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Higher for longer?

The recent fed funds rate “dot plot” and remarks from US Federal Reserve officials have convinced markets that US rates will be higher for longer.

Strikes impact sentiment

The ongoing auto workers strike and a possible health care workers strike are raising concerns that higher wage growth could contribute to sticky inflation in the US.

Resiliency in China

China continues to face headwinds, especially in the property sector. However, I remain impressed with the resilience of the Chinese economy.

Compelling evidence continues to show that most developed economies are experiencing disinflation. At the same time, most developed central banks are maintaining their “higher for longer” stance on interest rates, which we’re seeing reflected in the bond market. But it’s difficult to have visibility even a few months ahead, so I hold out hope that we could be pleasantly surprised by rate cuts before too much longer.

Growing evidence points toward disinflation

Last week provided further confirmation that disinflation is a powerful trend:

- The flash estimate for year-over-year euro area inflation was lower than expected. Core inflation was up 4.5% in September, down from 5.3% in August and well below expectations. Headline inflation moderated to 4.3% from 5.2%, an almost two-year low that was also below expectations, led by a drop in energy costs but with services also slowing significantly.¹
- The August US Personal Consumption Expenditures (PCE) print showed lower than expected inflation. Core PCE in particular has had an impressive move downward. The three-month annualized rate for core PCE was 2.2%.²
- The University of Michigan’s final consumer inflation expectations reading for September showed improvement from August.³ Five-year ahead inflation expectations are at 2.8% — the lowest reading in more than two years. And one-year ahead inflation expectations fell to 3.2% despite higher gas prices. This helps build the case that the US Federal Reserve (Fed) can stop hiking. (I should add that there are legitimate concerns that higher energy prices would filter into shorter-term consumer inflation expectations, but so far that hasn’t happened.)

Bond markets react to the “higher for longer” signals

I’ve found that there are weeks when a slew of data can solidify one’s macro view and make it seem close to a “fait accompli.” I think last week’s data has convinced many skeptics that the Fed will not hike rates further. However, the recent fed funds rate “dot plot” — as well as recent “Fedspeak” — has convinced markets that US rates will be higher for longer.

For example, last Friday New York Fed President John Williams shared, “My current assessment is that we are at, or near, the peak level of the target range for the federal funds rate ... I expect we will need to maintain a restrictive stance of monetary policy for some time to fully restore balance to demand and supply and bring inflation back to desired levels.”⁴

And it's not just the Fed. It seems that many developed central banks are sending the same message: higher for longer (perhaps they're all using the same communications agency for messaging?). Bank of England Governor Andrew Bailey explained, "We will need to keep interest rates high enough for long enough to ensure that we get the job done."⁵

This has been borne out in the bond market's behavior. Last week, Treasury yields on the short end, such as the 6-month T-bill yield, were relatively flat on the assumption that the Fed will probably not need to hike rates again. But the view that rates will be higher for longer has caused Treasury yields on the longer end of the yield curve to rise significantly. The three-, five-, and 10-year US Treasury yields rose to their highest levels since 2007 last week. And the 30-year US Treasury yield rose to its highest level since 2011.⁶

I remain skeptical. What is "restrictive"? What is "longer"? These are all ambiguous words that are being given an enormous amount of importance, along with the Summary of Economic Projections (the SEP or 'dot plot') which we know has historically been at times wildly inaccurate in predictions just a year out. As I have said before, it's hard to have visibility beyond even a few months. And as I have said before, it behooves central banks to talk down markets and tamp down any positive fervor as they attempt to sustainably control inflation. But those are just words and dots, not sticks and stones. We could be pleasantly surprised that developed central banks are not that high for that long after all.

Policy uncertainty continues

And so policy uncertainty continues in the Western world, especially in the US. While the US government shutdown has been at least temporarily avoided — thanks to a 45-day spending bill that was passed over the weekend — there are still significant question marks about the path of monetary policy next year.

In addition, we have the ongoing United Auto Workers strike, which has expanded in the last week, and an impending strike by US health care workers at Kaiser Permanente. This is negatively impacting sentiment because it raises concerns about higher wage growth that can contribute to sticky inflation. However, I think the impact of these strikes is more psychological than material.

China's economy shows resiliency against headwinds

China continues to face headwinds, especially in the property sector. A unit of Chinese property owner Evergrande defaulted on some of its debt. It is attempting to restructure \$20 billion in debt, but that effort is being complicated by last week's arrest of its CEO. However, despite all this, the Chinese economy remains relatively resilient:

- China's official manufacturing Purchasing Managers' Index (PMI) clocked in at 50.2, moving into expansion territory in September for the first time in five months.⁷
- Caixin/S&P Global manufacturing PMI fell slightly from 51 to 50.6, but it remains in expansion territory.⁸

It is worth noting the World Bank just released its growth forecasts for 2024, and it has cut growth expectations for China from 4.8% to 4.4% for next year. However, I remain impressed with the resilience of the Chinese economy and believe it's hard to make forecasts for next year without knowing what targeted stimulus may be unveiled in coming months.

The waiting game continues

And so we wait for more information and more data. We wait for more data supporting the disinflationary narrative in the developed world — in particular, we're looking for more signs of an economic slowdown in the US, as that will help dictate when rates will begin to be cut next year and by how much. We wait for signs of how significant the global economic slowdown is, especially how it impacts emerging market countries, and we wait for the rollout of more targeted policies to support the Chinese economy. We also wait for the Bank of Japan to decide when it's time to begin to "normalize" monetary policy.

But waiting should not equate to sitting on the sidelines, despite the potential for volatility in the near term. I believe it's important to have adequate exposure to equities, fixed income, and alternatives globally. At the expense of repeating myself, I think the biggest mistake investors made during the Global Financial Crisis was to lock in losses and sit on the sidelines. It is difficult to time markets, so I believe a prudent approach is to have a core strategic allocation that is broadly diversified, which can still leave room for a portion of a portfolio to be tactically allocated.

Dates to watch

In the coming week, I'm most focused on US wage growth, given the headlines about strikes and wage demands. I'm also hopeful we'll see a further decrease in job openings in Canada and the US. UK, US, Canadian, and eurozone PMIs will give us a sense of how economic activity is faring in major Western economies, while we will also get decisions from two major central banks, one emerging (the Reserve Bank of India), and one developed (the Reserve Bank of Australia).

Date	Report	What it tells us
Oct. 2	Manufacturing PMI for US, UK, Canada, and eurozone	Indicates the economic health of the manufacturing sector.
Oct. 3	US Job Openings and Labor Turnover Survey	Gathers data related to job openings, hires, and separations.
Oct. 3	Reserve Bank of Australia meeting	Announces interest rate decision
Oct. 4	Services PMI for US, UK, and eurozone	Indicates the economic health of the services sector.
Oct. 6	US Employment Situation Report and Canadian Labour Force Survey	Monitors labor market data on a monthly basis.
Oct. 6	Reserve Bank of India meeting	Announces interest rate decisions.

Notes

¹Source: Eurostat, as of Sept. 27, 2023

²Source: US Bureau of Economic Analysis, as of Sept. 29, 2023

³Source: University of Michigan Survey of Consumers, Sept. 2023

⁴Source: Fed's Williams says central bank may be done with rate rises, Reuters, Sept. 29, 2023

⁵Source: Global central banks unite in 'higher for longer' credo, Reuters, Sept. 22, 2023

⁶Source: Bloomberg, as of Sept. 29, 2023

⁷Source: China National Bureau of Statistics, as of Oct. 2, 2023

⁸Source: Caixin/S&P Global, as of Oct. 2, 2023

Important information

Past performance is not a guarantee of 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.

All investing involves risk, including the risk of loss.

Diversification does not guarantee a return or eliminate the risk of loss.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

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 risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

The Caixin China General Manufacturing PMI™ is compiled by S&P Global from responses to questionnaires sent to purchasing managers in a panel of around 650 private and state-owned manufacturers.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

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

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The Eurozone (also known as the euro area or euroland) is an economic and monetary union of 18 European Union member states that have adopted the euro (€) as their common currency.

The federal funds rate is the rate at which banks lend balances to each other overnight.

Inflation is the rate at which the general price level for goods and services is increasing.

Headline inflation is the raw inflation figure reported through the Consumer Price Index (CPI) that is released monthly by the Bureau of Labor Statistics.

Core inflation is the change in the costs of goods and services, but it does not include those from the food and energy sectors. This measure of inflation excludes these items because their prices are much more volatile.

The Michigan Consumer Sentiment Index (MCSI) is a monthly survey of consumer confidence levels in the United States conducted by the University of Michigan.

Personal Consumption Expenditures (PCE) includes a measure of consumer spending on goods and services among households in the US. The PCE is used as a mechanism to gauge how much earned income of households is being spent on current consumption for various goods and services. Core PCE excludes the prices of food and energy and is the Fed's preferred inflation measure.

PMI (formerly Purchasing Managers Index), a commonly cited indicator of the manufacturing sectors' economic health, is calculated by the Institute of Supply Management.

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

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The opinions referenced above are those of the author as of October 2, 2023. 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.