CIO's base case remains that the Fed will start cutting rates in June, with a total of three cuts by the end of this year. (UBS)

Labor report adds to Fed's confidence in rate cuts

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US equities fell on Friday after the labor report for February showed an above-consensus increase in nonfarm payrolls, with the S&P 500 ending the week 0.3% lower. The headline pace of job creation of 275,000 was ahead of forecasts of 200,000, and the three-month average of payroll growth remained robust from a historic perspective.

With the benchmark index just off its all-time high, investors may be cautious at the start of the week ahead of Tuesday's release of consumer price index (CPI) data for February.

However, there were some weaker parts of the labor report, which together with recent data and commentary from Federal Reserve officials suggest that rate cuts remain on the way.

The labor market sees further signs of cooling. While payrolls increased more than expected again in February, the numbers for the prior two months were revised lower by a total of 167,000. Average hourly earnings growth moderated, up by just 0.1% month-over-month from 0.5% in January, and below expectations of 0.2%. In addition, the unemployment rate rose to 3.9%, from 3.7% in January, marking the highest level since January 2022. Earlier last week, the Fed's Beige Book stated that "labor market tightness eased further," with businesses reporting better labor availability, and the January Job Openings and Labor Turnover Survey (JOLTS) showed the quits rate remains at the lowest level since August 2020. Overall, this recent series of data suggests the US labor market is becoming less overheated, which helps make the case for the Fed's decision on rate cuts.

Softer inflation after February should provide further confidence for the Fed. The upcoming consumer price index data for February is expected to show another strong monthly increase on rising gasoline prices and a slower decline in used vehicle prices. However, we project declines over the next several months as a softening labor market, slower

economic growth, and moderating shelter inflation should help overall inflation trend lower over time. This should give the Fed the confidence it needs to cut rates this year. Last week, Fed Chair Jerome Powell in his testimony to Congress said that policymakers are "not far" from being convinced that inflation is coming down sustainably to the 2% target. The Beige Book also contained evidence that inflationary pressures are waning, with companies reporting more pushback from consumers on price increases.

Recent Fed comments have been consistent with rate cuts this year. Markets are not going to get additional clues from Fed officials in the next 10 days as the central bank goes into a blackout period ahead of the next FOMC meeting on 19–20 March. But Powell's remarks last week echoed a consistent message from other Fed officials that rate cuts remained on the cards this year. Both Atlanta Fed President Raphael Bostic and Boston Fed President Susan Collins had said the path down to the Fed's inflation goal could be bumpy, while former St. Louis Fed President James Bullard said the February jobs report increased the likelihood that the central bank would make a move soon.

So, our base case remains that the Fed will start cutting rates in June, with a total of three cuts by the end of this year. We think this means that cash should progressively deliver lower returns, creating a risk for investors who do not take advantage of current high yields on quality bonds. We recommend diversifying one's liquidity strategy beyond cash and money market funds, with a combination of fixed term deposits, bond ladders, and structured investment strategies. Attractive yields on quality bonds can also be locked in, as they provide the added benefits of diversification and potential capital gains.

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