Market Watch

The Fed keeps going

Summary

- The US Federal Reserve raised its benchmark rate 25bps to a 15-year high of 5.0%, as expected, and said it was prepared to continue with the second steepest rate hiking cycle in history as it stayed focussed on subduing inflation, despite ongoing concerns about banking sector instability.
- The US S&P500 stock index closed the day 1.7% lower while bond yields and the USD fell. Fed Chair Powell said policymakers did not expect to cut rates this year and, while US bank failures have tightened financial conditions, it is too soon to assess their impact on financial stability.
- Separately, Treasury Secretary Yellen told lawmakers the government was not considering “blanket” deposit insurance to stabilise the banking system.
- We remain defensive in our allocations, preferring high grade USD bonds, especially in Asia, over equities, as we see rising probability of a US recession this year. While the Fed maintained its end-year rate expectations at 5.1%, money markets are pricing in over 50bps of rate cuts in H2, taking the Fed rate to 4.2% by December 2023.

The Fed’s dilemma

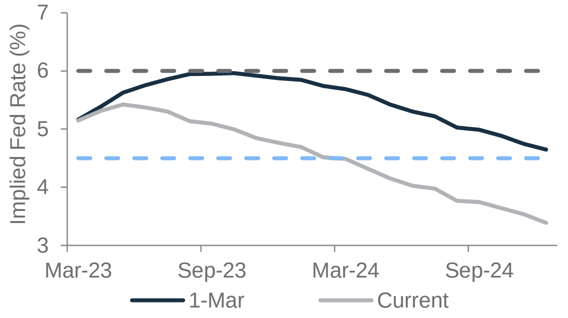
The Fed faces the classic central bank dilemma. US core inflation measures have been accelerating and broadening of late, driven by shelter and other services sector costs, despite over 450bps of Fed rate hikes in the past 12 months.

Meanwhile, most of our leading recession indicators, including consumer and business confidence, money supply, banking lending conditions and some early job market measures, are warning that a downturn in imminent. Higher rates have led to deposit flight from smaller, regional banks, triggering two of the three largest US bank failures in history over the past month.

Nevertheless, the Fed is concerned that a still-tight labour market could lead to wage inflation. We believe it wants to induce a mild recession to sustainably cool the job market. This explains the changes to the Fed’s projections: it cut 2023-24 growth estimates to well below long-run trend and expects the jobless rate to be 1ppt higher through end-2025. Yet, core inflation is seen staying above the Fed’s 2% target into 2025.

Fed rate expectations have slumped this month as money markets start pricing in rate cuts later this year amid rising recession risks

Market estimates of Fed Funds Target rate through to 2024



Source: Bloomberg, Standard Chartered

US short-term bond yields have dropped more sharply than long-term yields over the past couple of weeks as the bond market expects the Fed to cut rates

US 10-year government bond yield minus 2-year bond yield

Source: Bloomberg, Standard Chartered

Fed projections point to slower growth, higher inflation and an elevated jobless rate over the next two years

Fed’s new economic projections

	GDP		Unemploy-ment		Core PCE		Rates estimates	
Dates	Old	New	Old	New	Old	New	Old	New
2023	0.5	0.4	4.6	4.5	3.5	3.6	5.1	5.1
2024	1.6	1.2	4.6	4.6	2.5	2.6	4.1	4.3
2025	1.8	1.9	4.5	4.6	2.1	2.1	3.1	3.1
LR*	1.8	1.8	4.0	4.0			2.5	2.5

Source: Bloomberg, Standard Chartered

Policy mistake?

While the Fed seems to be aiming for a soft-landing of the economy, its focus on inflation raises the risk that tightening financial conditions could lead to a severe economic downturn, accentuating the ongoing troubles in the banking sector. Inflation and the job market are typically lagging indicators and there are already signs that the Fed tightening over the past year is starting to cool goods prices. Shelter costs, which account for almost a third of US inflation, are also indicating a slowdown by the end of the year, based on private sector data from the new rental contracts signed in recent months.

Against this backdrop, further rate hikes (and quantitative) tightening could impact the most vulnerable parts of the economy. Banking sector stress seems to be an early warning that financial conditions are likely turning too restrictive. While the authorities have swiftly dealt with the liquidity crunch by guaranteeing deposits at the failed banks and introducing new liquidity provisions for all US lenders, it remains to be seen whether the steps are enough to reassure small bank depositors and financial markets.

The smaller US banks are particularly exposed through their loan books to the US commercial real estate sector, which has seen stress initially triggered by COVID aggravated then by the rapid interest rate hikes over the past year.

Given this, we believe the coming economic slowdown is likely to turn the Fed's focus back to supporting growth. Thus, we see rising chances of Fed rate cuts in H2.

Asset class implications – staying defensive

- The Fed's hawkish stance has further raised the risk of a recession, reconfirming the defensive investment stance we adopted at the end of last year. This implies adding exposure to high grade income assets, with a preference for Investment Grade Developed Market bonds and Asia USD corporate bonds.
- We continue to rebalance out of US equities into Asia ex-Japan as we see the US bear market rally faltering. US earnings estimates are likely to be downgraded as recession risks rise. The S&P500 index faces further downside towards 3,809 if it breaks below its 200DMA.
- While the USD typically gains from global risk-off sentiment, it is unlikely to benefit if the source of market concerns is the US economy itself. The USD index fell to its lowest since early February after the Fed meeting and Yellen's comments on bank deposits. The index is testing a key support at 102.3. Gold appears stretched after a strong run up in March and faces resistance at c. USD2000.

— **Rajat Bhattacharya**
Senior Investment Strategist

The S&P500 index faces strong resistance just above 4,000; a sustained break below the 200DMA around 3,934 could lead to further downside in the coming days

S&P500 index

Source: Bloomberg, Standard Chartered

The USD faces further downside if its breaks below key support around 102.3

USD index (DXY) and rate differential between the US and its key trade partners

Source: Bloomberg, Standard Chartered

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