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Market Update: 10th July 2019

Powell's Semi-Annual Monetary Policy Speech

Equity markets face potential headwinds this week, as the Federal Reserve Chairman Jerome Powell returns to the spotlight to deliver his semi-annual monetary policy report to congress. The event will be closely watched by investors to confirm expectations for a potential July rate cut and may provide some detail on the timing of a mini-easing cycle through interest rate cuts. Against a backdrop of political uncertainty and weakening global economic data in the first half of the year, coupled with an escalation of trade tensions in recent months, markets are pricing in a July rate cut, however the tone of the speech will shed some light on the likelihood and size of a potential cut. In the near term, any suggestion that a July cut may not transpire could result in a sell-off in equity markets.

US Jobs Report

Following a series of downward corporate earnings reversions ahead of Q2 corporate earnings season after a period of weakness in US economic conditions, equity markets had priced in a 50bps rate cut ahead of the next FOMC meeting in July. At the June meeting, Powell announced that the Fed would be closely monitoring the economic data to ascertain whether a rate cut would be required in the near term to stimulate the US economy. Friday's US jobs data displayed an increase of 224,000 jobs added to the US economy in June, beating market expectations of 160,000 as weakness in the US economy failed to feed through into the US labour market. Global equity markets traded lower on the back of stronger than expected US job data, tempering expectations that the Fed will lower interest rates by 50bps later this month. A stronger labour market will give the Fed less ammunition to cut rates aggressively in the near term and could result in disappointment based on the markets optimistic expectations, acting as a potential catalyst for a downturn in equity markets.

As a result of abating expectations for an aggressive rate cut over the last week, risk off sentiment has been spreading among investors, causing a flight to safety in safe haven assets. This further reiterates our view that despite the June rebound in employment (which is a lagging economic indicator), global crosscurrents and low inflation are apparent as the global economic slowdown continues. Investors are still anticipating insurance cuts to ease economic pressures; however the Fed may require further substantial data to determine whether an insurance rate cut at the end of the month will be needed to sustain the economic expansion. It is our view that the Fed do not have solid reasoning to implement a rate cut at this point, and that a cut will most likely be delayed later into the year once US economic weakness has fully fed through into markets, however should Q2 earnings come through as negative as expected, this could give the Fed reason enough to cut as soon as July. Over the coming weeks, the Fed will be watching US retail sales and CPI inflation to provide further clarity over the extent of the weakness within the US economy and the requirements for further stimulus in July.

Market Expectations vs Reality

After expectations for an aggressive cut abated this week, markets have now priced in a 25-basis interest rate cut in July, with the expectation that Powell is likely to leave interest rate cuts on the table in his speech later today. Given slowing global growth, heightened trade policy uncertainty and low inflation expectations, the markets are confident that the Fed will continue to play the role of risk manager and implement an 'insurance' cut in the near term.

Markets are hoping for crucial signals for rate cuts in the coming weeks, however as Powell is expected to discuss the Fed's concerns regarding the US-China trade dispute in recent weeks, alongside President Trump's latest commentary regarding the Fed and their policy objectives, this will most likely leave room for Powell to remain vague on monetary policy until the FOMC meeting later this month. Powell's updated assessment of risks to the U.S outlook is expected to give some indication behind the rationale for rate cuts in July and the outlook for the remainder of the year, and provide forward guidance on what the expectations are on the US economy going forward. There are three potential outcomes from the speech: Powell may signal that a July rate cut will go ahead, it will not go ahead, or he may reiterate that the Fed remains on the fence and will continue to assess US economic data in the run up to the FOMC meeting on July 30-31st.

In our view, Powell is likely to highlight weakness but remain on the fence, awaiting further data as not to tie the committee's hands if data improves or worsens. It is our expectation that US jobs data will play an influential role in deciding whether a rate cut will happen in the near term, alongside the ISM manufacturing index data which demonstrated better than expected expansion and the trade truce between the US-China following the G-20 meeting. In our view, these three factors do not point to an immediate rate cut.

Nonetheless, the overall US economy is losing momentum and showing weakness as Q2 corporate earnings are expected to be negatively impacted by persisting economic uncertainties, with a recovery in the second half of the year now looking unlikely. In our view, rate cuts are on the horizon, however, may not be as imminent as markets are expecting.

The timing of a rate cut will be pivotal in determining the direction of financial markets. A rate cut in July would potentially lead to a temporary rally on the back of optimism in markets in the near term, however, only reiterates our view of a weakening US economy which does not justify current equity valuations. Weakness in corporate earnings in Q2 is expected to also feed into the markets and therefore could become a catalyst for the expected drop back in H2 2019. Moreover, the Fed have only recently shifted from a hawkish stance and any further shift would not be warranted. Markets are highly optimistic about a July rate cut with plenty of room for disappointment remaining in our view.

Portfolio Positioning

Overall, risks remain tilted towards the downside, and with risk off sentiment spreading across bond markets, equity investors will be forced consider weakening economic data and trade concerns in the coming weeks. As June jobs data triggered a pullback in equity markets as investors scaled back the scope of expected interest-rate cuts by the Fed, it is clear that optimism from a July rate cut will be short-lived as weakness in the global economy continues and weak corporate earnings data begins to feed into the US economy. Similar trends were seen in 2001 and 2007, where investors began to focus on rate cuts rather than fundamental economic data, however weak corporate earnings and stretched valuations will cloud enthusiasm, with no signs of the recovery in the second half of the year which was expected in Q1. It remains our view that given weakness in the economic data, a July rate cut will have minimal impact on economic growth in the near term.

Given the economic data and current market conditions, we remain defensively positioned for a decline in equity markets and will act accordingly when economic conditions change. We continually monitor the economic data and analyse trends in markets, and at the moment, the data is only confirming our thesis and reinforcing the need for defensive positioning and caution in financial markets.