



Market Watch

Fed hikes, allays rate fears

Summary

The US Federal Reserve delivered a 50bps rate hike as expected but played down market expectations of a more aggressive pace of hikes. Chair Powell said 75bps hikes are not under consideration, although he expects 50bps rate increases at the next couple of meetings to tame inflation.

The S&P500 and Nasdaq 100 indices jumped 3% and 3.4% respectively following Powell's comments. The US 10-year bond yield eased below 2.95% while the USD fell.

The upbeat equity market reaction following Powell's comments suggests investors have largely priced in a hawkish Fed cycle. Concerns about rising rates and increasingly aggressive Fed policy were primary factors behind a slump in stocks and bonds this year.

We continue to see value in beaten-down stocks, especially in the US financial sector, but also more broadly in Asia ex-Japan. Emerging Market and Asia USD bonds are also likely to outperform and the USD to weaken over the next 6-12 months as US rate concerns abate.

Background

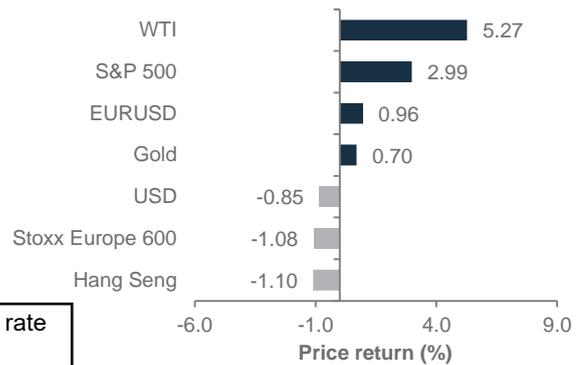
The Fed's rate hike is part of a planned policy 'twin-tightening' to tame inflation. The 50bps rate hike, the biggest increase since 2000, took the Fed's benchmark policy rate to the 0.75-1.0% range. Markets are pricing in another c.200bps of rate hikes by the end of the year.

The Fed also announced plans to reduce its nearly USD 9tn of bond holdings, as expected. From 1 June, it will allow USD 47.5bn of maturing Treasuries and mortgage-backed bonds to roll off the balance sheet each month. After three months, the pace of roll-off will rise to USD 95bn. The pace of balance sheet reduction would then be almost twice the pace seen in the 2017-18 balance sheet tightening cycle.

The policy tightening comes against the backdrop of rising inflation. US consumer price inflation rose to a 40-year high of 8.5% in March on the back of surging commodity prices following the Russia-Ukraine conflict, which added to supply dislocations caused by the pandemic. US 10-year inflation expectations rose to 3%.

US equities jumped, while the USD fell after Fed Chair Powell allayed concerns about a more aggressive pace of policy tightening

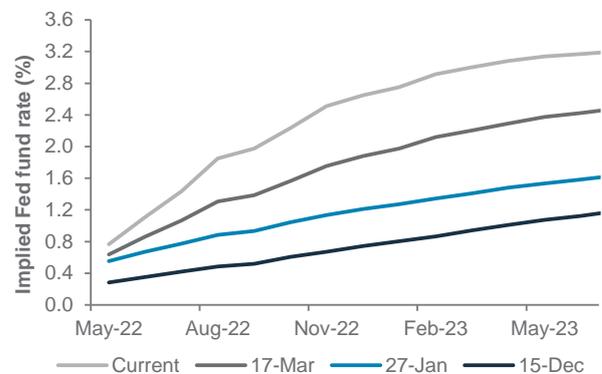
1-day price return (%) on 4 May



Source: Bloomberg, Standard Chartered

Markets are pricing close to 3% – another c.200bps of rate hikes – for the Fed's benchmark rate by year-end

Market expectation of Fed funds rate at end-2022



Source: Bloomberg, Standard Chartered

What does this mean for investors?

A peak in Fed rate hike expectations is likely to trigger equity market revival. US stocks had declined sharply this year, with the technology-sector heavy Nasdaq 100 index entering a bear market earlier this week, partly because of rising concerns that the Fed may have to turn more aggressive to dampen inflation expectations. With the market already pricing another c. 200bps of rate hikes by the end of the year, a hawkish Fed rate cycle has largely been priced in. The US 10-year government bond yield would be a key signal to watch. The yield has failed to sustainably break above 3% and faces significant technical resistance at 3.26%.

Crude oil prices and long-term inflation expectations are key risks to watch. The acceleration in US long-term inflation expectations was the primary trigger for the Fed to turn more hawkish in recent months. Crude oil is a key driver of long-term inflation expectations. Thus, the outcome of the Russia-Ukraine conflict and the impact of Western sanctions on commodity prices are other factors to watch. EU efforts to ban Russian oil are likely to keep oil prices elevated. The OPEC meeting this week could provide signals about whether the bloc plans to boost supplies further. The impact of China's lockdown on global prices is another risk.

US financial sector equities likely to benefit from rising rates environment. The sector bounced on Wednesday following the Fed's rate hike decision and Powell's comments downplaying concerns about a faster pace of policy tightening. The financial sector's net interest margins, and ultimately earnings, are likely to rise on higher interest rates. However, the sector has been beaten down lately on concerns that an aggressive Fed could slow US growth sharply. Powell allayed those fears, pointing out that the US economy remains strong, with a robust job market and healthy household balance sheets. We agree with the assessment, given the near-record levels of job vacancies and household net worth accumulated during the pandemic.

Emerging Market, Asian USD bonds to benefit as US rate outlook, USD peak. With Fed policy tightening largely priced in, we expect the USD to peak in the coming months. A peak in the USD is needed for a sustainable revival of fund flows into Emerging Markets. The beaten-down Asia USD bond market offers significant value, in our view, especially given China's increasingly supportive fiscal and credit policies.

Technical: The Nasdaq 100 index, which saw the brunt of downside pressure due to a hawkish Fed, has support around 13,020, followed by the recent low around 12,731. The long-term bullish trend is not over yet, according to the charts. The USD index (DXY) needs to sustainably break below 99.40 to signal that upward pressure has faded.

— Rajat Bhattacharya, Senior Investment Strategist

US inflation is showing signs of peaking; this should help alleviate the Fed's concerns

US core CPI and core PCE inflation, %m/m



Source: Bloomberg, Standard Chartered

The US 10-year US government bond yield, which has been driven higher by long-term inflation expectations, faces strong resistance around 3%

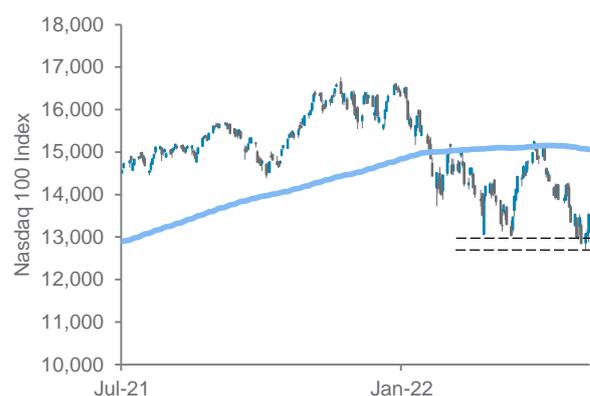
US 10-year US government bond yield and 10-year inflation expectations derived from inflation protected securities



Source: Bloomberg, Standard Chartered

The technology sector-heavy Nasdaq index has technical support around 13,020, followed by the recent low of 12,731

Nasdaq 100 index and technical support levels



Source: Bloomberg, Standard Chartered

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