With rates likely to start falling this year, the opportunity to lock in near-peak yields on fixed income is unlikely to last indefinitely. (UBS)

Fed remains likely to cut rates despite firmer data and ‘hawkish’ minutes

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US stocks and Treasuries fell in tandem on Thursday. Signs of continued labor market strength and stonger-than-foreseen activity sentiment indicators added to the seemingly hawkish tone of the latest FOMC minutes, prompting investors to scale back expectations around Federal Reserve rate cuts.

US initial claims for state unemployment benefits for the week ending 18 May dropped by 8,000 to 215,000, lower than an expected 220,000 claims and a second weekly decline. And the flash US composite purchasing managers' index for May rose to 54.4, above the expected 51.2 reading and the highest level in more than two years, with the service sector subcomponent up to 54.8 from a prior 51.3.

The S&P 500's 0.7% decline was the index's worst trading session of the month, while the yields on 2-year and 10-year US Treasuries rose 7 and 6 basis points to 4.94% and 4.48%, respectively. By the close of Thursday trading, market-based probabilities of a Septemeber rate cut stood at 56%, compared to 72% on Wednesday. Negative sentiment spilled over into global equity markets on Friday, with Hong Kong's Hang Seng Index 1.5% lower and the Euro Stoxx 600 down 0.8%. But US Treasuries had stabilized at the time of writing, with the 2-year and 10-year yields at 4.92% and 4.47%, respectively.

The stronger US activity and jobs data releases followed Fed minutes out Wednesday that showed “various” officials at the prior meeting would be willing to hike rates further should more inflation risks materialize, and that “many” were uncertain whether current monetary policy was restrictive enough. This appeared more hawkish than Fed Chair Jerome Powell’s remarks after the meeting on 1 May, when he downplayed the need for further rate hikes.

However, it's important to note that the minutes' commentary predates last week's publication of the US consumer price index (CPI) for April, which showed inflation slowing from the trend displayed in the first quarter of 2024. We maintain our base case that the Fed is likely to loosen financial conditions in 2024, with cumulative cuts of 50bps by year end.

The Fed has maintained its patient, data-dependent approach all along. We view the minutes as consistent with the Fed's communications over the past several months that policymakers would like to gain greater confidence that inflation is moving sustainably toward its 2% target. As inflation prints had been stronger than expected for three consecutive months at the time of the meeting, policymakers' focus on inflation risks is unsurprising. But while rate hikes are not excluded, the minutes showed that policymakers continued to expect that inflation would return to 2% over the medium term. Fed officials also acknowledged that deceleration in items such as rents and new leases should drive the decline of housing services prices going forward.

The latest data point to a resumption of US disinflation. In addition to easing price pressures seen in April's inflation readings, there have been other economic data releases showing signs of deceleration for the US economy. In fact, before the publication of April's weaker-than-expected labor report, Fed officials already expected the disinflation trend to resume. According to the minutes, several participants stated that core non-housing services price inflation could resume its decline as wage growth slows further in a better-balanced labor market. Many officials also commented that ongoing increases in productivity growth, if sustained, would likely support disinflation.

So, with rates likely to start falling this year, the opportunity to lock in near-peak yields on fixed income is unlikely to last indefinitely. Strategically, we recommend that investors hold diversified exposure across fixed income to realize the full return potential of the asset class. Tactically, we continue to favor high-quality segments—valuations look fairer compared to the higher-credit-embedded sectors that have outperformed year-to-date. In addition, if global growth slows abruptly, quality bonds would likely rally sharply.

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