RATES: THE TURN OF THE OIL TANKER

Not even September, statistically one of the worst months of the year, managed to resolve the mellifluous contradiction between the exacerbation of geopolitical tensions and the bubbly cheerfulness of financial markets. The global index (MSCI World) grew by 1.8%, the American S&P by 1.5%, while the Nasdaq, which represents tech stocks, rose by 2%. In Europe, where difficulties in undertaking a true growth path are evident, the Eurostoxx50 increased by 1.1%, helped by the index of the economically weakest country, Germany (+2.3%). On the other hand, the Swiss SMI struggled (-2%), a victim of the strength of the franc and the weakness of Nestlé. Toward the end of the month, Asia also gave a boost to the markets: Hong Kong (+17.5%) and China's domestic index of Shanghai and Shenzhen CSI 300 (+21%).

While portfolios are consolidating at high levels, international tensions are escalating. The war in Ukraine shows no signs of stopping, quite the opposite. Zelensky is asking for more powerful weapons and authorization from allies to use them on Russian soil. Putin is announcing a strategic shift, expanding the possibilities that could justify the use of nuclear weapons. The situation in the Middle East is also very tense, given the escalating conflict between Israel and Hezbollah in Lebanon after the disappearance of the Shiite group's leader. Nasrallah's death could further worsen the conflict, with the risk of a broader regional war involving not only Israel and Hezbollah but also other players like Iran and neighboring Arab powers. In the Pacific, dangers are also present: three Chinese warships were spotted near the Japanese coast close to Taiwan, a strategically sensitive area where even small military movements could have far-reaching geopolitical consequences, raising concerns of a possible military escalation.

Geopolitics, as an old economist says, is like an oil tanker in maneuver for financial markets: when it turns, it takes a long time before the external observer perceives the change in direction. So it's better not to spend too much time analyzing it. Yet, signs of significant changes in international power dynamics seem evident. But markets cling to strictly financial dynamics, convinced that they can only grasp those because they carry measurable risk. Everything else falls into the realm of uncertainties and unpredictability. There is a connection between these two spheres of human action, and the markets are likely evaluating it. It is pointless to focus on peripheral realities. Today, the essential thing is to understand how much and how the United States manages to control what is happening both geopolitically, economically and financially, and how China positions itself in this architecture, which is in clear transition.

The decision by the Federal Reserve to cut rates by 0.5% instead of the expected 0.25%, bringing them to 4.75%-5%, gave new life to the markets, which had started the month with cautious profit-taking. In perspective, according to the governors' view (dot plot), there will be a further reduction of 0.5% in 2024 and another percentage point in 2025. Jerome Powell managed to perform a balancing act that pleased the markets: inflation is moving “sustainably toward the target,” while it is now necessary to support “maximum employment” in a context that is not recessionary but one of a soft landing. In other words, the Federal Reserve was good at quickly raising rates, defeating inflation without causing a recession, as has often happened in the past, and as markets feared in August with the employment data.

The American central bank's decision confirms the shift that occurred during the summer when the number of central banks globally loosening monetary policy exceeded those tightening it. Washington’s expected move pulled the European Central Bank (ECB) and the Swiss National Bank (SNB) into its pro-market vortex in the following days. This occurred shortly after the OECD essentially confirmed global economic growth estimates at 3.2% for 2024, reducing them for Europe (+0.7%) while confirming them for China (4.9%) and the United States: 2.6% this year but slowing in 2025 to 1.6% (-0.2% compared to June estimates).

At the end of the month, China decided on a substantial relaunch of its stagnant economy as well as its stock markets, which appreciated by nearly 20% in just a few days. On September 24, the People's Bank of China announced significant monetary stimuli to promote lending in the real estate market, cutting mortgage rates by 0.5%, reducing the interbank rate by 0.2%, and lowering the minimum reserve requirements (-7%) that commercial banks must hold at the central bank. Mao's country also decided to support stock prices with a "stock stabilization fund" aimed at banks and insurers, which, in exchange for collateral, will receive capital to actively intervene in the financial market. However, China's search for independence from the international system remains relative. It's no coincidence that these long-awaited interventions came just days after the Federal Reserve's decision to cut interest rates. The American monetary easing was necessary for action on the Yuan without causing excessive devaluation against the dollar: Chinese authorities want their currency to gain and consolidate credibility through stability. Beijing's move also benefited European stock markets, particularly Germany's, whose companies have strong economic ties with China.

Just as geopolitical tensions are increasing, the Federal Reserve is deciding to give a breath of fresh air not only to its own economy but also to the global one. Of course, this move could be interpreted as a sign of weakness for the United States, but also as a clear manifestation that it is Washington dictating the pace of international flows. On the other hand, Xi Jinping's moves are also ambivalent: he waited for the Federal Reserve's monetary policy shift to act, restraining his economy while showing patience and resilience.

There are no clear elements to define whether Jerome Powell's move was also politically motivated, given that a new U.S. president will be elected in November, at a time when international conflicts are at an acute stage. From an operational finance standpoint, investors have no definitive answer as to why a 0.5% cut was decided immediately.

Since the 1980s, the U.S. has experienced seven interest rate reduction cycles. Some, like those of 1984-1986, 1995-1996, 1998, and 2019, were preventive in nature. During these periods, while economic prospects remained positive, the stock market generally recovered, benefiting from increased liquidity and a "soft landing." The monetary easing of 1989-1992, 2001-2003, 2007-2008, and 2020 involved recessionary cuts: the economy was already slowing down. The stock market then continued to decline in a hard-landing context. It remains to be seen whether this first major Fed cut presupposes preventive or recessionary easing.

Recent U.S. economic data shows that the labor market is showing signs of weakness through unemployment figures, which rose to 4.2% in August, with the Sahm Rule[1] triggered for two consecutive quarters. However, other indicators, such as retail sales and the industrial production index, have continued to reach new highs or remain resilient. Therefore, it cannot be definitively stated that the current rate-cutting cycle is recessionary, but the S&P celebrated a new all-time high following the Fed's decision. If we analyze the geopolitical context alongside the Fed's rate cut and China's moves, there are at least clues that suggest there might be a deliberate effort to provide as much fuel as possible to prepare for the oil tanker's change in direction. Certainly, if China's economy restarts, some inflationary pressure via commodity prices is not out of the question. Artificial intelligence and deflation imported from China, calibrated by tariffs, will define the smoothness of the turn. It's not time to lower the lifeboats. The tanker is turning, and at this stage, the two main helmsmen are watching each other closely and perhaps complementing each other a little.

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[1] See our August Newsletter, 'The party is not over yet but the joys will be volatile', https://www.centrostudimonte.com/en/7/159/commento-ottobre-2024---tassi-la-virata-della-petroliera_r