Daily: Fed inflation concerns put US data in focus

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From the studio

Video: Three reasons why we find Japanese equities attractive (6 mins)Video: Big Tech earnings and the sell-off in semis (4 mins)

Thought of the day

Concerns over progress toward reopening the Strait of Hormuz caused a renewed rise in oil prices, rekindling worries that higher inflation will lead to tighter central bank policy. Brent crude rose 3.8% on Thursday to above USD 83 a barrel, and oil prices remained around those levels on Friday. Inflation concerns also helped push the 10-year US Treasury yield to around 4.67%, up around 5 basis points from the middle of the week. The focus will now shift to US economic data, with the release of employment numbers for July on Friday and consumer price inflation next week.

Recent comments from top central bank officials have suggested they remain willing to act if inflation stays above target, and markets are pricing around 34 basis points of tightening by the end of the year, equivalent to a full 25-basis-point increase along with some potential for a further move. Fed Chair Kevin Warsh would be prepared to raise rates at the September meeting if inflation readings released in the coming weeks are hot, the Financial Times reported, citing people familiar with his thinking. The Fed's latest meeting revealed a meaningful hawkish minority, with three officials dissenting from the 9-3 decision to leave rates unchanged.

But while the risks of tighter policy are clear, our base case is that the Fed will remain on hold this year, creating a positive backdrop for quality fixed income.

The US labor market, though resilient, has not been pointing to an overheating that could exacerbate inflation. We still expect moderate slowing in employment, while the continued resilience of the labor market does not give us cause to think consumer spending will fall sharply. The consensus forecast is for job creation of 80,000 in July, up from 57,000 in June, with the jobless rate steady at 4.2%. Average earnings growth is expected to remain unchanged at 3.5%, suggesting no imminent risk of a wage-price spiral. Initial jobless claims also fell to 199,000 last week, their lowest level since January.

Underlying inflation has been moving in the right direction. Oil remains volatile, with renewed increases in energy prices pushing yields higher. Despite this, we do not currently see higher oil prices as a source of sustained underlying inflationary pressure. The consensus forecast is for core inflation to come in at 0.2% for July, up from zero in June and still at a level consistent with the Fed approaching its 2% inflation target. The annual core rate is expected to decline from 2.6% to 2.5%. The July data will be important, but one monthly reading should not determine the policy outlook on its own.

Fed officials are preserving the option to tighten, rather than committing themselves to an increase. Warsh's openness to a September rate rise is conditional. At his press conference following the Fed's July meeting, Warsh said the central bank would "not hesitate to act" where "necessary and appropriate," according to CNBC, but did not commit to a particular course for rates. The Fed's Lisa Cook was similarly conditional, saying in her speech: "If I do not see signs of continued disinflation soon, I am prepared to act." She also voted with the majority to hold rates steady, explaining that she wanted to assess how the various pressures on inflation evolve. The comments confirm that a rate increase is a genuine risk, but one that remains dependent on the data rather than a settled decision. If core inflation continues to moderate and the labor market remains solid without overheating, we believe the Fed will have scope to leave rates unchanged this year.

So, we remain in favor of locking in attractive yields in quality short- and medium-maturity bonds. We believe market pricing for central bank rate increases remains too aggressive. High starting yields provide an attractive source of income and a material cushion against further rate increases before a potential loss is realized. Quality bonds can also help diversify portfolios and have the potential to perform well if slowing economic activity eventually leads markets to reduce their expectations for tighter policy. Inflation, fiscal concerns, and credit deterioration remain important risks, reinforcing our preference for quality and for the short- and medium-maturity parts of the market.

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