July 11th, 2022

The Fed Serves Up a Reality Check

- **The Fed reminds the market of its intention to increase rates markedly and at speed**
- **US corporate results from banking sector due this week as well as inflation report**
- **Global energy sector looks good value despite the debate about the path for oil prices**
- **Europe looks vulnerable to further currency weakness versus the dollar**

The Federal Reserve means business. Just when the markets were getting comfortable with the idea of a less aggressive pace of Fed tightening, last week's publication of the minutes from the previous Federal Reserve policy meeting spooked them further.

In the Fed's words, "Many participants judged that a significant risk now facing the committee was that elevated inflation could become entrenched if the public began to question the resolve of the committee to adjust the stance of policy as warranted". They also made it quite clear that the anchoring of inflation expectations is more important than a potential slowdown in economic activity. Officials "recognised that policy firming could slow the pace of economic growth for a time, but they saw the return of inflation to 2% as critical to achieving maximum employment on a sustained basis".

The Fed is determined to get ahead of the curve and tighten policy to a point where it slows the US economy. In all likelihood, the next meeting will deliver a further 75bps increase in the Fed funds rate. In fact, the market has since upped its expectation of future Fed funds rate increase by 25bps for the period to March 2023. Meanwhile, the US 10-year government bond yield rose 20bps on the week to 3.08%. The market expects this week's June US inflation report to show headline inflation of 8.8%, the highest since the end of 1981.

Chart 1: Market pricing of Fed rate hikes

Chart shows the market's pricing of Fed Funds by February 2023

Source: Bloomberg

Despite the Federal Reserve's hawkish tones, **there was a distinct whiff of risk-on sentiments in the markets last week**. Equity markets saw some support, with the tech-heavy NASDAQ up 5.5% on the week. Equity markets in the US, Europe and Japan all managed to eke out positive returns. Even as the fundamentals look challenging, we do not believe 10% rallies are entirely impossible. Hence, a move back to 4000 on the S&P500 is possible, and a brush with the recent high of 4180 is not ruled out. However, we see this as noise amid still challenging conditions for the markets. Indeed, the US 10-year government bond yield pushing through 3.0% does not bode well for equities.

With the US Q2 results season getting into full swing, it could be a testing week for the equity market. Investors will train their focus the large US banks and other financials, including JP Morgan, Citibank, Morgan Stanley and Blackrock. Focus will also be on the management of these firms for their views on the challenges facing the global economy and their collective risk appetite now. At this juncture, any signs of a credit crunch would not be helpful.

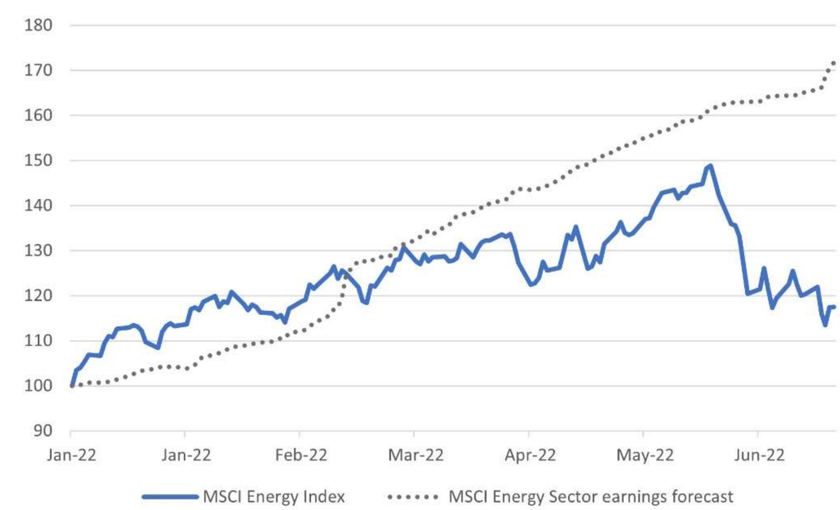
Last week there was clear evidence of some investor interest in the high yield bond market. The global high yield index returned little on the week, but the spread over government bonds narrowed 28bps. The performance of US high yield was even more impressive, with spreads narrower by a huge 58bps on the week. The US high yield bond index returned 1.3% for the week. Comments from the US banks could determine whether lower-quality bonds will hold onto their recent gains.

Commodities had a mixed last week. WTI oil prices were down as much as 5% for the week, in a wide range of $16 price moves, the most volatile since March. We tend to favour the view that oil prices will hold up even if investors fear a recession. The Ukraine war is curbing Russian supply and the limited ability of OPEC to meet its current production targets. Citigroup analysts elicited much attention last week as they suggested that demand destruction could take prices down to $65bbl by year-end.

Oil equity stocks look attractive at this juncture. The global energy sector is off 22% in absolute terms since early June. The poor performance of the stocks is at odds with the ongoing upgrades to earnings forecasts. Since the beginning of the year, corporate profit forecasts for the current year are up more than 70%,

Chart 2: MSCI World Oil Integrated Stock Index and corporate profits

Rebased to Jan 2022=100

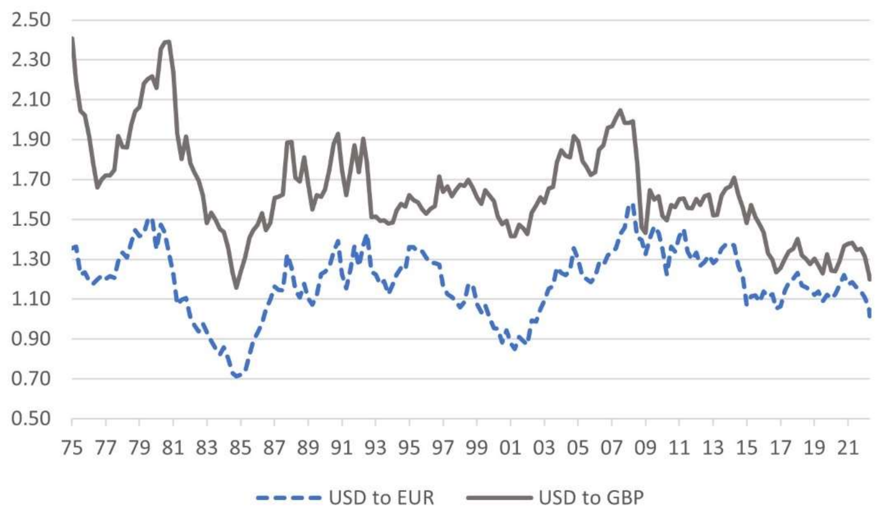


Source: Bloomberg

The European economy looks increasingly vulnerable to a further loss of momentum if Russia goes through with its threat to cut off supplies. The Bundesbank has forecast that German GDP could fall by as much as 6%, with JPMorgan forecasting 4-5% off EU GDP growth. The euro continues to look very vulnerable with forecasts of the $/EUR falling to as low as 85, a level last seen in June 2001.

British Prime Minister Boris Johnson’s ousting **brings the risk of a future UK policy mix further destabilising sterling,** which has been under pressure in recent months. Two of the leading contenders for the UK PM’s post have indicated that their economic policies could include a loosening fiscal policy that the Bank of England's Monetary Policy Committee is likely to respond to with even higher interest rates. Such a policy mix takes us back to the days of economic mismanagement of old. Sterling breached $1.20 at one stage last week and is down 5.2% against the dollar month-to-date. The slide, if it continues, can only exacerbate the inflation pressures on the UK economy. The last time that sterling was this weak was in 1985, when it hit $1.05.

Chart 3: UK sterling and the Euro on a tear to the bottom against the dollar



Source: Bloomberg

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