BROOKS MACDONALD

Chief Investment Office

Weekly Round-Up

For professional advisers only

In Brief

- Italian government announces a surprise windfall tax on Italian bank profits, but as bank shares reel, policy makers make a partial U-turn, promising to cap the tax hit.
- China battles deflation, as annual consumer price changes in the world's second biggest economy turn negative, marking the first year-on-year decrease in over two years.
- US consumer inflation data lands marginally below market expectations, boosting hopes for a pause in interest rates at the US Federal Reserve's next meeting in September.

Monday

Equities lost ground last week as investors upgraded their forecasts for the amount the US Treasury will need to finance this year, and therefore the amount of liquidity that would be removed from the financial system. Technology shares underperformed however this was largely due to poorer US technology company Apple earnings than a broader sectoral story. Last Friday saw the release of the US non-farm payroll report which recorded 187,000 new jobs created in July, slightly more than were created in June but fractionally behind the consensus estimates. Within the data we saw strong gains for certain sectors such as private education whereas others saw small contractions such as manufacturing, transportation, and warehousing. In terms of the average number of hours worked in a week, that number unexpectedly fell by 0.1 to 34.3 but average hourly earnings surprised to the upside, staying flat at 4.4% when the market was expecting a decline. This sticky wage growth inflation will be a concern to the US Federal Reserve (Fed) who were hoping for the reading to start to decline towards 3%. For the time being, the labour market remains tight as can be seen by the US unemployment rate which now stands at a mere 3.5%. With the jobs report out of the way, the market will shift to the US Consumer Price Index (CPI) release on Thursday of this week. There were substantial rises in oil and gas prices last month which are likely to feed into US consumer inflation if they stay elevated, but it is probably too early for them to have made a substantial impact for this week's reading. Core CPI, which excludes these components (core excludes energy and food prices), is expected to stay flat at 4.8% year-on-year. Headline US CPI meanwhile is expected to accelerate on a year-on-year basis from 3% to 3.3% but importantly the month-on-month reading is expected to be a mild 0.2%, matching last month. These month-on-month readings are arguably more important than the annual figures as it is easier to spot inflection points (albeit these individual numbers can be quite volatile). Just as we need to be cautious about excluding items from the CPI basket that don't fit our narrative, we need to be cautious of annualising short-term figures. That said, there are growing signs that the monthly inflation data is pointing to a far more benign inflation outlook as we progress through the summer.

Tuesday

Equities saw some gains on Monday with the US outperforming Europe, reversing some of the losses of the previous week. Despite an almost 1% rally in US equities, there was little in the way of new news, with markets awaiting US CPI on Thursday before making a definitive next move higher or lower. We did hear from a number of Fed speakers on Monday, with Fed Governor Michelle Bowman,

one of the more hawkish members, discussing the possibility of further hikes by saying that 'additional increases will likely be needed to lower inflation to the FOMC's (Federal Open Market Committee) goal'. At the other end of the spectrum, New York Fed President John Williams seemed more comfortable with pausing at the current level given that 'monetary policy is in a good place'. Both speakers discussed the need to be data dependent given the evolving inflation narrative with Williams even suggesting a 2024 rate cut should the signs of easing inflation continue. It is worth noting that while the Fed is quite cautious around the possibility of 2024 rate cuts, the market is far more confident. US interest rates are expected to be 5.38% by the end of this year but 4% by the end of 2024 so quite a significant amount of easing is priced into the bond market as things stand.

Wednesday

Equities fell again on Tuesday with the MSCI USA index down half a percent (in US dollar total return terms) due to concerns over weaker Chinese trade sector as well as the banking sector. Feeding the risk-off mood, rating agency Moody's downgraded several small and mid-sized US banks as well as putting some of the larger banking firms on a negative outlook. Analysts had hoped that the recent bank stress tests would help put to rest the fears following the Silicon Valley Bank (SVB) crisis back in March, however this downgrade highlights the sector's continued fragility. The regional banking sector was particularly hard hit on Tuesday with the sector underperforming the wider banking sector. The detail of the downgrade showed a concern around capital weakness, higher funding costs in the wake of SVB and the risks from commercial real estate losses. Over in Europe, European banks were also in focus on Tuesday after the Italian government unveiled a windfall tax on Italian banks given the impact of higher interest rates on net interest margins for the sector. The draft bill will take the excess net interest margin achieved in 2023 (or 2022 if higher) and apply a 40% tax on that amount. Italian banks were sharply lower in response to this announcement however overnight the government appeared to U-turn on the scale of the tax hit, saying that the maximum tax would be limited to 0.1% of a bank's assets. The impact of this tax will be reduced by this clarification which will support the sector going forwards. Windfall taxes are never welcomed by investors given they reduce short term profitability, but they also create greater uncertainty over the future policy path for the sector.

There is a general feeling that once the windfall tax is out of the bottle, future governments will utilise it when it is expedient to do so. This is arguably the greatest impact of such moves, raising the cost of capital and risk premium associated with politically exposed sectors (such as oil & gas, banking, and utilities) as investors need to account for a greater range of tail risks. The clarification overnight that this tax would be capped at each bank has helped repair some sentiment however the cost to the Italian banking sector market capitalisation is likely to be more significant than the sums raised by the tax, as investors recalibrate for the re-emergence of political risk in the sector. Also of note first thing on Wednesday morning, China's consumer prices dropped by 0.3% year on year in July in the latest inflation data to be published. This marked the first decrease since February 2021, compared to a flat reading in June but marginally ahead of market estimates of a 0.4% fall. With the world's second biggest economy seeing annual prices falling outright, this increases the risk that China may start exporting deflation to the rest of the world unless promised China policy stimulus later this year arrests this decline.

Thursday

Despite expectations for a quieter August, several themes from the last 18 months are flaring up to add volatility to markets.

On Wednesday it was a surge in European natural gas prices which at one point traded 40% higher on the day but ultimately settled at 27%. Back to the issues earlier in the week, Italian banks rallied on Wednesday after the Italian government announced the cap on the windfall tax levy. The catalyst for the rapid rise in European natural gas prices was news suggesting that a strike could occur which would impact LNG (Liquefied Natural Gas) export supplies from Australia. The LNG market remains tight at the same time as oil prices have been steadily rising. The US benchmark oil price, WTI (West Texas Intermediate), hit a nine-month high on Wednesday as the market adjusts for stronger demand amid a still constrained supply outlook. Should the recent rises in oil and gas prices continue, we could see a pickup in US and European inflation again in future months. All this inflation focus brings us neatly to the US CPI (Consumer Price Index) release which is due later on Thursday. The market is expecting headline CPI to have grown by 3.3% year-on-year but for the monthly gain to have been a mere 0.2%, a large deceleration compared to earlier in the year. The core CPI figure is expected to remain steady at 4.8% year-on-year but again the CPI gain is expected to be just 0.2% month-on-month. Should these smaller monthly numbers be confirmed, this will represent the second month in a row where the monthly gains are close to the Fed's 2% inflation target (where a one month-on-month reading of 0.2% annualised would equate to a value of 2.43%). With the market adopting a risk off tone in recent sessions, brought about by several risks re-emerging such as US regional bank funding, sentiment is fairly skittish coming into the important US CPI release. The recent rises in energy commodity prices also cloud the picture somewhat and likely prevent the market from reading too much into the low month-on-month CPI figures given they could quickly reverse if energy prices start providing a tailwind to inflation yet again.

Friday

US equities were unmoved on Thursday after US CPI came in line with market expectations, but the US 30-year Treasury auction struggled. Over in Europe, equities rose more than three-quarters of a percent as the market closed before the later US sell-off. Travel and luxury goods companies did particularly well after China announced that it would be ending its ban on outbound international group tours. The monthly July US CPI print came in line with market expectations but taking the readings to two decimal places there was even better news. Headline CPI expanded by just 0.17% month-on-month with core CPI expanding by just 0.16% over the same period. These very low monthly figures brought headline annual inflation to 3.2% whereas core stayed at 4.7%, reflecting the stickiness of monthly core CPI earlier in the year. The monthly numbers will receive the most attention with both the core and headline readings now near the 2% Fed target for a second month in a row. In terms of contributors to this, airfares were down 8% over the month, building on a similarly sized decline the month

prior. We have a while until the next Fed meeting (the next two-day meeting is due to be held on 19-20 September), therefore there were Fed speakers immediately available to comment on the CPI. San Francisco Fed President Mary Daly welcomed the numbers but said that the monthly reading was 'not a data point that says victory is ours'. In terms of timing of any interest rate cuts, Daly said that she expected those conversations to wait until 2024, pushing back against market hopes for a December 2023 cut. The major bond market news came with the 30-year Treasury auction however as strong demand failed to materialise, causing the bonds to be issued at 4.189%, this then catalysed further concern over the sheer size of the US deficit and its linked funding needs. In terms of what it means for markets, stripping out some of the more volatile disinflationary contributors, such as airfares, we still see a stickier inflation backdrop in the US. That said, these volatile components can be lead indicators of wider moves within the inflation basket, just as we saw in 2021 and 2022 when inflation was on its ascendency. The bottom-line takeaway for investors is a positive one to end this week's investment commentary – that the overall US CPI reading will support the case for a pause in US interest rates when the Federal Reserve meet in September.

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