

# Rising Treasury yields, falling oil prices, and hawkish talk from the Fed



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## Hawkish talk intensifies

Last week brought hawkish remarks from a cast of Federal Open Market Committee members.

## Interest rate implications

I still believe a US rate cut in June and a total of three cuts for the year are very real possibilities, but markets need to see more data.

## Crude oil prices fell

Prices for West Texas Intermediate crude oil fell last week from recent highs despite tensions in the Middle East.

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### Weekly Market Compass | April 23, 2024

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A rising 10-year US Treasury yield, falling oil prices, eurozone disinflation, and some strong US economic data top my list of notable items impacting markets and investors over the past week. Here's what I'm watching at the moment, including talk from central bankers about interest rates.

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### Hawkish talk grows louder from US central bankers

Last week, the 10-year US Treasury yield rose to levels not seen since last November.<sup>1</sup> The catalyst was the higher-than-expected US Consumer Price Index (CPI) print several weeks ago, which caused markets to change their collective mind about Federal Reserve (Fed) policy this year. That view was reinforced by last week's retail sales report, which rose well above expectations<sup>2</sup>, as well as hawkish Fed speak from a cast of Federal Open Market Committee members. A few highlights from the past week:

- From Fed Vice Chair Philip Jefferson: "...if incoming data suggest that inflation is more persistent than I currently expect it to be, it will be appropriate to hold in place the current restrictive stance of policy for longer. I am fully committed to getting inflation back to 2%."<sup>3</sup>
- From Fed Chair Jay Powell: "The recent data have clearly not given us greater confidence and instead indicate that it's likely to take longer than expected to achieve that confidence. Right now, given the strength of the labor market and progress on inflation so far, it's appropriate to allow restrictive policy further time to work and let the data and the evolving outlook guide us. If higher inflation does persist, we can maintain the current level of restriction for as long as needed."<sup>4</sup>
- From New York Fed President John Williams: "We've got interest rates in a place that is moving us gradually to our goals, so I definitely don't feel the urgency to cut interest rates."<sup>5</sup>
- From the Federal Reserve Financial Stability Report released last week: "The risk of persistent inflationary pressures leading to a more restrictive than expected monetary policy stance remained the most frequently cited risk, mentioned by nearly three-fourths of survey participants. The share of survey participants mentioning policy uncertainty as a risk to the financial system stood at just under two-thirds, significantly higher than in the October report."<sup>6</sup>

(Read our explainer about inflation and how the Fed measures it.)

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### Oil prices fall despite Middle East tensions

Prices for West Texas Intermediate crude oil actually fell last week from recent highs.<sup>7</sup> That was a head scratcher for some given the high tensions in the Middle East, but I think it reflects a few key factors:

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- First of all, US oil production has been a game changer in terms of softening the impact of Middle East geopolitical risks on the price of oil. According to the US Energy Information Administration, the US has been the largest producer of crude oil since 2018. Its 2023 production of 12.9 million barrels per day was far higher than the second-largest oil producer, Russia, at 10.1 million barrels per day, and Saudi Arabia at 9.7 million barrels per day.<sup>8</sup>
  - In addition, while Middle East tensions are high, they are not as high as many feared. The measured responses between Iran and Israel have been performative in my opinion - they are very controlled, intending to show displeasure with the previous act of aggression but seemingly designed to avoid escalation in military actions.
  - Also, the new conventional wisdom that rates will be higher for longer is expected to cause some level of demand destruction, which I believe has exerted some downside pressure on oil prices as well.

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### **Hope continues for more rapid disinflation in the UK**

The most recent UK CPI print supported the thesis that UK inflation will remain sticky. Services inflation eased, but not as much as market watchers would have liked. In addition, UK wage growth has also slowed less than expected. This caused markets to change their collective mind on when the first Bank of England rate cut will occur.

I, however, hold out hope for a rate cut before the end of the second quarter. As such, I took comfort from the words of Bank of England Deputy Governor David Ramsden, who said: "Given we know the level of the Ofgem price cap for April and also taking account of the freezing of fuel duties in the March Budget, then other things equal we can be confident headline CPI inflation will fall sharply in April, to close to the 2% target."<sup>9</sup> The significant increase in unemployment in the UK from 3.9% in January to 4.2% in February<sup>10</sup> helps make the case for easing sooner rather than later, in my opinion

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### **The eurozone makes significant progress with disinflation**

Eurozone year-over-year inflation for March was 2.4%, down from 2.6% in February and 2.8% in January. This is impressive progress considering that a year ago, the inflation rate was 6.9% year over year. Core inflation, excluding food and energy, was also unrevised at 2.9% year-over-year for March - and excluding tobacco as well was 2.6%.<sup>11</sup> In my view, this trend virtually ensures that the European Central Bank will enact a rate cut at its June meeting.

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### **The US economy appears strong, but small consumer headwinds are appearing**

A substantial amount of data supports the view that the US economy is quite strong. Just look at last week's US retail sales report, which followed a slew of relatively strong data. This is reflected in high yield spreads, which have actually tightened in the last several months. They are well below the 30-year average spread of 4.93% - and far below the 7.5% level that has historically coincided with recessions.<sup>12</sup>

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However, some data suggests consumers - at least lower income households - are starting to experience some headwinds. For example, US credit card delinquencies in the fourth quarter reached their highest levels since the Philadelphia Fed started tracking this data in 2012.<sup>13</sup> And the share of accounts making minimum payments rose 34 basis points to a data series high from last quarter's reading, indicating increased income stress.<sup>14</sup>

Some credit-card issuing banks are more exposed to rising delinquency rates than others, and we've already seen the issue of delinquencies show up in the earnings call of one lender who has more exposure to lower income American households. We will want to follow this closely. Any significant rise in unemployment could have a corresponding impact on lower income households, especially given the low level of savings they have - which means they lack a buffer against economic headwinds if they increase. This is not my base case, but we need to resist complacency in our views, so following the health of the consumer closely is important.

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### **News from China and Canada**

It's also worth noting that China's gross domestic product print for the first quarter positively surprised, coming in above expectations. This suggests targeted fiscal stimulus is improving confidence and having a beneficial impact on the economy.

Meanwhile, Canada's federal budget for 2024 was released last week. While there are some interesting proposals that could boost economic growth, and help increase household financial stability, it also raises concerns about government debt and the high cost to service that debt - although not nearly as significant as the concerns being articulated south of the border in the US.

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### **Asset class implications**

Risk assets are clearly under pressure and likely will continue to be with higher yields. However, I believe this too will pass. I still believe a Fed rate cut in June and a total of three rate cuts for the year are very real possibilities. But markets likely won't change their minds - and therefore pressure likely won't come off risk assets - until there is significant data that shows more disinflationary progress and a "less hot" economy.

When I think about my hopes for upcoming data, I am reminded of something that Antonio Salieri, the rival of Wolfgang Amadeus Mozart, supposedly proclaimed (at least in the movies), "I speak for all mediocrities. I am their champion ... I am the patron saint of mediocrity." Well, we could have used some Salieri-type CPI and retail sales data in the last few weeks. And I am hoping for some Salieri moments for US economic data in coming weeks and months - mediocre inflation data, and economic data in general, that doesn't surprise to the upside.

There is reason for optimism once we get more evidence of the US' disinflationary trend. I think the pullback we have experienced is healthy, and it renders valuations on risk assets more attractive. And there is still significant cash on the sidelines that could move into markets. In fact, a comment in an earnings call last week from the chief financial officer of a major global bank supports this view: "...there's a lot of cash at this point. So that would tell you it's supporting the ability to see continued assets under management flows going forward, depending on how the --

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obviously, the stock market shakes out over time. But we're all struck by just the sheer amount of cash on the sidelines at this point."<sup>15</sup> I don't think this is an anomaly; I suspect that many banks are seeing elevated levels of cash sitting on sidelines.

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### What to watch this week

The most critical data point in the coming week, in my opinion, will be US Personal Consumption Expenditures. Also important will be US gross domestic product and the University of Michigan consumer inflation expectations. Needless to say, I am hoping these will be "Salieri" data points - ones that are mediocre and do not surprise to the upside.

We also have the Bank of Japan (BOJ) decision this week. We have heard a lot from Governor Kazuo Ueda in recent days suggesting the BOJ will not be afraid to tighten monetary policy further if inflation keeps rising. A recent survey by Tsutomu Watanabe<sup>16</sup> indicates that Japanese consumer inflation expectations have risen, which supports the view that higher inflation has legs. And so this central bank meeting could be important in terms of providing guidance on when the BOJ is likely to act again. This could be helpful in strengthening a very weak yen.

Also this week we have some important speeches from European Central Bank (ECB) members, including President Christine Lagarde. I expect continued messaging essentially confirming the start of rate cuts in June.

Finally, earnings season will be picking up steam. I look forward to the information gleaned on earnings calls for insights into industries, consumer and business behavior and the overall economy.

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### Dates to watch

Date	Event	What it means
Apr 22	ECB President Lagarde speaks	Offers insights into central bank thinking.
	Eurozone Consumer Confidence	Tracks consumers' views of their finances and the economy.
Apr 23	Eurozone Purchasing Managers' Index (PMI)	Indicates the economic health of the manufacturing and services sectors.
	UK PMIs	Indicates the economic health of the manufacturing and services sectors.
	US PMIs (S&P Global)	Indicates the economic health of the manufacturing and services sectors.
	US New Home Sales	Measures the health of the housing market.
Apr 24	Germany Ifo Business Climate Index	Assesses the current German business climate and measures expectations for the next six months.
	US Durable Goods Orders	Tracks new orders placed with manufacturers for long-lasting goods.
	Canada Retail Sales	Measures consumer demand.
	ECB Governor Schnabel speaks	Offers insights into central bank thinking.
	Bank of Canada Summary of Deliberations	Offers insights into central bank thinking.

Date	Event	What it means
Apr 25	GfK Germany Consumer Climate	Measures a range of consumer attitudes, including forward expectations of the general economic situation and households' financial positions.
	Bank of Japan Decision	Reveals the latest decision on the path of interest rates.
	Brazil Central Bank National Monetary Council Meeting	Reveals the latest decision on the path of interest rates.
	US GDP	Measures a region's economic activity.
	UK GfK Consumer Confidence	Tracks UK consumers' views of their finances and the economy.
Apr 26	Bank of Japan Press Conference	Offers insights into central bank thinking.
	US PCE	Measures price changes in consumer goods and services.
	US Personal Income, Spending and Consumption	Indicates the health of the US consumer.
	Univ of Michigan Survey of Consumers including Michigan Inflation Expectations	Measures consumers' expectations of future inflation.

#### Notes

<sup>1</sup>Source: Bloomberg, as of April 19, 2024

<sup>2</sup>Source: US Census Bureau, April 15, 2024

<sup>3</sup>Source: Federal Reserve speech transcript, April 16, 2024

<sup>4</sup>Source: Reuters, "Fed's Powell says restrictive rates policy needs more time to work," April 16, 2024

<sup>5</sup>Source: Bloomberg, "New York Fed's Williams Sees No Urgency to Cut Interest Rates," April 18, 2024

<sup>6</sup>Source: Federal Reserve, Financial Stability Report, April 2024

<sup>7</sup>Source: Bloomberg as of April 19, 2024

<sup>8</sup>Source: US Energy Information Administration, In-Brief Analysis, March 11, 2024

<sup>9</sup>Source: The Guardian, "Pound drops as Bank of England deputy governor sees lower inflation ahead – as it happened," April 19, 2024

<sup>10</sup>Source: UK Office of National Statistics, April 2024

<sup>11</sup>Source: Eurostat, April 17, 2024

<sup>12</sup>Source: St. Louis Federal Reserve Economic Data, as of April 18, 2024, based on the ICE BofA US High Yield Index Option-Adjusted Spread. This index tracks the performance of US dollar-denominated, below-investment-grade corporate debt publicly issued in the US domestic market. Option-adjusted spread is the yield spread which must be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

<sup>13</sup>Source: Philadelphia Federal Reserve Bank Q4 2023 Insights Report, April 10, 2024

<sup>14</sup>Source: Philadelphia Federal Reserve Bank Q4 2023 Insights Report, April 10, 2024

<sup>15</sup>Source: Alistair Borthwick, CFO, Bank of America earnings call, April 14, 2024

<sup>16</sup>Source: Bloomberg, "Higher Inflation, Price Tolerance in Japan Boosts Case for BOJ Rate Hikes," April 21, 2024

#### Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

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.

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

The Consumer Price Index (CPI) measures changes in consumer prices.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The Financial Stability Report presents the Federal Reserve's current assessment of the stability of the US financial system.

West Texas Intermediate (WTI) is a type of light, sweet crude oil.

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The Ofgem energy price cap is the maximum amount energy suppliers can charge for each unit of energy and standing charge for those on a standard variable tariff. Ofgem is Great Britain's independent energy regulator.

A basis point is one hundredth of a percentage point.

Risk assets are generally described as any financial security or instrument that carries risk and is likely to fluctuate in price.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

The opinions referenced above are those of the author as of **April 22, 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.