Weekly economics podcast: Market Drivers October

By Perpetual Corporate Trust

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Risk assets mostly rose strongly again in October assisted by the US Federal Reserve's second rate cut this year and even though it came with a rider that it is uncertain when the next rate change will come. Markets remained unphased by the lengthy US government shutdown. Limited US economic data available during October indicated an economy growing around trend, but with inflation still above the Federal Reserve's target. Inflation running above central banks' targets and threatening to re-accelerate is looming as a problem for some countries, including Australia and the United. The phase of interest rate cutting by central banks appears to be drawing to a close, albeit erratically.

Share markets were mostly stronger in October. US share markets again made repeated record highs in the month driven by the AI thematic but assisted by the Federal Reserve's back-to-back 25bps rate cuts at its September and October policy meetings taking the Funds Rate down to 4.00%. The US S&P 500 rose by 2.3%. That gain was out-paced by a 3.9% lift in Britain's FTSE 100 and an extraordinary 16.6% lift in Japan's Nikkei. Japan's economy has been improving assisted by economic reforms over recent years. The recent run of share-market gains in China faltered in October with the Shanghai CSI flat for the month and Hong Kong's Hang Seng down by 3.5%. Australia's ASX 200 was up 0.4% in October. Stronger gains earlier in the month were tempered by a high Q3 CPI result eliminating hope of a November rate cut by the RBA.

Credit markets were a little softer in October with spreads drifting out from previously near-record tight levels compared with government bond yields. The Australian credit market, even on low spreads, continues to look relatively safer than the US market. Australian households remain in a strong position to meet their debt servicing, even though debt levels are high. Rising household disposable income, helped by rising real wages, falling mortgage interest rates and lower income tax through 2024-25 are enabling households to meet their high debt servicing requirements, although these positive factors are beginning to be tempered by a slightly higher unemployment rate

Government bond yields ended October little changed. In Australia, a rise in the unemployment rate to a 4-year high of 4.5% excited hopes of a November RBA cash rate cut promoting a mid-month bond market rally. Those hopes were dashed late in the month by the Q3 CPI result, +1.3% q-o-q, +3.2% y-o-y, much higher than expected and heralding the possibility of the cash rate staying on hold at 3.60% for a prolonged period. The 2-year government bond yield rose in October by 7 basis points (bps) to 3.55%, while the 10-year bond yield was unchanged at 4.29%.

The RBA meets tomorrow, Melbourne Cup Day, and will weigh the data over the past six weeks. It will also be informed by the latest RBA economic forecasts contained in the November Monetary Policy Statement. The past data show the unemployment rate up, but also inflation higher than forecast and relatively broad-based. The November MPS economic forecasts will show upward revision to inflation forecasts through to end 2026, but the possibility of steady to downward revision to inflation forecasts in 2027. Higher unemployment rate forecasts through 2026 are the reason why the RBA can still forecast mid 2-3% target range inflation in 2027. The combination of the mixed data and revised forecasts give cause for the RBA to hold the cash rate at 3.60% tomorrow and indicate an extended pause running through much of next year.

In the United States, the Federal Reserve used softer labour market conditions to justify cutting the Federal Funds Rate in both September and October. Inflation remains quite sticky in the US with annual CPI inflation rising to 3.0% y-o-y in September from 2.9% in August and the core CPI edging down to 3.0% y-o-y in September from 3.1% in August. Much of the upward pressure on US inflation from tariff changes still lies ahead. Also, demand in the US economy was rising and quite strongly until the government shutdown limited data readings. It seems that the Federal Reserve has little room to cut the Funds rate much further.

In October, the 2-year US bond yield fell by 4bps to 3.57% while the 10-year bond yield fell by 7bps to 4.08%. Both yield reductions in October were small relative to the 25bps cut in the Funds Rate. The US government bond market is getting warier of building in future Federal Reserve interest rate cuts.

Stubborn inflation in the US and in Australia are reducing the likelihood of future official interest rate cuts. Instead, a long period of no change in official interest rates is in prospect and that could be ahead of a rate hiking rather than a rate cutting phase, critically dependent upon how inflation and labour market readings pan out in the closing two months of 2025 and the first half of 2026. We see government bond yields more likely to rise than fall during this difficult period facing the Federal Reserve in the US and the RBA at home.

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