Market Watch

The Fed raises its game

Summary

The US Federal Reserve accelerated its rate hiking cycle, as expected, with a 75bps rise in its benchmark rate and signalled another 75bps hike was possible in July as it sought to rebuild market confidence in its ability to tamp down inflation running at a 40-year high.

The Fed also raised its terminal rate estimate for the end of the cycle, cut growth and raised core inflation estimates.

US S&P500 index rose more than 1.5%, while US government bond yields and the USD fell. The reaction suggests investors were reassured the Fed is determined to lower inflation down towards its 2% target.

The Fed faces a tough balancing act in cooling growth, without causing a recession. The strength of the labour market will be key, as any weakness could force the Fed to pause it tightening cycle. The Fed will also likely seek to avoid disorderly markets as tighter financial conditions could undo its chances of engineering an economic soft-landing.

Background

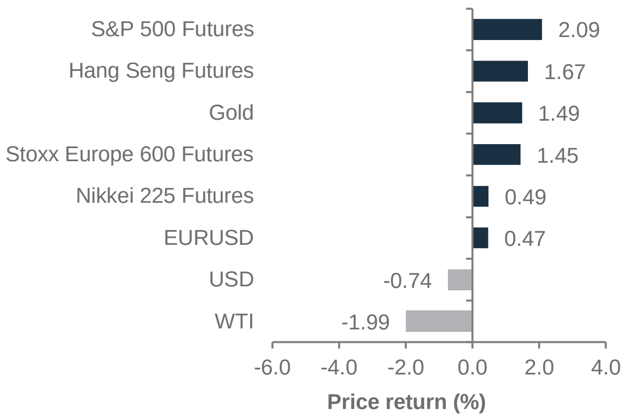
The Fed's increasingly hawkish stance comes against the backdrop of 40-year high (and still accelerating) inflation, slowing growth, stocks entering a bear market and the yield curve inverting. Inflation is increasingly being driven by energy and food prices (over which the Fed has little control), but also by stickier services sector costs, including shelter. Meanwhile, a tight job market and record high job openings have fuelled wages.

The Fed downgraded its economic growth estimates through to 2024 and now sees growth falling just below long-term trend this year and next. As growth slows with faster rate hikes, the Fed expects the jobless rate to rise gradually to just above 4% by 2024, from 3.6% in May, and core inflation to stay above its 2% target at least until 2024.

The acceleration in the projected pace of rate hikes means the Fed expects policy rate at 3.4% by end-2022, up from 1.9% forecast in March, and at 3.8% by end-2023, up from 2.8%. The Fed's estimates are now closer to market forecasts. It also raised its neutral rate to 2.5% from 2.4%.

The rise in US stocks and fall in USD following the Fed decision suggests investors were reassured that the central bank is determined to lower inflation

1-day price return (%) on 15-16 June (as of 8:15AM HKT)



Source: Bloomberg, Standard Chartered

The Fed projected a higher terminal rate for the end of the hiking cycle, even as it cut growth forecasts and raised unemployment and inflation estimates

The Fed's June projections vs. March estimates

	GDP		Unemploy-ment		Core PCE		Fed rate estimates	
Dates	Old	New	Old	New	Old	New	Old	New
2022	2.8	1.7	3.5	3.7	4.1	4.3	1.9	3.4
2023	2.2	1.7	3.5	3.9	2.6	2.7	2.8	3.8
2024	2.0	1.9	3.6	4.1	2.3	2.3	2.8	3.4

Source: US Federal Reserve, Standard Chartered

What does this mean for investors?

Downside growth risk as the Fed curbs demand to subdue inflation. The Fed's best chance to tamp down inflation is to curb demand, especially for labour and housing, by cooling overall economic activity through interest rate hikes. In doing so, it aims to put a cap on wages and shelter inflation. The risk is that the Fed over-tightens, just as the economy in slowing. While job vacancies are at a record high, the labour market seems to be softening, with initial jobless claims bottoming in March. A sustained rise in initial jobless claims could force the Fed to shift its balance towards supporting growth and pause its rate hikes.

Other factors to watch: a) **Oil and the inflation expectations**: a slowdown in US growth is likely to put downward pressure on oil prices, further lowering inflation expectations. We note that US long-term inflation expectations have not retested their May highs, despite the upside surprise from May's inflation data. A sustained decline in inflation expectations would enable the Fed to slow the pace of rate hikes. b) **Business confidence data**: the upcoming PMI data should signal whether the tightening of financial conditions since the start of the year is crimping business activity significantly. c) **Bond yield curve and corporate credit spreads**: the spread between 10-year Treasury yields and 2-year yields turned negative this week. The risk of a recession would rise if it stays inverted. Meanwhile, yield premiums of High Yield corporate bonds over Treasuries have yet to rise above the threshold (c. 200bps) that has historically heralded a recession; and **d) Retail sales**: Consumption has been the main driver of the post-pandemic recovery. Retail sales have remained well above pre-pandemic trend, despite rising inflation as consumers, buoyed by plentiful jobs deployed their savings built during the pandemic. However, retail sales have started to flag as rising costs and interest rates start to bite.

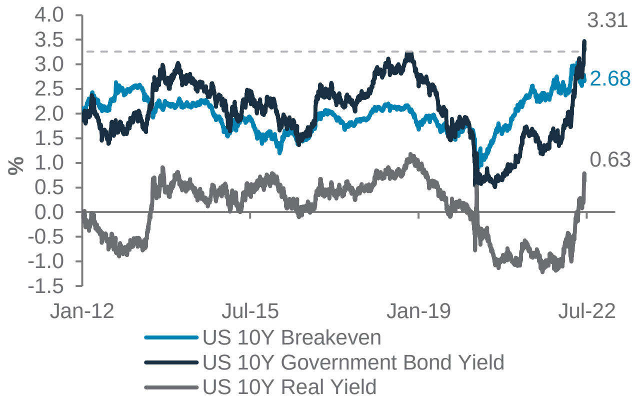
Income assets, Asian equities look increasingly attractive. The surge in bond yields this year means our model income portfolio now offers more than 5% yield. In equities, the drawdown in US (and European) stocks on the back of tightening monetary policies contrasts with the revival in China equities as policy there turns more supportive. Meanwhile, US energy and financial equity sectors are likely to benefit from high oil prices and rising interest rates.

Technicals: The S&P 500 index's break below support at 3,800 earlier this week opens the path towards the next key supports of 3,715 and 3,625. The next resistance is 3,800 followed by 4,000. The US 10-year Treasury yield's earlier break above key resistance at 3.26%, raises the chance of a test of next resistance at 4%.

— **Rajat Bhattacharya,** *Senior Investment Strategist*

US inflation-adjusted yields have risen lately as long-term inflation expectations fell from May's highs

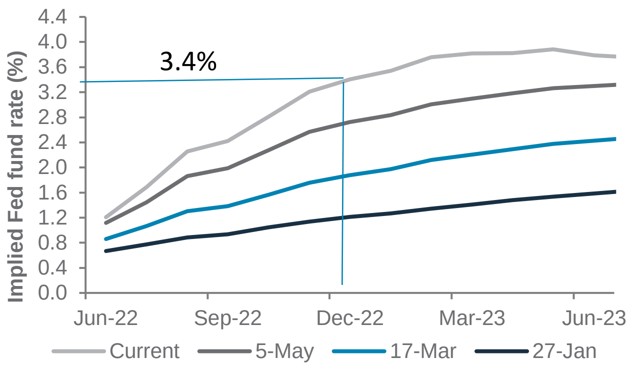
US 10-year Treasury yield, inflation expectations based on inflation protected Treasuries and inflation-adjusted yields



Source: Bloomberg, Standard Chartered

Investors have consistently repriced higher Fed policy rate expectations after each meeting since December

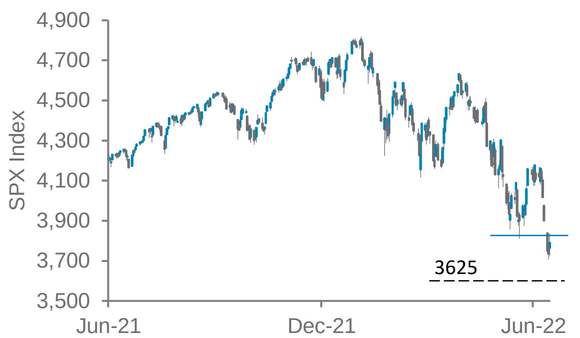
Implied Fed fund rate following the last few Fed policy meetings; %



Source: Bloomberg, Standard Chartered

The S&P500 index's break below support at 3,800 opens the way towards next key support at 3,625

S&P500 index and key technical levels



Source: Bloomberg, Standard Chartered

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