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The Fed pauses for thought

Over the past 18 months, amidst stubbornly high inflation, the US Federal Reserve (the Fed) embarked on its most rapid rate hike campaign since the 1980s. The resulting surge in interest rates sent financial markets on a tumultuous journey last year, with concerns of a recession triggered by the aggressive rate hikes still haunting the market this year.

However, the recent announcement by the Fed to keep the policy rate unchanged during its June meeting has brought a sense of relief to market participants. With the Fed skipping a hike for the first time since March 2022, it begs the question: is the year-to-date rally across global equity indices better underpinned, and might there be more 'sentiment fuel' in the tank for a continued grind higher? In this communication, we aim to answer this question by examining the current macroeconomic environment, assessing potential rate trajectories, and discussing the implications for investment strategy.

Macroeconomic backdrop calls for a pause

US (all items) Consumer Price Index inflation, currently 4.0% for May, has significantly decreased from the 9.1% peak observed in Q2 2022, but it is still a far cry from the Fed's long-term target of 2%. Despite a less favourable growth outlook, inflation seems to be moderating at a slow pace. The shift in US consumer spending from goods to services initially contributed to a decline in core inflation. However, ongoing labour constraints and historically low unemployment rates have propped up wage growth, keeping overall inflation stubborn. It is important to consider the ongoing dynamics of wage rates, as they are experiencing a downward trend. The key question lies in the speed and ultimate level of the decline, and where the stabilisation point will be reached.

At the same time, the growth outlook is clouded by weakened demand from both corporations and households. Global manufacturers are experiencing excessive inventory build-up as supply chain bottlenecks ease. Simultaneously, households squeezed by higher cost of living could cut back spending as the post-pandemic surge in goods demand wanes, although US retail sales have generally been holding up indicating resilience of the US consumer. Furthermore, stress within the regional banking system has resulted in tighter credit lending conditions, potentially further hindering growth.

The Fed's goal (through its mandate of maximum employment and stable prices), is at the current time to seek to curb inflation without extinguishing growth. Considering various factors, the decision to temporarily halt interest rate hikes is well-timed and reflects the Fed's confidence in the trajectory of inflation towards its long-term target of 2%. There is no immediate need for another wave of aggressive rate hikes that could potentially disrupt the delicate balance of economic growth.

Divergence between the Fed announcement and market expectation

The policy rate is now 0.5% below the US Federal Reserve's year-end guidance, with 5.5-5.75% being the median projection for 2023 in the Federal Open Market Committee's (FOMC) latest Summary of Economic Projections ('dot plot'). While the Fed hasn't indicated a long pause, market sentiment overwhelmingly suggests that the end of this rate hike cycle is in sight, barring any significant changes in the economic outlook or unexpected shocks. Bond markets are now pricing in peak interest rate in autumn and rate cuts by the end of this year, reflecting the traditional recession playbook where central banks cut rates on signs of economic and financial damages. However, this is not the first time that the market has misjudged the Fed's intentions to ease. Should inflation prove persistent, this could mean rates could stay higher for longer.

It is important to recognise that skipping a hike does not necessarily indicate the end of the rate hike cycle. The timing and duration of peak interest rate are dependent on subsequent economic and inflation data. Looking at historical patterns, in the five previous hiking cycles since 1990, the Fed typically maintained peak interest rate for an average of 10 months between its last hike and its first rate cut. Consequently, we may not see significant easing measures until the second half of 2024.

Will central banks in Europe follow suit?

On the other side of the Atlantic, inflation in Europe, particularly in the UK, is running even higher. The latest inflation figures for the eurozone exceed 6%, while the UK's inflation is above 8%. Similar to the US, services inflation has been a significant factor, but food and core goods have also shown stronger price momentum despite input prices easing over the last few months.

There are some signs that the rate hikes implemented by the European Central Bank (ECB) are beginning to impact economic activity and cool down inflationary pressures. The German economy has contracted for two consecutive quarters, and eurozone bank lending has stagnated for six months. If inflation continues to moderate in the coming months, the hiking cycle may come to a halt by autumn.

In contrast, inflation in the UK appears to be more persistent. The significant increases in inflation have prompted higher wage demands, which, in turn, encourage companies to sustain price increases. Consequently, the Bank of England (BoE) is expected to continue raising rates in the near term, and the BoE's rate hike cycle may last longer than that of the ECB.

Investment outlook and tactical positioning

Investors who are bullish on equity markets view the interest rate pause as a stock-buying opportunity, based on the belief that the Fed would soon begin cutting rates, which would support higher equity valuations. This sentiment is evident in the recent rally of interest-rate sensitive technology stocks, which broke away from the broader market since early April. However, it is important to note that while the Fed is currently in a wait-and-see mode, the risk of further rate hikes in this cycle should not be overlooked. It is also worth considering that the impact of rate hikes can take up to 24 months to fully materialise in the broader economy. As a result, the complete effects of previous hikes are yet to be felt and could potentially further dampen economic activities. In such times, we emphasise the importance of diversification, and focus on high-quality segments in both equities and fixed income space in the short term but maintaining an optimistic view towards risk assets with a slight overweight in equities relative to our strategic equity ranges.

We continue to emphasise balance in stock portfolios, as rates could remain relatively firm as we edge closer to the end of this rate hike cycle. We continue to seek an equity barbell balance between growth and value investment styles, and we would use the recent outperformance of technology exposures in particular as an opportunity to rebalance portfolios in line with our asset allocation guidance, where necessary. Given the diverging expectation between market participants and the Fed regarding rate cuts, we anticipate an extended period of volatility in the fixed income space. Therefore, we reiterate our stance on shorter duration investments to take advantage of higher short-term rates while avoiding speculation on the longer-term interest rate trajectory. Lastly, portfolio diversification across different asset classes and regions remains crucial for optimising risk exposure.

Important information

Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Past performance is not a reliable indicator of future results. Investors may not get back the amount invested. Changes in rates of exchange may have an adverse effect on the value, price or income of an investment. Investors should be aware of the additional risks associated with investing in smaller companies, emerging or developing markets. The value of your investment may be impacted if the issuers of underlying fixed income holdings default, or market perceptions of their credit risk change.

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