Wealth Management Chief Investment Office
4 May 2023

Market Watch

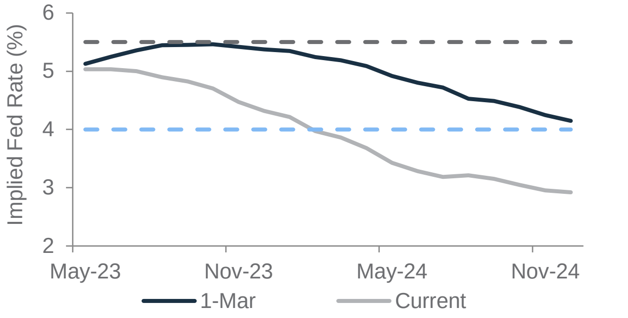
The Fed hints at a pause

Summary

- The US Federal Reserve hinted that it may put on hold **the second steepest rate hiking cycle** after raising the benchmark rate by 25bps, as expected, to a 15-year high of 5.25%. It dropped a phrase from its previous statement that "additional policy firming" will be necessary.
- The US S&P500 stock index closed the day 0.7% lower, while bond yields and the USD fell. Fed Chair Powell pushed back against market expectations of rate cuts as early as July, citing still elevated inflation.
- We expect the Fed to **keep its benchmark rate on hold over the next few meetings** as it seeks confirmation from data that the US job market and wage inflation are cooling. We then expect it to cut rates by 50bps later this year as the jobless rate starts to rise and a mild recession sets in.
- The above scenario calls for a **defensive allocation:** we remain Overweight high quality government bonds and gold and Underweight high yielding bonds and equities. We see the rally in risk assets over the past month as an opportunity to rotate to our preferred assets.

Although Fed Chair Powell ruled out rate cuts this year, money markets are pricing in cuts to start as soon as July this year

Market estimates of Fed Funds Target rate through to 2024



Source: Bloomberg, Standard Chartered

Background

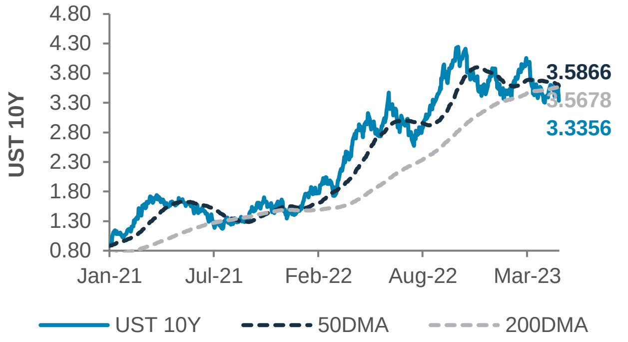
The Fed has delivered 500bps of rate hikes in just over a year, the fastest pace of tightening since the 1980s. It initially sought to catch up with surging inflation, having started on its rate hiking path later than usual. Now, with manufacturing activity, job creation and inflation slowing, it believes **monetary policy has likely turned restrictive enough** for it to take a pause.

Although Powell said the US banking sector remains healthy, the Fed would also be concerned about the **failure of three large regional banks** since March. While its liquidity measures have helped stabilise financial markets, US banks (especially small lenders) continue to lose deposits. Bank lending is likely to tighten further amid concerns about corporate defaults.

Inflation remains a near-term concern, which is likely to keep the Fed from cutting rates just yet. US employment costs accelerated to 1.2% q/q in Q1 and the labour market remains tight. Hence, the Fed needs confirmation that the job market is slowing enough to sustainably bring down wage pressures.

The benchmark long-term US government bond yield has fallen below a key technical support level as markets price in an economic downturn later this year

US 10-year government bond yield



Source: Bloomberg, Standard Chartered

The end of the road?

Slowing growth vs. elevated wage pressures. While hinting at a rate pause, Chair Powell left the door open for more hikes, highlighting the challenge the Fed faces in determining whether inflation is cooling sustainably. He said more data is needed to decide whether policy is restrictive enough, since policy tightening impacts the economy with a lag. He pushed back against rate cut bets, saying "inflation is going to come down not so quickly," given strong demand and tight labour markets.

Powell still expects an economic soft-landing. The Fed Chair reiterated that he believes the US economy can avoid a recession and a sharp rise in unemployment despite the steep rate hikes. He expects job openings, which rose to a record last year, to continue declining, eventually cooling wage pressures.

We see elevated recession risk: The Fed's steep rate hiking cycle is already causing collateral damage. Last weekend, First Republic became the third large regional bank to fail in the past three months as higher rates cause asset-liability mismatches in bank balance sheets. The Fed's latest Beige book survey showed smaller banks are curtailing lending, adding to cyclical credit tightening. The Fed's Senior Loan Officers' Survey on 8 May is likely to show further tightening of lending conditions.

Debt ceiling risk: As if the inflation and banking sector challenges are not enough, the Fed faces a non-negligible near-term risk of a US debt default, or at least a sharp cutback in fiscal spending as the government hits its Congress-approved debt ceiling in the next 1-3 months.

Asset class implications – Fade the 'melt-up'

- As we highlighted in our latest Global Market Outlook monthly, the run-up in risk assets since mid-March is not justified by fundamentals. **While still-bearish investor positioning remains a possible driver for a short-term extension of the risk asset rally, we see this as an opportunity to rotate to our preferred areas**: safer assets, with a preference for Investment Grade Developed Market bonds and Asia USD corporate bonds.
- **We expect the rally in US and European equities to falter** as tighter financial conditions lead to an economic downturn and downgrades to corporate earnings. The S&P500 index faces further downside towards 3,951. Asia ex-Japan equities, particularly in China, offer attractive value instead, as China's economy recovers, in our view.
- **The USD index (DXY) could see a near-term bounce** towards 102.3; we would sell into the rebound as we expect markets to again price in Fed rate cuts in H2. **We would continue adding Gold exposure** below USD2,000/oz.

— **Rajat Bhattacharya**
Senior Investment Strategist

We would fade any short-term bounce in the USD as expected Fed rate cuts later this year should narrow US interest rate differentials vs its key trade partners

USD index and US rate differentials vs. key trade partners

Source: Bloomberg, Standard Chartered

The S&P500 index has failed to break above the 4,200 threshold since Q4 last year; we see further declines over the next 6-12 months as the US enters a recession

S&P500 index

Source: Bloomberg, Standard Chartered

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