At a glance: The world right now

Recession risks, rate cut bets, carry trade unwinds. This summer had it all. Here's our look at where the world is as we head into Autumn

The yen carry trade has largely been unwound

July was dominated by the, at times, disorderly unwind of the yen carry trade. At the heart of the story was extreme, one-way positioning in the yen, a hawkish Bank of Japan and some softer US data. The surge in volatility on the back of this undoubtedly added to the broad risk reduction seen into early August, which included a sharp correction in US tech stocks. The 12% peak-to-trough adjustment in USD/JPY now leaves speculative positioning in the yen near flat.

The US jobs market isn't looking too healthy

A particularly weak July jobs report was enough to spark widespread fears about an imminent US recession. The unemployment rate has risen from 3.4% to 4.3% in little over a year, which is above the 4% rate the Fed predicted for the end of the year. This has in turn triggered the Sahm rule, a momentum measure of changes in the unemployment rate that has historically been consistent with recession.

On top of that, the Bureau of Labor Statistics has adjusted its figures, removing a third of the jobs previously believed to have been added in the 12 months leading up to March 2024. This revision, stemming from incorrect assumptions about job creation in small businesses, raises serious questions about whether the slowdown in job creation since April has been worse than reported. We think the unemployment rate will be closer to 5% than 4% at the end of this year.

The Fed has opened the door to big rate cuts

Fed chair Jerome Powell used his speech at the Jackson Hole symposium to tell us that the “time has come” to cut interest rates. He also said he didn’t welcome further weakness in the jobs market and did little to dispel lingering expectations of a 50 basis point cut at the September meeting.

A 25bp move on 18 September is slightly favoured by markets right now, but if we get a sub-100k on payrolls and the unemployment rate ticks up to 4.4% or even 4.5%, then 50bp looks likely.

An Olympics boost is masking sluggish economic growth in the eurozone

The combined impact of the Paris Olympics, and a strong tourist season in Spain/Italy, has helped lift service-sector sentiment in the eurozone. But it would be premature to label this as the start of an acceleration of growth. Manufacturing remains weak and is likely to stay that way while US growth is slowing and domestic demand in China remains under pressure.

Consumers are enjoying positive real wage growth, but increasing wariness about job security might simply push up the savings ratio rather than spending. We expect the eurozone economy to continue to grow, but at a slower pace.

The ECB is treading more cautiously than the Fed

The ECB is finally rallying around a September rate cut but appears more cautious than the Federal Reserve in endorsing further easing. Headline wage growth is slowing, but partly due to base effects from last year’s inflation compensation schemes.

Big union demands in Germany are also a reminder that the direction for pay remains an uncertainty for the ECB. We therefore expect gradual cuts in September and December, but a weaker growth outlook suggests the ECB can step up the pace thereafter.

The Bank of England is moving slowly – for now

Not for the first time in recent years, investors are thinking that the Bank of England will take a more hawkish path than the Federal Reserve. That follows very strong growth in the first half of the year, ongoing stickiness in services inflation, and a more hawkish tone from BoE officials. That means August’s BoE rate cut is unlikely to be followed by another later this month. We expect the next cut in November, but like the ECB we think the pace of cuts will accelerate as it becomes clearer that inflation “persistence” is reducing.

Momentum in China’s economy has continued to slow

After a surprisingly strong performance in the first half of the year, China’s manufacturing sector seems to be slowing down. This is partly due to a significant decline in auto production, which risks turning this sector from a supportive tailwind into a challenging headwind for the broader economy in the near future.

Meanwhile, a negative wealth effect and low wage growth continue to suppress consumption. This will make it challenging for China to hit its 5% growth target this year. We will need to see continued policy rollout to reverse the momentum, particularly as base effects turn less supportive for growth in the second half of the year.

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