Market Watch

Will the Fed or markets blink first?

Summary

Inflation, and the Fed's response, remains the pivotal factor in markets today. Markets are already looking for over 4% Fed policy rates by end-2022.

A pessimistic scenario would involve the Fed taking policy rates well above 4% in 2023. Inflation hedges, rising rate winners likely to outperform in such a scenario.

An optimistic scenario is one where the Fed pivots towards supporting growth in 2023. Equities and credit are likely to perform well in such an outcome.

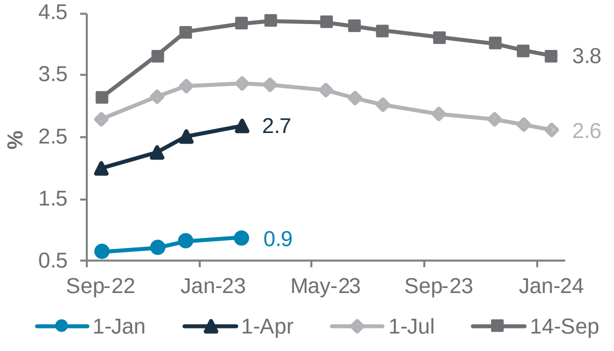
Background – Inflation and why the Fed response is the pivotal factor today

A shift in the outlook for policy rates, driven by the Fed, continues to be a pivotal factor in markets this year. Since the start of 2022, the market's expectations of Fed policy have moved from expecting just three 25bps rate hikes to now expecting a Fed policy rate of over 4% by year-end. We also now know that Fed efforts to shift these expectations have been a key factor behind the correlated fall across major asset classes, including equities and bonds, and the rise in the US Dollar. This has meant there were very few places to escape negative returns year-to-date, outside of cash and select commodities and hedge fund strategies.

Does this move have further to go? One of the most common questions among investors today is whether this move is now complete (ie. markets have now fully priced the likely extent of the Fed hiking cycle) or whether there is room for these expectations to rise further, with the resultant negative implications for major asset classes. While there have been several points at which the market believed the hiking cycle was fully priced, the Fed ended up pushing expectations even higher amid elevated inflation, regardless of rising concerns over the growth outlook (with FedEx's profit-warning last week likely to raise concerns on this front given its perception as an economic bellwether).

Market expectations of Fed policy have shifted significantly through 2022

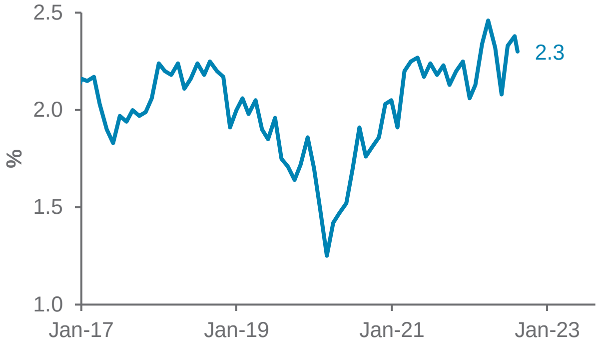
Market pricing of Fed rates at each quarter in 2022



Source: Bloomberg, Standard Chartered

A hawkish Fed has kept the market's inflation expectations from accelerating further, but they remain above the 5-year average of around 2%

The market's expectation of 5-year inflation in 5-years' time



Source: Bloomberg, Standard Chartered

Inflation, and factors that influence it, remain the key to possible scenarios from here. From the Fed's point of view, there are several ways to view inflation:

- **Supply side inflation (i)** – energy prices: Rising energy prices, led by disruptions triggered by the Ukraine conflict, have been one driver of higher inflation. This suggests any worsening, or improvement, in the conflict is likely to influence the Fed's response.
- **Supply side inflation (ii)** – supply chain disruptions: These were a second driver of supply-led inflation. Several indices suggest these have started to moderate, but the pace of improvement is likely to be a second key input into inflation and the Fed's response.
- **Demand-led inflation** – the housing market: US house prices, either directly or via estimated rents, form the largest single component of US inflation indices. This suggests the housing market would need to cool (or at least stop strengthening) for the Fed to be less concerned about this source of inflation.
- **The labour market** – low unemployment: One concern for the Fed is the risk that wages start rising in response to higher inflation, setting up a 'wage-price' spiral where higher wages, in turn, feed even higher inflation. This likely helps explain why the Fed may be placing much greater weight on demand-side inflation factors in the context of a tight labour market. A cooling of the labour market would likely be key to the Fed pivoting.

Our central scenario

Against this context, we maintain a central scenario of Fed policy largely in line with market expectations. We rank this scenario highest of the three scenarios in terms of probability of occurrence. We attach around a 50% probability of a US recession in the next 12 months, but critically assume that any such recession is shallow and short-lived in nature. We believe this is largely priced by financial markets, although it does suggest more volatility in the months ahead.

Our preferred approach to asset allocation in this scenario is captured in our current tactical asset allocation – a balanced approach between equities and bonds, a preference for easing policy cycles (Chinese equities), high dividend yield (UK equities), higher quality bonds (Asia USD bonds and a shift away from HY towards IG bonds across US/Europe/Asia) and gold as a hedge. See our *Global Market Outlook* for more details.

Having said that, we explore pessimistic and optimistic scenarios for Fed policy, what could drive these and what asset classes could prove best in each. The scenario-based approach can also help investors prepare should one of these scenarios start to look increasingly likely.

Gold, commodities and private real estate historically outperformed in high and very high inflation regimes*

Average 12m returns under high and very high inflation regimes (since index inception to April 2022)

	High inflation	Very high inflation
From 1977		
Gold	5.1%	11.6%
Commodities	1.6%	9.8%
Private real estate	8.9%	9.6%
From 2002		
Global bonds	2.6%	3.3%
Global equities	4.6%	-9.0%
US equity	4.0%	-10.1%
Euro area equity	5.0%	-7.9%
Asia ex-Japan equity	10.2%	-0.7%
DM govt bond	2.5%	4.0%
DM corp bond	3.8%	1.7%
DM HY	7.2%	-1.0%
EM USD	9.5%	1.7%
EM local	6.3%	3.9%
Asia USD**	7.2%	2.9%
Leveraged loans	3.6%	-3.1%
TIPS	2.5%	1.3%
Global REITs**	12.5%	5.7%
Natural resources equities	5.9%	-10.1%
Global infrastructure	11.3%	-4.3%

Source: Bloomberg, Standard Chartered
* High inflation regime is defined as CPI levels between 3-4%; very high inflation regime is defined as CPI levels above 4%. ** Asia USD index data since 2005 and Global REITs index since 2008

The c.24% peak-to-trough drop in the S&P 500 this year suggests the market is pricing a mild US recession

US equity market drawdowns during past recessions

Recession start	Recession end	S&P500 peak	S&P500 trough	S&P500 Peak-trough (months)	Draw-down
Jul-53	Apr-54	Jan-53	Sep-53	8	-11%
Aug-57	Mar-58	Jul-56	Dec-57	17	-17%
Apr-60	Jan-61	Jul-59	Oct-60	15	-10%
Dec-69	Oct-70	Nov-68	May-70	18	-36%
Nov-73	Feb-75	Oct-73	Oct-74	12	-44%
Jan-80	Jun-80	Jan-80	Mar-80	2	-15%
Jul-81	Oct-82	Nov-80	Aug-82	21	-27%
Jul-90	Feb-91	Jul-90	Oct-90	3	-20%
Mar-01	Oct-01	Aug-00	Oct-02	26	-49%
Dec-07	May-09	Oct-07	Mar-09	17	-57%
Feb-20	Aug-20	Feb-20	Mar-20	1	-34%
Median				**15**	**-27%**

Source: Bloomberg, Standard Chartered

The pessimistic scenario – The Fed goes well above 4%

There is a scenario where the Fed does not stop hiking rates at 4%, but goes much further because inflation fails to cool or growth remains strong (or both) – and the inflation print last week certainly has got more investors more focused on this risk. We rank this scenario second of the three scenarios in terms of probability of occurrence.

Inflation failing to slow is likely to be a key driver of such a scenario, either because supply side factors like oil prices take a new leg higher (following a removal of significant Russian output from global supply, for example) or demand-led factors prove to be stronger than expected. This would imply a scenario where even a 4% Fed Funds rate remains well below the inflation rate, raising fears among policymakers that real (net-of-inflation) policy rates remain negative and too low to bring inflation down. Under such a scenario, the Fed is likely to guide markets to reprice their expectations significantly higher from today's levels.

Equities and other risky assets may face further downside in this pessimistic scenario, consistent with past bear markets, as higher interest rate expectations would imply a further leg lower in valuations, especially for rate-sensitive parts of the market like growth equities. Bond yields would likely move higher, though here the pain may be more contained than that witnessed in H1 2022 because (i) any rise in longer-maturity bond yields is likely to be limited by rising growth concerns, and (ii) the higher yield today offers a greater offset to price declines over a 12-month horizon.

In such an outcome, key outperformers are likely to include:

(i) Assets that historically did well during periods of very high (>4%) inflation: gold, commodities and private real estate. Global REITs have also demonstrated some long-term inflation hedge characteristics, though with greater volatility given their interest rate sensitivity.

(ii) Assets that usually rise alongside rising interest rates, including floating rate loans and the USD.

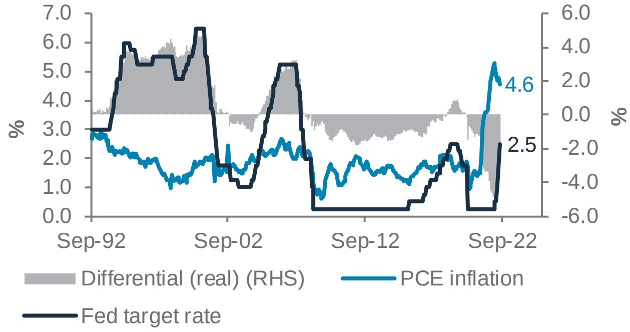
(iii) US government bonds, which history shows ultimately benefit from the rise in bond yields and growth concerns over 12-18 month horizons, despite initially witnessing price declines during the period of rising interest rates.

The optimistic scenario – inflation slows, growth worries dominate and the Fed pivots

At the other extreme, there is a scenario where the Fed proves more dovish than the market's current expectations, either because inflation starts to rapidly cool or growth starts to weaken unexpectedly rapidly (or both). We rank this

The Fed policy rate has risen, but remains far behind inflation for the time being

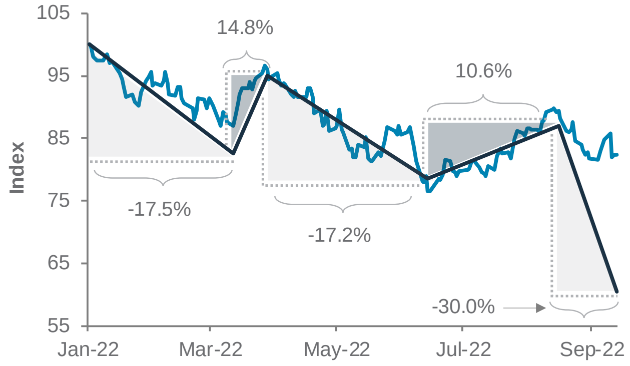
Fed rates, PCE inflation and the implied 'real' Fed rate



Source: Bloomberg, Standard Chartered

History suggests equities may have further to fall in a pessimistic, bear market scenario, though magnitudes remain debatable based on the depth of any recession

The S&P500 index in 2022 relative to an average* bear market pattern



Source: Bloomberg, Standard Chartered
*Average price action of the S&P 500 during the past six US (NBER) recessions

scenario last among the three scenarios in terms of probability of occurrence.

Such a scenario is likely to be led by a significant improvement in inflation.

On the supply side, one likely driver is energy prices. An improvement in the Ukraine conflict, for example, of a nature that allows for Western sanctions on Russian energy supplies to ease, would be one event that could rapidly cool both actual and expected inflation and reduce the Fed's concerns to a significant extent. A rapid easing of supply chain disruptions would also help, though the composition of US inflation suggests this factor alone may not be sufficient to significantly cool inflation and Fed concerns.

On the demand side, a sharp turn lower in the US housing market (activity and prices) is likely to be an important factor that would help alleviate Fed worries about inflation, given it remains the single largest component of the US inflation basket and (at least in the Fed's view) one key to mitigating the risk of a wage price spiral in a tight job market.

Finally, a weakening of the job market (such as a sustained rise in unemployment or significant slowing of new job addition) would also reduce Fed concerns of a wage spiral. A slowing of either demand-side factor is likely to be naturally accompanied by rising concerns of slowing growth. This, in turn, can be the combination that drives a dovish Fed pivot and move the focus away from the Fed's inflation goal to the Fed's full employment mandate.

In such a scenario, key outperformers are likely to include:

(i) Equities, particularly interest-rate sensitive styles like growth equities (eg. technology sector equities) which would benefit from expectations of lower interest rates

(ii) Corporate/EM bonds, as expectations of falling interest rates and bond yields, and a reduced risk/severity of a global recession is priced in, pushes bond prices higher

(iii) Cyclical currencies like the AUD and 'anti-USD' currencies with extreme positioning, like the JPY

— **Manpreet Gill,** *Chief Investment Officer, AMEE*

Fig. 1 **Inflation outlook remains the key variable across our scenarios**

Possible macroeconomic scenarios with likely policy and market implications over the next 6-12 months

	Optimistic scenario (Our view: Low probability)	**Central scenario** (Our view: High probability)	**Pessimistic scenario** (Our view: Medium probability)
Inflation	• Inflation rapidly falls back towards **2-3%** levels • **Long-term inflation expectations fall back below long-term average** as oil prices fall sharply	• **Inflation peaks in H2 22** and falls gradually to around **5%** by late-2022/early-2023 • **Long-term inflation expectations stay below 3%** even as oil prices stay elevated	• Inflation **stays high or moves higher** • **Long-term inflation expectations stay elevated or rise further**, a result of either demand or supply side factors
Fed Policy	• **Fed pauses rate hikes in late-2022/early-2023**, and signals it is considering cutting rates later in 2023 to support growth	• Fed still hikes rates, but by a **similar or lesser amount** than the 4.4% markets expect	• Fed sees a need to tighten more aggressively than current market expectations • **Fed accelerates the hiking cycle and tightens well beyond 4.4%** in 2023
Economic Growth	• **Growth slows, but a recession is either very shallow or avoided altogether** • Job markets remain relatively robust	• **The US economy tips into a shallow recession**, albeit within bounds of current market forecasts	• Growth decelerates sharply • Economy **enters a deep and/or prolonged recession within the next 12 months**
Financial Markets	• Equities, especially growth equities, outperform • Corporate/EM bonds deliver attractive returns amid falling rate expectations • USD rapidly weakens	• UK, Asia ex-Japan equities outperform • Asia USD bonds outperform • Gold benefits from reducing interest rate pressures • USD peaks	• Inflation hedges like gold, commodities and private real estate outperform • Floating rate loans, USD rise alongside rising rate expectations • US government bonds ultimately benefit on 12-18 month horizon after initially falling • USD strengthens moderately

Source: Standard Chartered

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