



Market Watch

Fed signals March rate hike

Summary

The S&P500 stock index fell 0.2%, 10-year Treasury yields rose to 1.85% and the USD rose on Wednesday after the Fed hinted it will start raising interest rates as soon as in March and reduce its balance sheet later this year.

Fed Chair Powell's comments that there was "quite a bit of room" to raise rates amid upside risks to inflation and the job market can handle higher rates were slightly more hawkish than before, leading to a reversal of early gains in risk assets.

We believe markets have priced in the Fed's hawkish shift. Markets were expecting four rate hikes this year going into the Fed meeting. In fact, we see scope for the Fed to tone down its hawkish stance as inflation peaks later this year with a moderation in US growth and easing supply bottlenecks.

We see opportunities to add to risk allocations. January's pullback presents opportunities to put cash back to work, in our view. We expect above-trend growth to support strong corporate earnings, offsetting a less accommodative Fed.

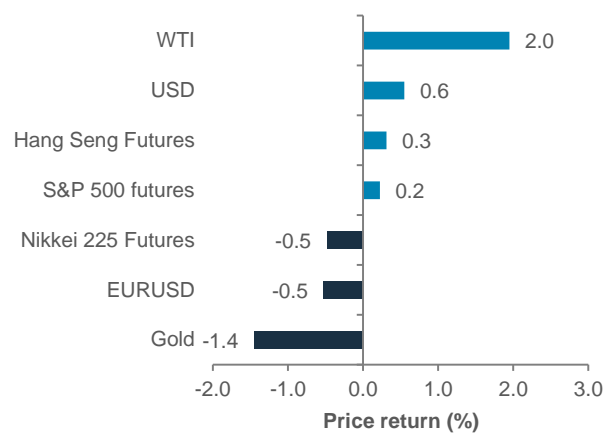
Background

Risk assets have pulled back sharply this year as investors priced in a faster pace of Fed policy tightening amid a tighter-than-expected US job market and persistently high inflation. Global stocks have fallen 7.7% from their peak, led by the S&P500 index (down 9.3%). The technology sector-heavy Nasdaq index fell into 'correction' territory, having lost 16% from its peak, as investors factored in higher interest rates when calculating the present value of future earnings.

Last month, the Fed signalled an earlier-than-expected March end to its emergency bond purchases and projected three rate hikes each for 2022 and 2023, followed by two more in 2024, amid persistently high inflation pressures. It upgraded its inflation expectations for 2022 and 2023 to 2.7% and 2.3%, respectively, and raised its US growth forecast to 4%. Since those projections, data showed the US jobless rate fell to 3.9% in December, below the Fed's 4% long-term target. The tighter job market, as labour participation stays well below pre-pandemic levels, is fuelling wage and inflation pressures. US consumer inflation rose to a 39-year high of 7% in December.

Most risky assets are up after the Fed meeting

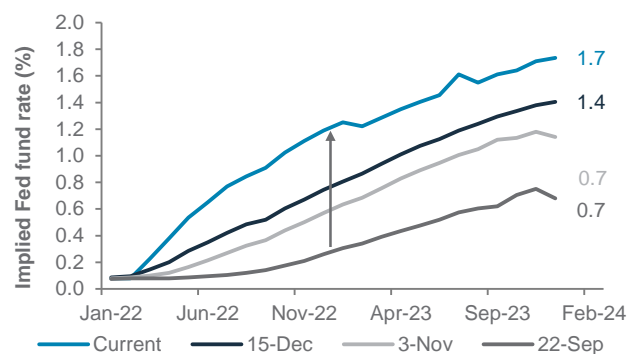
Price returns (%) from close of 25 January to 27 January (7:45 AM Hong Kong/Singapore time)



Source: Bloomberg, Standard Chartered

Investors have progressively priced in a faster pace of Fed rate hikes in the coming years

Implied Fed fund rate over the next two years following the last four Fed policy meetings



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Markets have largely priced in Fed's hawkish shift. The Fed's projections of three rate hikes this year matches our own estimates and contrasts with four rate hikes priced by markets. We see a high probability of the Fed dialling down its hawkish rhetoric as inflation peaks in H1, economic growth moderates on the back of a sharp decline in government spending and as three new pro-growth and arguably dovish members nominated by President Biden join the seven-member Fed Board after getting Senate approval.

Bond markets signalling a gradual normalisation of Fed policy. Indeed, the flattening of the Treasury yield curve (chart) in the build up to the Fed meeting suggests bond investors are more concerned about a growth slowdown due to excessive Fed policy tightening than they are about a sustained inflationary upsurge. We expect the Fed to heed the warning from the bond markets in the coming months as US inflation peaks in H1 with demand for goods waning and more workers returning to jobs as pandemic stimulus savings are exhausted and vaccinations lift public confidence. An expected US fiscal tightening, combined with the lagged effects of a strong USD and China's slowdown, are also likely to impart disinflationary pressures on US prices by H2. This would offer the Fed the option to stagger rate rises after the first hike likely in March.

Opportunity for investors to add to risk allocations. With Fed rates hikes mostly priced in and risk assets more attractively priced following this month's pullback, we see opportunities for investors to put cash to work. We expect equities to outperform bonds this year on the back of above-trend growth, strong corporate earnings and still accommodative financial conditions, especially in the US and Euro area. Equities typically continue to deliver strong returns in the lead up to rate hikes and in the year after the first rate hike as monetary policy is usually tightened against the backdrop of robust economic and earnings growth.

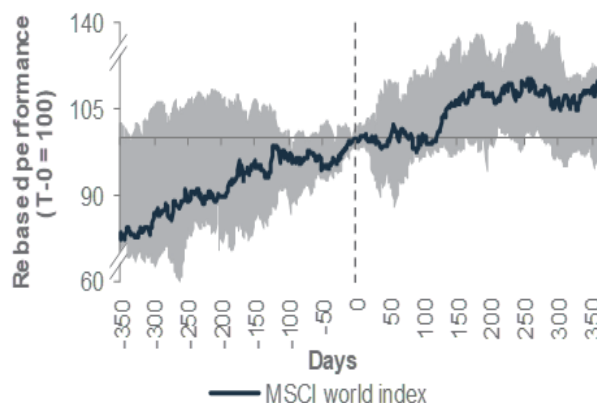
The US technology equities sector has turned more attractive after the recent correction. We also favour Developed Market High Yield bonds and Asia USD bonds, the latter turning more attractive with China easing policy.

On technical charts, the MSCI All Country World index's break below the strong support at the October low of 702 has opened the way towards a test of 640. The 10-year US Treasury yield needs to break above 1.98% to signal a further uptrend. The USD index (DXY) continues to hold above its 100DMA, suggesting it is yet to reverse its broader uptrend.

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Senior Investment Strategist

Equities have historically performed well in the year following the first rate hike of a Fed hiking cycle

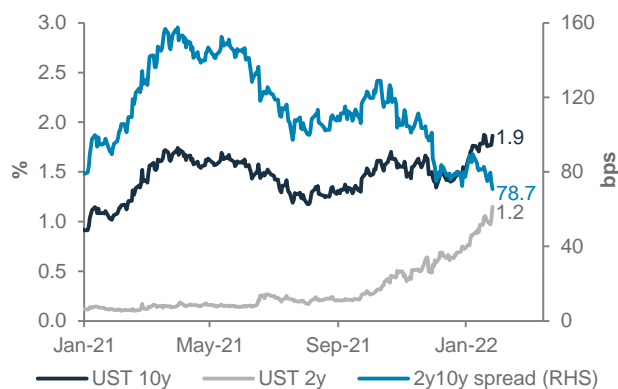
12m returns for the MSCI World Index (Developed Market equities) before and after the first hike of a Fed hiking cycle



Source: Bloomberg, Standard Chartered; Data since 1980; Grey area shows min/max performance over different Fed cycles

The flattening Treasury yield curve illustrates the bond market's concern about excessive Fed tightening

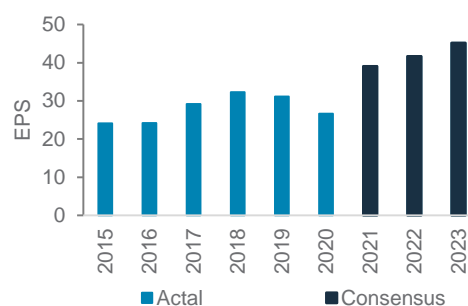
US 2-year and 10-year Treasury yields and their difference



Source: Bloomberg, Standard Chartered

Global corporate earnings outlook remains healthy, which is likely to offset a less accommodative Fed

Consensus EPS estimates for MSCI All Country World index



Source: MSCI, FactSet, Standard Chartered

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