Market Watch

Fed hints at a slower pace of rate hikes

Summary

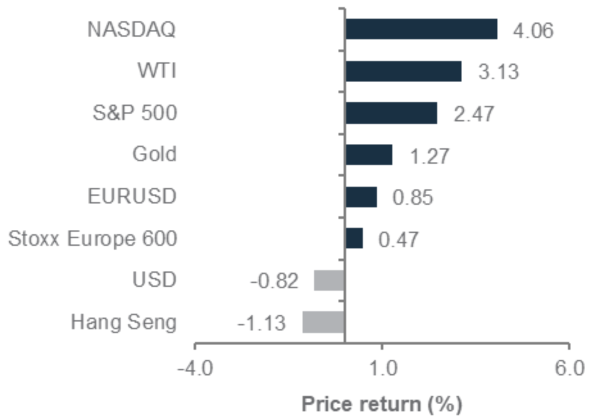
The US Federal Reserve hiked rates by 75bp for the second consecutive meeting and Fed Chair Powell guided that a similar move was possible in September, while downplaying concerns about a recession. He left the door open for a slower pace of hikes if inflation decelerates.

The S&P500 and Nasdaq stock market indices rose 2.6% and 4.2% respectively, while US government bond yields and the USD fell. Weaker USD and lower bond yields pushed gold higher.

The Fed faces a tough balancing act as it raises interest rates, with economic data slowing in recent weeks. The sharp revisions lower in Q2 GDP estimates highlight the risk of a quarterly contraction, implying the US may have entered a technical recession in H1.

The rise in US stocks and fall in USD following the Fed decision suggests that markets focussed on the possibility of a slower pace of rate hikes going forward

1-day price return (%) on 27-28 July (as of 8:40AM SGT)



Source: Bloomberg, Standard Chartered

Background

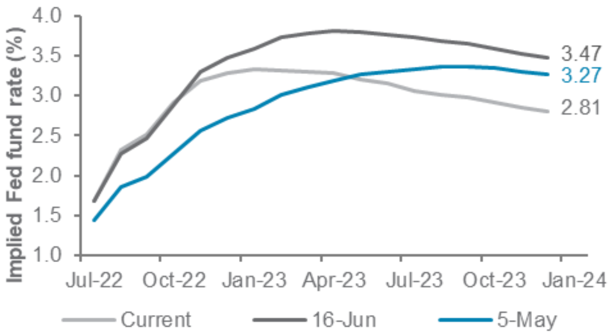
The Fed remains focussed on curbing inflation. The rise in June CPI to 9.1% y/y had paved the way for the 75bp rate hike this month. Given the high and sticky inflation which has surprised markets and the Fed multiple times, the Fed is unlikely to back off unless there are sustained signs of a decline in inflation. Powell also signalled that the Fed would set policy on meeting-by-meeting basis, rather than offering explicit forward guidance.

Growth outlook remains the key. In the press conference after the FOMC meeting, Fed Chair Powell rejected the speculation that the US was in a recession, pointing towards strong labour markets and a low unemployment rate. However, the risks to growth have clearly risen as evidenced by the sharp contraction in flash PMI data, subdued consumer confidence and slower retail sales.

Powell's hint of a slower pace of rate hikes was likely the main driver for the sharp bounce in equities. However, bond yields declined marginally, with 2-year yields declining nearly 12bp intra-day before edging modestly higher. Lower bond yields and the broader risk-on sentiment drove the USD lower.

Market-implied peak Fed Funds rate expectation has fallen sharply relative to post-June FOMC meeting

Market-implied Fed interest rates until early 2024



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Lack of forward guidance is likely to bring economic data to the forefront. Powell's message that the Fed is likely to remain data dependent is likely to increase market volatility around economic data releases.

The release of Q2 US GDP data later today will be closely watched. While Powell downplayed recession risks, Atlanta Fed's NOWCast model has been flagging risks of GDP contraction in Q2, following a 1.6% contraction in Q1. The consensus growth forecast has been revised lower from 3.0% in June to 0.5% in the latest survey of economists. Hence, the risks of a technical recession have risen, although we acknowledge that NBER, which officially calls US recessions, may not do so, as it looks at a number of indicators, including US labour market data.

Additionally, the US PCE deflator (the Fed's favoured measure of inflation), personal income and University of Michigan consumer sentiment data releases on Friday could also be catalysts for sharp market moves in the near-term.

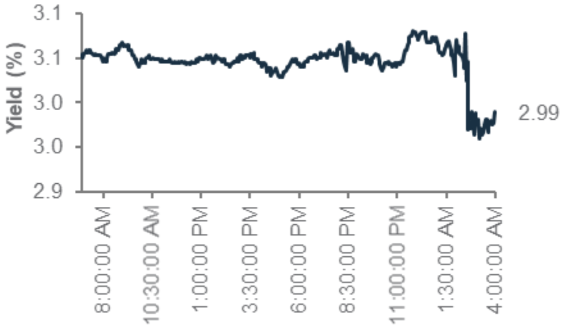
The pace of rate hikes likely to slow. The Fed officials will have the opportunity to assess two additional inflation and job market data prints before the next FOMC meeting on 21 September. Given the recent decline in energy and food prices as well as base effects, it is possible that inflation may show signs of peaking in the coming months. Additionally, we believe that greater political uncertainty around mid-term elections in November and slowdown in economic growth may lead the Fed to slow the pace of rate hikes later this year. Hence, we expect the Fed to hike rates by another 75bps from now till end-2022.

Remain diversified. Elevated risks to growth, as the Fed keeps hiking, justifies maintaining a diversified investment allocation and adding to bonds at the expense of equities. Given the divergent growth trajectories for Asia and the US, we maintain our preference for Asia ex-Japan equities and Asian USD bonds.

— **Abhilash Narayan,** *Senior Investment Strategist*

The US 2-year government bond yield fell sharply after the FOMC meeting

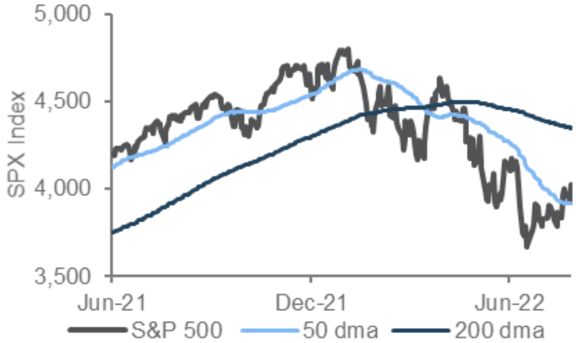
US 2-year government bond yield



Source: Bloomberg, Standard Chartered

The S&P 500 index bounced higher from the 50-day moving average of 3919 following the FOMC meeting

S&P 500, 50- and 200-day moving averages



Source: Bloomberg, Standard Chartered

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