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Wealth Management Chief Investment Office
13 June 2022

Market Watch

An ugly inflation report

Summary

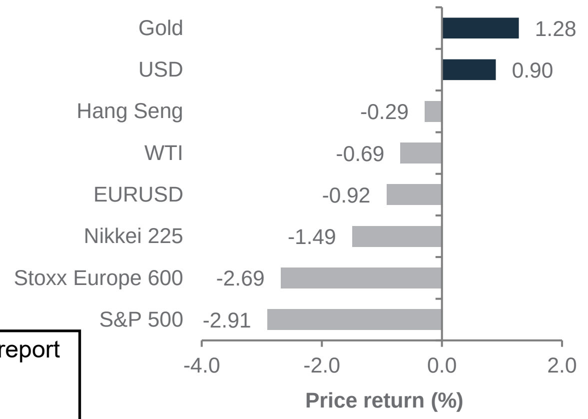
US stocks fell sharply after higher-than-expected inflation. The S&P500 fell 2.9% and Nasdaq fell 3.5%. The USD rose alongside a rise in bond yields.

Fed Chair Powell's comments after the June policy meeting this week is the next key event to watch.

We continue to see opportunities in Asian, sector and income assets, supporting by valuations, Chinese policies and the rise in bond yields.

Friday's weakness was led by US and Europe equities, while Gold and the USD rallied

1-day price return (%) on June 10



Source: Bloomberg, Standard Chartered

An ugly inflation report

Background

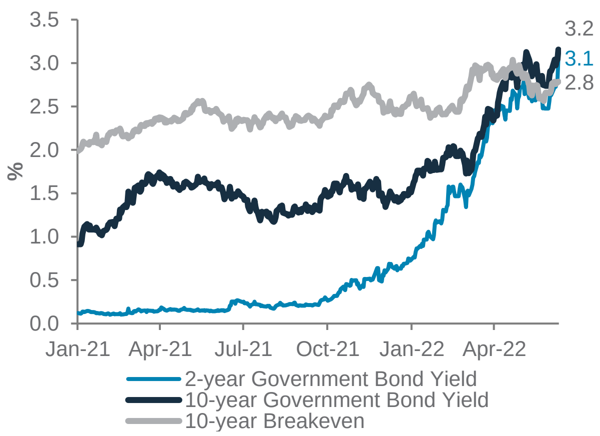
US equities posted their worst week since January after inflation failed to peak. The steeper-than-expected increase in US consumer prices in May raised fears of a more aggressive Fed hiking cycle by the Fed than is currently priced. The S&P500 and Nasdaq indices fell 2.9% and 3.5% respectively, with growth stocks – whose valuations rely disproportionately on cash flows far in the future – leading the decline. In Europe, the Stoxx 600 extended losses following the ECB's signalling of a policy rate lift-off. US and Euro-area (German Bunds) bonds tumbled, sending 10-year yields higher by 11bps and 9bps respectively. Gold rallied on risk-off sentiment while the USD climbed on higher rates.

The US May inflation report showed larger-than-expected rise across most categories. Headline CPI increased to 8.6% when consensus was expecting it to stay flat at 8.3%; core CPI moderated to 6.0% y/y but was still slightly higher than forecast (5.9%). Energy and food inflation were the main drivers of the headline inflation number while services inflation contributed to the increase of the core index, which excludes food and fuel. The broad-based advance increased concerns of faster and larger Fed rate hikes, with the markets now pricing in 3.06% rate (vs 2.78% before the inflation release) by end-2022.

The ECB's signal of a start to policy rate rises was likely an additional factor pressuring equities on Friday. The central bank confirmed that the net asset purchases would conclude at the end of the month and a 25bps rate hike increase would follow at the July meeting. They added that "a large increment will be appropriate at the September

US long-term inflation expectations crept higher, putting upward pressure on government bond yields; this arguably creates an opportunity in diversified income assets

US 10-year inflation expectations*, US 2-year & 10-year government bond yield (%)



Source: Bloomberg, Standard Chartered

*Based on inflation-protected government bonds meeting" if the inflation outlook "persists", opening the possibility of a 50bps increase. The ECB also cut growth and raised inflation forecasts for 2022 and 2023.

What does this mean for investors?

Lack of inflation peak refocuses attention on risks of a renewed rise in Fed rate expectations. The early signs of a top in inflation in April turned out to be a head fake, with inflation proving to be stickier than expected. This arguably makes the Fed's balancing act between inflation and growth tougher. Based on Fed fund futures, markets expect the Fed to stick to a 50bps rate hike this week and in July, as was previously priced. However, the lack of a peak in inflation makes Powell's press conference at this week's policy rate meeting crucial to get a sense of whether they see the need to further tighten the market's policy rate expectations, or not.

Markets are likely to remain sensitive to any further shifts in Fed policy rate expectations. This is especially so for sectors like technology which tend to be more sensitive to changes in bond yields in the short term. We would argue that a fairly aggressive rate hiking cycle is already priced in the US, especially after Friday's move. However, we acknowledge the focus is likely to return to upcoming Fed policymaker comments, especially if energy prices continue to rise or if supply chain disruptions intensify.

Asia ex-Japan equities, financial and energy sectors offer diversification opportunities. As we highlighted in the Weekly Market View (*Stars aligning for Asia, 10 June 2022*), Asia ex-Japan equities as well as Asia USD bonds offer an opportunity to diversify away from a US-centric view of markets alone, given their higher correlation to the Chinese policy cycle as well as their attractive valuations relative to their own history and their global peers. Our preferred energy and financials should also offer a route to mitigate the risks from a further repricing higher of Fed rate expectations.

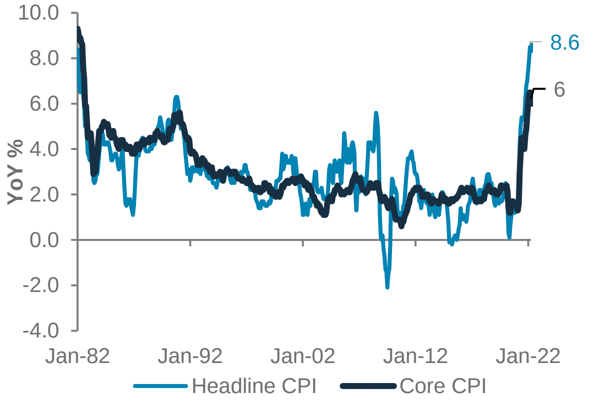
The surge in bond yields re-emphasises the opportunity in income assets. As we highlighted in the *Global Market Outlook (The income opportunity, 3 June 2022),* rising yields have meant the yield on our multi-asset income strategy is increasingly attractive, in our assessment. Current yields are not far from the 2020 sell-off peak and the strategy offers a way to gain exposure to our preferred bonds – Developed Market High Yield bonds, Asia USD bonds, Emerging Markets USD government bonds – but within a well-diversified portfolio that also incorporates high dividend-paying equities and non-core income assets such as REITs.

Technicals: After S&P500 broke the first support at 4,000, we see the next support near previous lows at 3,800. On the upside, 4,000 is the immediate resistance, followed by the 50DMA at 4,198 and 200DMA at 4,440.

— **Zhong Liang Han, CAIA,** *Investment Strategist*

US consumer prices rose to a four-decade high…

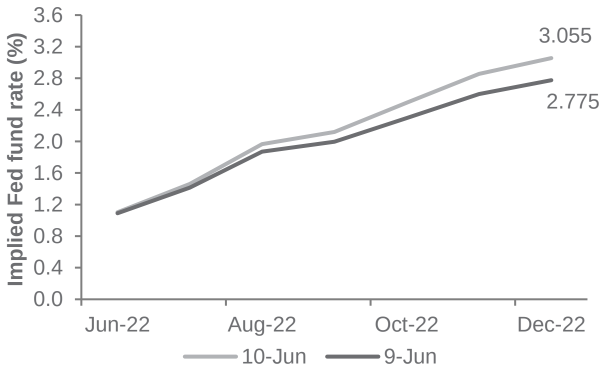
US consumer price index (%y/y)



Source: Bloomberg, Standard Chartered

…which drove markets to raise their Fed rate hike expectations

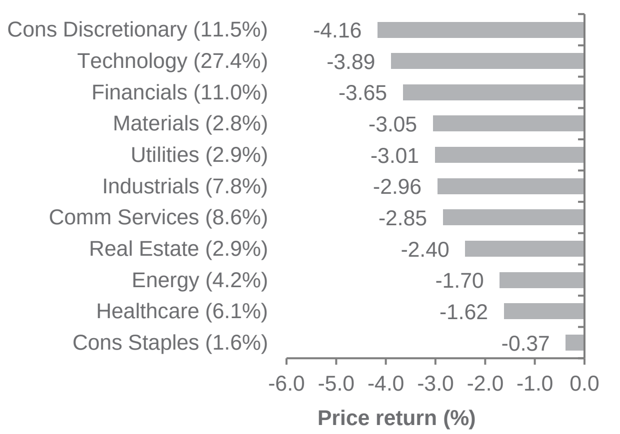
Implied Fed fund curve (%) on June 9 & 10



Source: Bloomberg, Standard Chartered

Rate sensitive sectors like technology and consumer discretionary led the drop in US equities

S&P 500 sectors 1-day price return (%) on June 10*



Source: Bloomberg, Standard Chartered
*Sector weights in index in brackets

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