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Wealth Management Chief Investment Office
15 June 2023

Market Watch

A hawkish pause?

Summary

- The US Federal Reserve **paused its second-steepest rate hiking cycle**, as expected. While it assesses the impact of the past hikes, it also signalled another 50bps of further rate hikes to 5.50-5.75% by end-2023.
- The **US S&P500 stock index initially fell** and bond yields and the USD rose after the Fed's new projections showed higher rates, but markets subsequently pared back those moves, with **the S&P500 closing the day little changed**.
- **In our core scenario, the Fed stays on hold in Q3,** before starting to cut rates by Q4 this year as growth slows and inflation cools. However, **any easing of financial conditions,** such as through the ongoing rally in risk assets, **or continued resilience in the job market and core inflation, would raise the risk of further hikes.**
- **As such, we remain defensive in our foundation asset allocation:** Overweight high quality government bonds and gold, Underweight high yielding bonds and equities.

Background

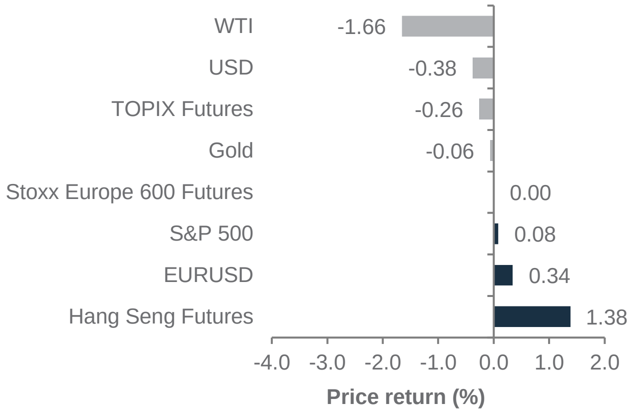
The Fed delivered what the market (and we) expected – a rates pause after delivering 500bps of hikes since March last year to take the benchmark rate to a 15-year high of 5.25% in May. Since monetary policy works with long lags, a pause here makes sense, especially with headline inflation having fallen sharply from last year's peak and leading economic indicators pointing to continued deterioration in economic activity.

Nevertheless, the Fed was understandably cautious in signalling an end to the rate hiking cycle, especially with core inflation stagnating at more than twice its 2% target, the job market still generating more jobs than what is required to keep wage pressures from building and risk assets rallying in recent months on expectations a recession will likely be averted.

Chair Powell, at his press conference, acknowledged the resilience in economic data so far in explaining why rates are expected to go higher than previous projections. The Fed's new projections upgraded 2023 growth estimates to 1% from 0.4%, core PCE inflation to 3.9% from 3.6% and lowered the unemployment rate estimates to 4.1% from 4.5%.

Major asset classes, including the S&P500 index, were little changed after the Fed's decision to pause rates; the weaker USD suggests markets are sceptical the Fed will be able to deliver two more rate hikes as projected

Change in key asset prices on 14 June 2023*



Source: Bloomberg, Standard Chartered; *except for Stoxx Europe 600 and Hang Seng Futures which show 1-day change as of 15 June 2023

The Fed raised end-2023 rate projections by 50bps, upgraded growth and core inflation forecasts and cut unemployment rate estimates for 2023

The Fed's latest projections vs. March estimates

	GDP		Unemploy-ment		Core PCE		Rates estimates	
Dates	**Old**	**New**	**Old**	**New**	**Old**	**New**	**Old**	**New**
2023	0.4	1.0	4.5	4,1	3.6	3.9	5.1	5.6
2024	1.2	1.1	4.6	4.5	2.6	2.6	4.3	4.6
2025	1.9	1.8	4.6	4.5	2.1	2.2	3.1	3.4
LR*	1.8	1.8	4.0	4.0			2.5	2.5

Source: Bloomberg, Standard Chartered; Old – March estimates; New – June estimates; *Longer run estimates

Further tightening ahead?

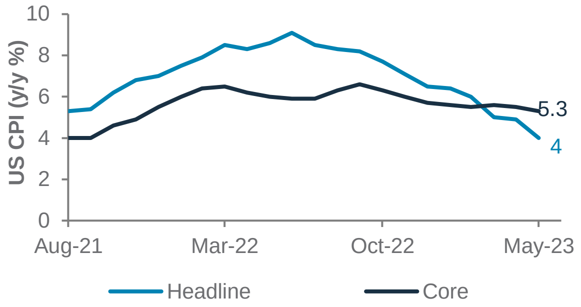
Policy working with lags. Monetary policy works with long lags, with inflation historically peaking almost two years after the Fed starts on its rate hiking cycle. However, this has been the second-steepest Fed rate hiking cycle in history. Hence, the hikes should typically deliver a sizable shock to the economy over a shorter period compared with the past. The Fed's key challenge is assessing the timing of the lagged impact.

Leaving the option open for hikes. Against this backdrop, we see the Fed's rate pause as creating some space for it to assess incoming data before signalling an end to the hiking cycle. As such, we see the Fed's latest projections of another 50bps of rate hikes to 5.75% by the end of the year more as an optionality, rather than a definitive view that rates need to go higher to cool the economy and bring inflation back to its target

Caution against further easing of financial conditions. By signalling higher terminal rate, the Fed is potentially implying that it stands ready to turn policy even more restrictive should risk assets continue to rally and ease financial conditions further. As such, the Fed, like the central banks of Australia and Canada recently (which delivered surprise rate hikes this month), is reiterating that it remains focussed on bringing inflation back to its 2% target.

Although US headline inflation has fallen steadily, core inflation remains resilient and well above the Fed's 2% target; this explains the Fed's reluctance to decisively signal an end to its rate hiking cyle

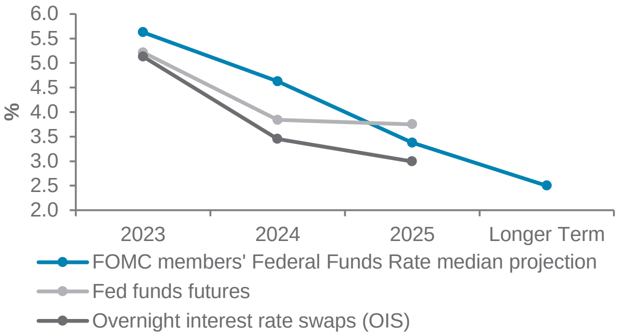
US headline and core consumer inflation



Source: Bloomberg, Standard Chartered

Money markets remain sceptical the Fed will be able to deliver the 50bps of further rate hikes it has projected in its June estimates

Money market estimates of Fed rates over the next two years vs. Fed's new rate projections



Source: Bloomberg, Standard Chartered

Asset class implications – Fade the rally

- We remain sceptical of the two key macro factors driving the recent rally in risk assets: "immaculate disinflation", wherein inflation falls sharply without significant economic downturn, and central banks softening in the fight against inflation. The Fed's hawkish pause suggests policymakers remain resolute on bringing inflation back to target.
- As such, we see the recent rally in risk assets facing headwinds from weakening fundamentals and resolute monetary policy. We view this as **an opportunity to rotate to our preferred areas**: Developed Market government bonds and predominantly investment grade Asia USD corporate bonds. The **S&P500** index, after having broken higher this month, **faces resistance 4% higher at 4,548.**
- **We believe bond yields have peaked**, especially yields on longer-maturity bonds, as higher-for-longer benchmark rates are likely to slow the economy decisively, raising the risk of a recession over the next 12 months.
- **The USD's weakness after the Fed's hawkish pause** suggests the market too is not convinced that the Fed will be able deliver two more rate hikes as projected, as the economy slows in the coming months. A hawkish ECB policy meeting tonight could drive EUR/USD towards 1.09.

— **Rajat Bhattacharya**
Senior Investment Strategist

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