Market Watch

Is 75 the new 50?

Summary

Equities and bonds extended losses as markets re-assessed the Fed rate hike cycle. 2- and 10-year bond yields jumped, the S&P500 fell 3.9% and the USD surged.

Yesterday's drop meant the S&P500 broke below a key technical support near 3800, though we see several subsequent technical supports 3-5% lower from here.

The Fed rate decision and signal on the path of rate hikes from here remains the main focus in the coming days. We retain our equity sector and regional preferences, with higher yields intensifying the opportunity in income assets.

Background

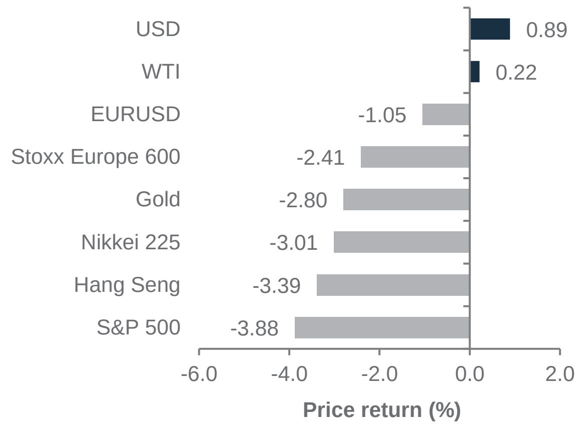
US equities extended their fall further from the start of the week even as bond yields jumped. The S&P500 fell 3.9% while the Nasdaq fell 4.7%, with the latter closing more than 20% below its early-January peak, a popularly accepted definition of a 'bear market'. Yesterday's sell-off, however, was broad. Within US equities, all major sectors fell. US equity losses themselves followed weakness across both major Asian and European benchmarks earlier in the day. Market worries in risky assets were intensified by unusually high volatility in cryptocurrency markets as well, with at least two major platforms temporarily halting withdrawals, citing "extreme market conditions".

Both short- and long-term bond yields rose sharply, with the 10-year yield rising to 3.36% with the 2-year yield not far behind. The gap between the two – the 10-2 year yield curve – also briefly turned negative, reigniting recession fears. Gold failed to offer a safe-haven, falling 2.8%, but the US Dollar surged, with the DXY index moving above its mid-May peak.

A re-assessment of Fed rate hikes was the main driver of the move. Yesterday, several media reports said Fed policymakers were considering the possibility of a 75bps rate hike at this week's policy meeting. Markets also moved to price in a more aggressive Fed rate hiking cycle, with futures markets now indicating a significant probability of a 75bps rate hike this week and a likely Fed rate above 3.5% by year-end (up from just 2.77% last week).

Most asset classes extended yesterday's move lower, with gold failing to offer a safe-haven

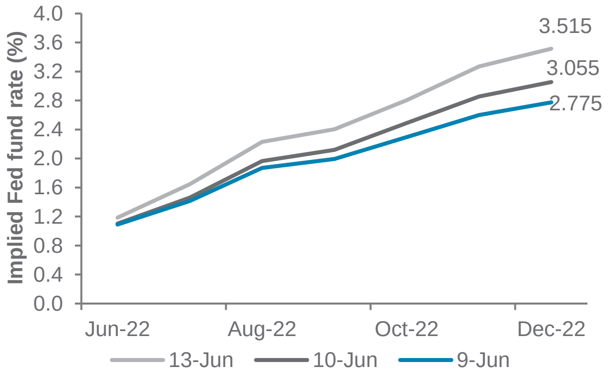
1-day price return (%) on June 13



Source: Bloomberg, Standard Chartered

Markets continued to sharply reprice their Fed rate hike expectations from last week

Implied Fed fund curve (%) on June 9, 10 and 13



Source: Bloomberg, Standard Chartered

What does this mean for investors?

The path of inflation, and the Fed's reaction to it, remains the main swing factor for financial markets. As we noted yesterday, inflation proving to be stickier than expected makes the Fed's balancing act between inflation and growth much tougher. As we noted in the *Global Market Outlook*, inflation remains the key swing factor that determines whether our base case scenario plays out – one where Fed tightening ends up being relatively limited as inflation comes off its peak, helping the economy avoid a recession – or whether risks start to tilt towards our pessimistic scenario where the Fed is forced to further accelerate policy tightening, potentially pushing the economy to recession.

The size of the rate hike at this week's policy meeting, along with signals on how Fed policymakers are thinking about the path of rate hikes for the rest of this year, is likely to be the main factor to watch in the days ahead. We'd argue a focus on inflation alone would likely be a negative, while a more balanced approach to balance inflation and growth risks would be more positive. The fact that inflation expectations are significantly below recent peaks is a positive in this regard.

We retain our regional and sector preferences within equities and the opportunity in income. While there was almost nowhere to hide within the one day move, we believe our preference for energy and financial sectors is consistent with the risk of a tighter Fed hiking cycle (financials should benefit from directly from rising yields while energy should offer some protection against a rise in one key inflation driver). We would also continue to look for opportunities in Asia ex-Japan equities given Chinese assets offer a route to diversify from Fed and US-centric exposure alone. Finally, higher yields are ultimately positive for multi-asset income strategies.

Technicals: Yesterday's move took the S&P500 below the 3800 level we had flagged in yesterday's Market Watch. This arguably weakens the very short-term outlook, with subsequent supports sitting at about 3715 and 3625. On the upside, we now see 3800 as the immediate resistance, followed by 4000 and the 50DMA at 4180.

— **Manpreet Gill,** *Head FICC Strategy*

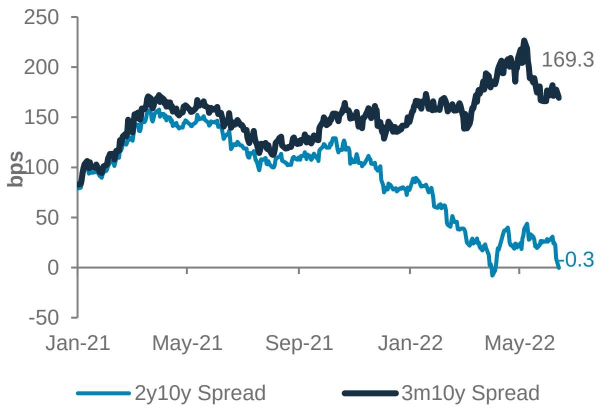
US inflation expectations remain below recent peaks

US inflation expectations as measured by break-evens on 10-year inflation-protected bonds and 5y5y inflation swaps

Source: Bloomberg, Standard Chartered

A renewed fall in the 10yr-2yr yield differential refocused attention on US recession risks

10yr-2yr and 10yr-3m yield curves (gap between yields)



Source: Bloomberg, Standard Chartered

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