank of Japan Monetary Policy Decision	Reveals the path of interest rates
	Eurozone Gross Domestic Product	Measures a region's economic activity

Date	Event	What it tells us
	Eurozone Consumer Inflation Expectations	Assesses consumers' expectations for the path of inflation.
	Eurozone Consumer Confidence	Tracks sentiment among eurozone consumers.
	Japan Retail Sales	Indicates the health of the retail industry.
July 31	Bank of Japan Outlook Report	Presents the Bank's outlook for developments in economic activity and prices, assesses upside and downside risks, and outlines its views on the future course of monetary policy.
	Eurozone Flash Consumer Price Index	Provides an early indication of the path of inflation
	Germany Unemployment Rate	Indicates the health of the job market
	Central Bank of Brazil Monetary Policy Decision	Reveals the path of interest rates
	Federal Open Market Committee Policy Decision	Reveals the path of interest rates in the US
	Canada Gross Domestic Product	Measures a region's economic activity
	Brazil Unemployment Rate	Indicates the health of the job market
	Japan Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
	China Caixin Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
August 1	India Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
	Eurozone Unemployment Rate	Indicates the health of the job market
	Bank of England Monetary Policy Decision	Reveals the path of interest rates
	US ISM Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
	UK Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
	Eurozone Manufacturing Purchasing Managers Index	Provides an indication of the economic health of the manufacturing sector
August 2	US Employment Situation Report	Indicates the health of the job market
	Mexico Unemployment Rate	Indicates the health of the job market

Notes

[1]Source: Bank of Canada

[2]Source: Federal Reserve

[3]Source: Statistics Canada, as of July 16, 2024

[4]Source: US Bureau of Economic Analysis, as of July 26, 2024

[5]Source: Statistics Canada, as of July 5, 2024

[6]Source: US Bureau of Labor Statistics, as of July 5, 2024

[7]Source: Statistics Canada, as of July 5, 2024.

[8]Source: US Bureau of Labor Statistics, as of July 5, 2024

[9]Source: Financial Post, "Bank of Canada governor Tiff Macklem says the central bank's 'balance of worries is shifting,'" July 25, 2024

[10]Source: Bloomberg, "I Changed My Mind. The Fed Needs to Cut Rates Now," July 24, 2024

[11]Source: Bloomberg, as of July 26, 2024

[12]Source: San Francisco Fed, as of July 19, 2024

[13]Source: FactSet Earnings Insight, as of July 26, 2024

[14]Source: Whirlpool earnings call, July 25, 2024

[15]Source: Alphabet earnings call

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Core PCE excludes food and energy prices.

The federal funds rate, or Fed Funds rate, is the rate at which US banks lend balances to each other overnight.

The terminal rate is the anticipated level a central bank's policy rate will reach before the central bank stops its tightening policy.

Tightening monetary policy includes actions by a central bank to curb inflation.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

A basis point is one-hundredth of a percentage point.

The opinions referenced above are those of the author as of **July 29, 2024.** These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.