

The Fed adjusts its focus, but the rate outlook remains blurry

Thomas Garretson, CFA – Minneapolis

The Fed keeps playing down upside risks to inflation, but did it just start playing up downside risks to labor markets? Ahead of key jobs data, how sensitive might the Fed be to any labor market weakness?

For the sixth meeting in a row, the Federal Reserve held interest rates steady at a 5.25 percent to 5.50 percent target range, as expected by all analysts surveyed by Bloomberg. Given recent economic and inflation data, markets have known—and priced—the reality that near-term rate cuts are off the table for the Fed. All markets wanted answered at this meeting was whether rate hikes were back on it.

Though markets at no point this year have taken seriously the idea that the next move by the Fed could be a rate hike, (most implied probabilities based on market pricing have been less than five percent), it has been a lingering risk and a key source of recent fixed income, equity, and currency market volatility.

While Fed Chair Jerome Powell stopped short of explicitly refusing to hike rates again, simply characterizing such a move as “unlikely,” his comments were arguably more dovish than broadly anticipated with the key takeaway that the Fed still looks to be walking down the path toward rate cuts and remains likely to reach that point sometime this year.

If there was one paragraph from Powell’s prepared remarks that caught our attention, and was newly added from the March meeting, it was this:

*“We have stated that we do not expect it will be appropriate to reduce the target range for the federal funds rate until we have gained greater confidence that inflation is moving sustainably toward two percent. So far this year, the data have not given us that greater confidence. In particular, and as I noted earlier, readings on inflation have come in above expectations. It is likely that gaining such greater confidence will take longer than previously expected. We are prepared to maintain the current target range for the federal funds rate for as long as appropriate. **We are also prepared to respond to an unexpected weakening in the labor market.**”*

The addition of that language wasn’t surprising—we expected the Fed would need to acknowledge recent elevated inflation data and that it had likely delayed any prospects for near-term rate cuts. The Fed certainly remains attentive to inflation and related risks. But as the first chart shows, markets and traders—which have had a better track record than economists in recent years—continue to price the idea that the recent inflation uptick should ultimately be modest and short-lived.

But the last sentence of Powell’s statement is a bit curious. Instead of adding a final sentence that was prepared to respond if inflation continues to move higher, the focus was immediately shifted to potentially responding to

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

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Priced (in USD) as of 5/1/24 market close (unless otherwise stated). Produced: 5/2/24 17:20 ET; Disseminated: 5/2/24 17:25 ET

a weaker labor market. Perhaps it was little more than stating the obvious, but why even add it at all?

Balance of risks

On the surface, it suggests that the bias remains toward easing policy at the Fed, and that it is still aiming to achieve a soft economic landing. Put differently, higher inflation won't mean higher rates, but lower employment will mean lower rates.

But with the latest jobs report for April scheduled to be released May 3, the timing is at a minimum somewhat curious. We certainly don't think there's any actual signal there, Powell has stated in the past that he receives key economic data along with everyone else, but it does speak to the broader concerns about the labor market that have been percolating over the past year.

To be sure, the jobs report is expected to show yet another strong month of employment gains. RBC Capital Markets is looking for nonfarm payrolls to rise by 267,000 and for the unemployment rate to hold flat at 3.8 percent. But that 3.8 percent has been trending higher since the 3.4 percent low in April 2023. Labor markets rarely deteriorate sharply, typically it's a slow turn that eventually builds on itself.

So, has the labor market turned? One metric we tend to track closely is the hiring plans index from the monthly NFIB Small Business Jobs Report. As the second chart shows, it has a strong correlation with the unemployment rate. In April, the percentage of small businesses planning to hire was just 12 percent, with an average of 16 percent over the past year. Both are the lowest levels since the depths of the pandemic, and at levels consistent with past recessions, while being consistent with an unemployment rate north of four percent.

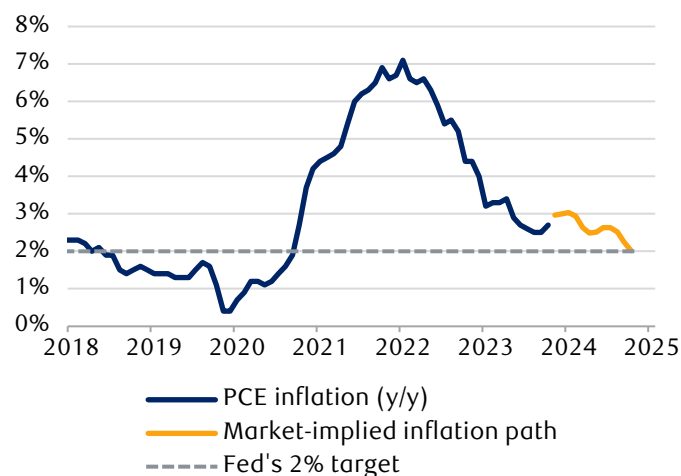
Like many economic indicators that have been distorted in a post-pandemic world, it could just be normalization. Hiring plans reached a record high in 2021, so the recent decline could be little more than a normalization, simply reflecting that labor markets are tight and there just isn't much hiring left to be done. But it has now marked a sustained change in trend, and certainly bears watching.

We know where the ceiling is, where's the floor?

Even though the Fed has left short-term rates steady since last July, longer-term Treasury yields have once again run higher, renewing fears about how high yields can go. Since the start of the year, the benchmark 10-year Treasury yield has risen by about 70 basis points to 4.60 percent, having peaked at 4.70 percent in April, though that remains below the 2023 high of five percent. Mortgage rates—which are more sensitive to the 10-year than the Fed's policy rate—have risen in kind to about 7.50 percent from 6.90 percent. In some sense, markets are doing the Fed's job for it, another reason policymakers can afford to be patient still, and why the Fed might not have to raise policy rates.

But with the Fed downplaying the possibility of further rate hikes, and with markets still pricing in a modest three rate

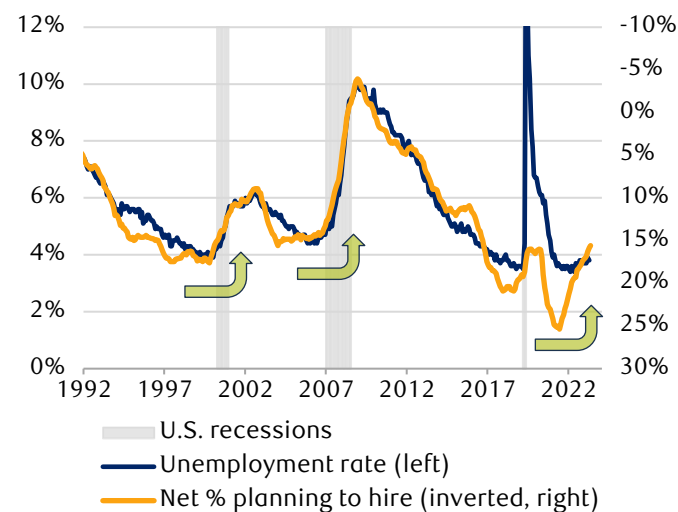
Market pricing shows expectation that inflation progress will stall, but only temporarily



Source - RBC Wealth Management, Bloomberg; market-implied inflation path based on CPI swaps; 45 basis points subtracted from Consumer Price Index (CPI) to estimate PCE inflation equivalent

With fewer small businesses planning to hire, is labor market weakness ahead?

U.S. small business hiring plans



Source - RBC Wealth Management, Bloomberg, National Federation of Independent Business; shows one-year rolling average of businesses reporting intent to hire

cuts over the next 12 months, we think investors can begin to stop worrying about higher rates. In our view, Treasury yields could now level out around current levels. That said, absent a material deterioration, the floor likely remains above four percent for the 10-year Treasury yield this year.

Fed-related risk isn't off the radar for markets even if rate cuts aren't on the horizon—each major economic data point will continue to drive cut timing expectations—but with ever-growing evidence that the Fed is truly on hold, and that any move will still likely be lower, fixed income investors should stay focused on locking in yields, and for gradually longer terms.

UNITED STATES

Tyler Frawley, CFA – Minneapolis

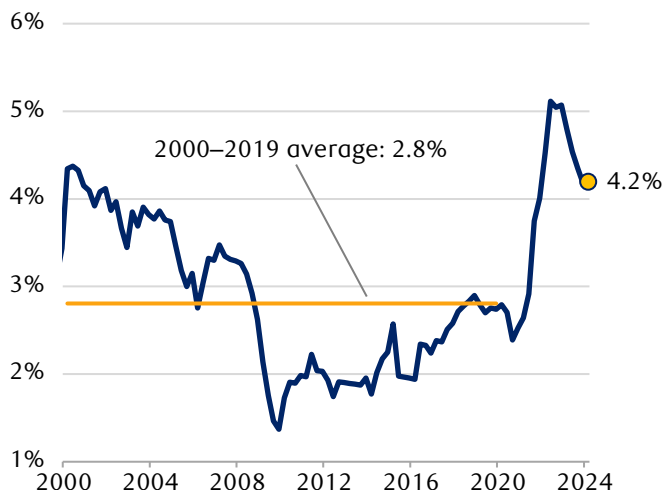
■ **U.S. equities are lower on the week following the Federal Reserve's decision to keep interest rates flat**—a move that had been widely anticipated by the market. The Dow Jones Industrial Average has been the best relative performer, falling 0.46%. The S&P 500 has outperformed the Nasdaq Composite, but both are lower, down 1.21% and 1.35%, respectively. Sector leadership is evident in Utilities, which has returned 2.35%, while Energy has lagged the most, falling 3.37%.

■ **Americans saw their wages and benefits grow more than expected in Q1 2024.** According to the U.S. Bureau of Labor Statistics' Employment Cost Index report, compensation for U.S. workers rose 4.2% y/y in Q1—above economists' expectations of 4.0% and well above the longer-term average of 2.8% from the beginning of the 2000s through 2019, just before the pandemic. This marks the second consecutive quarter of 4.2% readings, following four consecutive quarters of declines. **This stubbornly elevated compensation growth will likely add to concerns at the Fed that inflation may remain elevated in the coming months**, because the pace of worker compensation increases plays an important role in overall costs for companies. If employee wages continue to rise faster than anticipated, companies may decide to increase prices to compensate—which we think can lead to a vicious cycle of inflation that is difficult to break. Ultimately, we believe the report will likely stoke fears within the market that the Fed will have to put off rate cuts even longer than currently anticipated to get inflation under control.

■ **Consumer confidence dropped to its lowest levels since July 2022** as worries about elevated inflation and emerging concerns for the health of the labor market

Employment costs remained elevated in Q1 2024

Compensation costs for U.S. workers, year-over-year change



Source - U.S. Bureau of Labor Statistics, FactSet; data as of 5/2/24

weighed on sentiment. The Consumer Confidence Index fell to 97.0 in April, below economists' expectations of 104.0 and significantly lower than the 103.1 level that was seen in March. While elevated food and gas prices continue to be of concern, **it was fresh worries about the health of the labor market that caught investors' attention.** Most notably, the share of Consumer Confidence Survey respondents who said they expect more jobs to be available in the next six months fell to its lowest level since 2011—a potentially worrisome sign for the future of consumer spending.

CANADA

Matt Altro, CFA & Richard Tan, CFA – Toronto

■ **Interest rate expectations have remained fluid, with the bond market now calling for the Bank of Canada to deliver its first 25 basis points rate cut in July compared to the Federal Reserve in November.** This has caused the U.S. dollar to strengthen by approximately 4% year to date against the Canadian dollar. Recall that the U.S. is Canada's largest trading partner, and a stronger U.S. dollar would make it more costly to import goods into Canada. Additionally, sluggish economic growth likely hinders the ability of businesses to pass on higher import costs through price hikes, according to RBC Economics. Conversely, Canadian companies with U.S. operations should have some relative offsets once U.S. earnings are translated into Canadian dollars. In general, we believe the Canadian sectors that should benefit from a stronger U.S. dollar include Information Technology, Financials, Industrials, Energy, and Materials.

■ **The major oil benchmarks most in focus for North American investors are Brent, West Texas Intermediate (WTI), and Western Canadian Select (WCS).** These three benchmarks trade at different prices, based on location of production, access to transportation, and the quality of the oil. Brent and WTI are light (lower viscosity) and sweet (lower sulfur), allowing for easier refining into end products, but due to WTI's landlocked nature, it trades at a discount to Brent. WCS has suffered its own transportation-related discount that has been exacerbated by a lack of pipeline capacity out of Western Canada while its heavy (higher viscosity) and sour (higher sulfur) nature complicate the refining process and result in a quality discount to WTI. That said, with the Trans Mountain Pipeline Expansion (TMX) having gone into service on May 1, 2024, the WCS-WTI spread has begun to narrow to approximately US\$12.50/barrel compared to its long-term average of about US\$16/barrel as oil produced in Alberta can now reach a broader market via a tidewater port in British Columbia. This discount may continue to narrow as the TMX reaches full operational capacity, according to RBC Capital Markets.

EUROPE

Frédérique Carrier & Thomas McGarrity, CFA – London

■ **Before the Continent shut down for the May 1 Labour Day celebrations, data showed growth surprised to the upside while inflation made slight progress.**

■ **The euro area economy expanded 0.3% q/q in Q1 2024, after two 0.1% q/q contractions, one each in Q3 and Q4 2023, and ahead of the Bloomberg consensus estimate of 0.1% q/q growth.** This encouraging performance as well as the recent economic activity indicators suggest to us that a recovery is already underway, led by the services sector.

■ **Meanwhile, headline inflation was unchanged in March at 2.4% y/y, and core inflation fell to 2.7% y/y from 2.9% y/y in February, slightly less progress than the consensus projection.**

■ **We continue to expect the European Central Bank (ECB) to cut interest rates next month though it is likely to proceed cautiously after that, with potentially only one cut before year-end.** Historically, the ECB has synchronized its rate cycles with those of the Fed, the only exception being region-specific issues arising such as 2012's sovereign debt crisis. According to RBC Capital Markets, a more sustained rate-cut cycle in Europe would require not only inflation to continue to move to target but also the Fed to embark on its rate-cutting cycle. The length, depth, and durability of the ECB's rate-cutting cycle ultimately depend on the strength of the U.S. economy and Fed actions, in the ECB's view.

■ **Novo Nordisk, Europe's largest company by market capitalization, reported that sales and operating profit grew 24% y/y and 30% y/y, respectively, at constant exchange rates in Q1, driven by increased demand for its GLP-1-based diabetes and obesity treatments.** The company noted that demand for its new obesity drug Wegovy continues to exceed supply. Novo Nordisk continues to expect to gradually improve supply, with the company highlighting that the number of new patient starts for the drug has quadrupled since December 2023 to 20,000.

ASIA PACIFIC

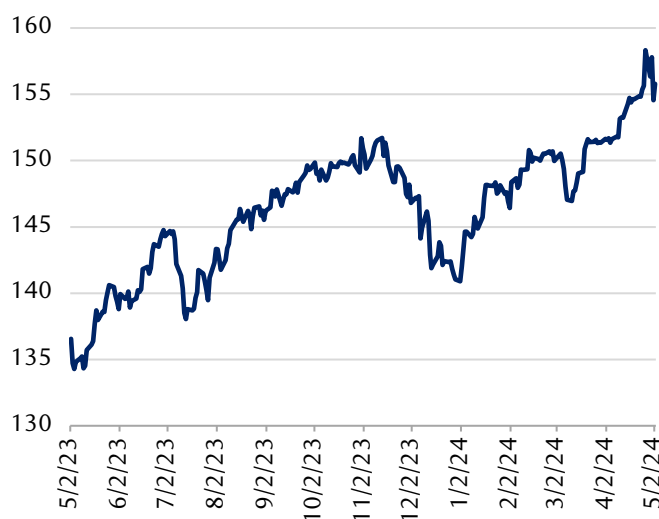
Nicholas Gwee, CFA – Singapore

■ **The Asia Pacific equity market traded broadly higher during a holiday-shortened week.** The MSCI AC Asia Pacific Index is currently up nearly 5% from its April low and up 3.30% year to date (as of May 1), **narrowing the relative performance gap with developed markets** (MSCI World Index: +4.65% year to date).

■ **The Japanese yen is seeing volatile trading this week.** On Monday, the yen slipped to a 34-year low of 160.17

Japanese yen volatile during the week

USD/JPY exchange rate



Source - RBC Wealth Management, Bloomberg; daily data through 5/2/24

against the U.S. dollar before quickly rebounding by almost 3% to end the day around 156.35. Traders have been on alert for many weeks as the yen fell to multiyear lows and Japanese officials ratcheted up their rhetoric around the pace of the currency's slide. **While officials declined to comment on any intervention on Monday, Bloomberg analysis of Bank of Japan (BoJ) current account data suggests that Japan probably spent about ¥5.5 trillion (\$35.06 billion) to support the currency.**

Another yen surge on Thursday morning suggests authorities may have intervened in the currency market for a second time this week. The yen gained more than 3% and hit 153.04 per dollar as more than \$4 billion of yen-related futures were exchanged in the final stretch of the U.S. trading session. Japan's top currency official, Masato Kanda, said he had nothing to say on whether Japan intervened when asked by Bloomberg in the aftermath of the move. Observers believe any attempts by the government to support the yen while not acknowledging intervention in the currency market should deter traders from taking short positions in the currency (i.e., a trade in anticipation that the yen will fall further). While we think a strategy of BoJ intervention may work in the short term, such an approach would likely face an uphill battle in the longer term due to the monetary policy divergence between Japan and the U.S., and given that a relatively healthy risk appetite continues to weigh on the yen.

■ **DBS Group (DBS SP), Singapore's largest bank by assets, reported Q1 2024 earnings that beat consensus expectations,** helped by strong lending and wealth fees. The bank's CEO noted that because the company expects income from these key areas to continue to be robust, total income growth may be 1–2 percentage points above the previous guidance of mid-single-digit growth, and he sees 2024 as another year of record profits.

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	5,018.39	-0.3%	5.2%	20.4%	21.5%
Dow Industrials (DJIA)	37,903.29	0.2%	0.6%	11.3%	14.9%
Nasdaq	15,605.48	-0.3%	4.0%	27.8%	26.5%
Russell 2000	1,980.23	0.3%	-2.3%	11.9%	6.2%
S&P/TSX Comp	21,728.55	0.1%	3.7%	5.4%	4.7%
FTSE All-Share	4,418.60	-0.3%	4.4%	3.1%	5.6%
STOXX Europe 600	504.31	-0.1%	5.3%	8.0%	12.0%
EURO STOXX 50	4,921.22	0.0%	8.8%	12.9%	29.4%
Hang Seng	17,763.03	0.0%	4.2%	-10.7%	-15.8%
Shanghai Comp	3,104.82	0.0%	4.4%	-6.6%	1.9%
Nikkei 225	38,274.05	-0.3%	14.4%	31.4%	42.6%
India Sensex	74,482.78	0.0%	3.1%	21.9%	30.5%
Singapore Straits Times	3,292.69	0.0%	1.6%	0.7%	-1.9%
Brazil Ibovespa	125,924.19	0.0%	-6.2%	20.6%	16.7%
Mexican Bolsa IPC	56,727.98	0.0%	-1.1%	2.9%	10.3%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	4.628%	-5.1	74.9	106.0	169.5
Canada 10-Yr	3.759%	-5.7	64.9	78.7	89.3
UK 10-Yr	4.366%	1.9	82.9	64.7	246.1
Germany 10-Yr	2.584%	0.0	56.0	27.1	164.6
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	5.31%	0.0%	-3.3%	-0.5%	-1.9%
U.S. Investment-Grade Corp	5.73%	0.0%	-2.9%	2.2%	1.7%
U.S. High-Yield Corp	8.11%	0.0%	0.5%	9.1%	10.3%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	2,319.55	1.5%	12.4%	17.0%	22.3%
Silver (spot \$/oz)	26.65	1.4%	12.0%	6.6%	17.0%
Copper (\$/metric ton)	9,892.40	0.0%	16.9%	15.3%	1.2%
Oil (WTI spot/bbl)	81.93	0.0%	14.3%	8.3%	-21.7%
Oil (Brent spot/bbl)	83.52	-4.9%	8.4%	5.3%	-23.6%
Natural Gas (\$/mmBtu)	1.93	-3.0%	-23.2%	-16.7%	-73.3%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	105.6690	-0.5%	4.3%	3.4%	2.6%
CAD/USD	0.7281	0.3%	-3.6%	-1.4%	-6.4%
USD/CAD	1.3734	-0.3%	3.7%	1.4%	6.9%
EUR/USD	1.0713	0.4%	-3.0%	-2.4%	1.6%
GBP/USD	1.2525	0.3%	-1.6%	0.2%	-0.4%
AUD/USD	0.6521	0.7%	-4.3%	-1.6%	-7.6%
USD/JPY	154.7600	-1.9%	9.7%	12.6%	19.3%
EUR/JPY	166.0200	-1.3%	6.6%	10.0%	21.2%
EUR/GBP	0.8554	0.2%	-1.3%	-2.6%	2.0%
EUR/CHF	0.9810	0.0%	5.6%	-0.2%	-4.4%
USD/SGD	1.3602	-0.4%	3.0%	1.8%	-1.7%
USD/CNY	7.2411	0.0%	2.0%	4.8%	9.6%
USD/MXN	16.9855	-0.9%	0.1%	-5.3%	-16.9%
USD/BRL	5.1934	0.0%	6.9%	4.1%	4.5%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.72 means 1 Canadian dollar will buy 0.72 U.S. dollar. CAD/USD -3.6% return means the Canadian dollar fell 3.6% vs. the U.S. dollar year to date. USD/JPY 154.76 means 1 U.S. dollar will buy 154.76 yen. USD/JPY 9.7% return means the U.S. dollar rose 9.7% vs. the yen year to date.

Source - Bloomberg; data as of 5/1/24

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			Count	Percent
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Sell [Underperform]	46	3.15	4	8.70

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