WILSONS

Peak Fed?

Our weekly view on asset allocation.

09 May 2022

Fed Lifts Rates By the Most in 22 Years

As expected, the US Federal Reserve (the Fed) hiked interest rates by 50 basis points (bps) last Wednesday, lifting the target federal funds rate to a range of 0.75% to 1%. This is the first 50bps rise since early 2000.

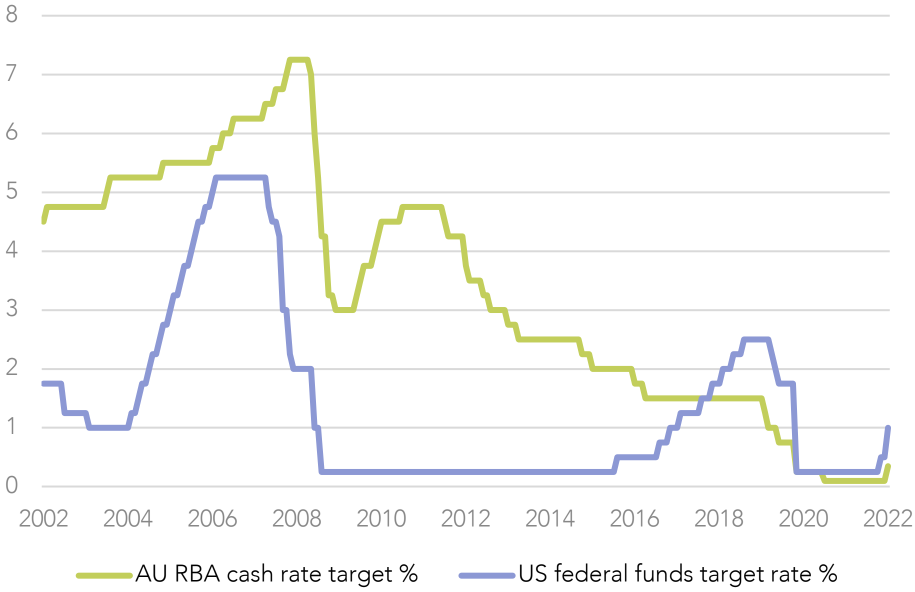
In addition, the central bank released details of its balance sheet reduction plan, which will begin June 1st (quantitative tightening, i.e., QT). For Treasuries, it will initially cap the run-off at $30 billion a month for the first 3 months, before raising the threshold to $60 billion a month. The threshold for mortgage backed securities (MBS) will be raised from an initial $17.5 billion in the first 3 months to $35 billion a month thereafter. This is a faster QT process than seen post the GFC and will likely keep some upward pressure on the long end of the curve, all things equal.

Peak Fed?

In the press conference, Chair Powell noted that while he expects the Fed to deliver another couple of 50bps rate hikes in upcoming meetings, a larger 75bps hike is not being actively considered. These comments eased investor concerns around a more aggressive tightening path. Bond yields declined, and the yield curve steepened following the announcement. The US dollar weakened, while the S&P 500 gained 3%, led by tech and cyclicals. Stocks subsequently reversed course again Thursday night as a contrasting bearish outlook for the UK economy spooked US investors.

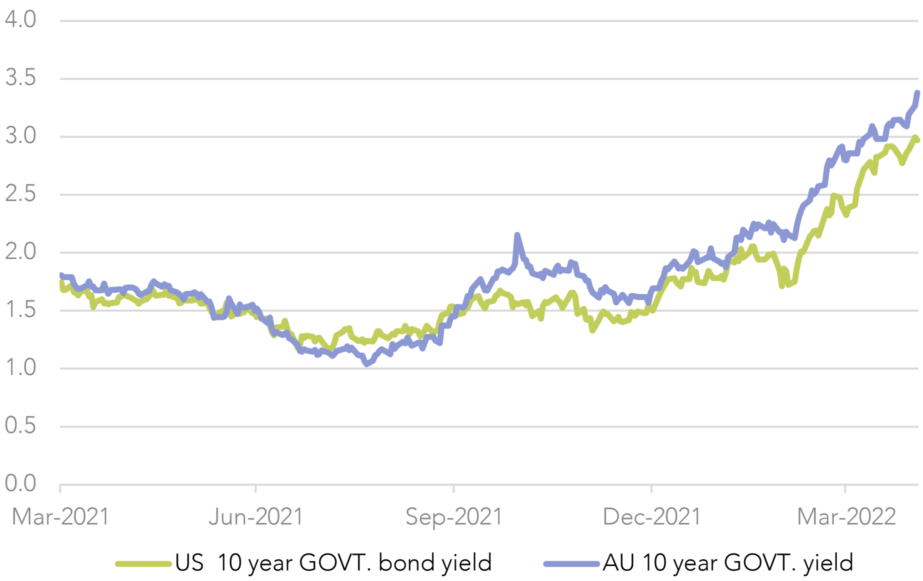
Equities and bonds have been under pressure so far this year, principally because of the Fed's increasingly hawkish policy pivot, and its increasing concern around the potential for embedded inflation pressures. This has seen bond yields rise across the curve, and the futures markets increasingly price in more and more policy tightening over the coming 18 months.

Figure 1: The Fed is now moving rapidly and the RBA is also beginning to normalise the cash rate



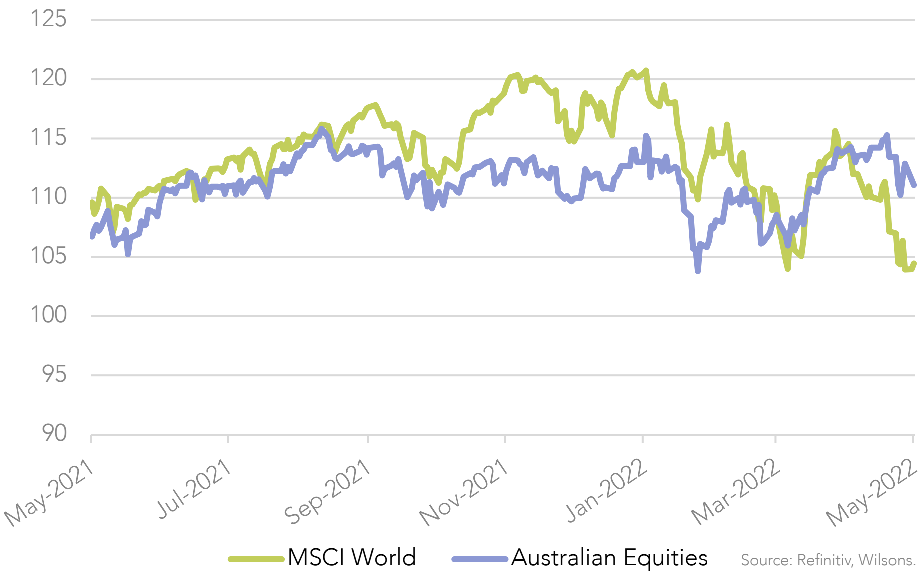
Source: Refinitiv, Wilsons.

Figure 2: US and Australian bond yields have moved up sharply this year



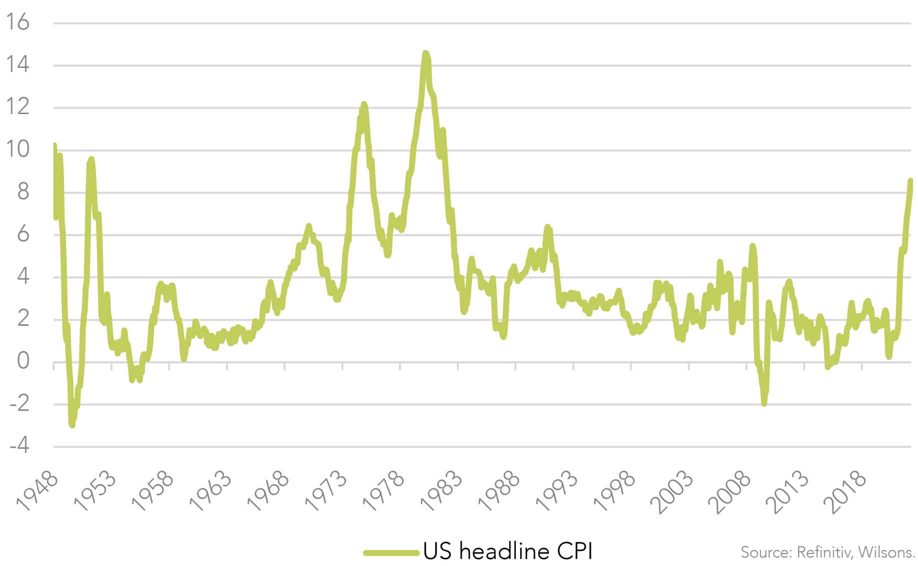
Source: Refinitiv, Wilsons.

Figure 3: Inflation and rate concerns have dragged global equities lower YTD. Australia has held up better



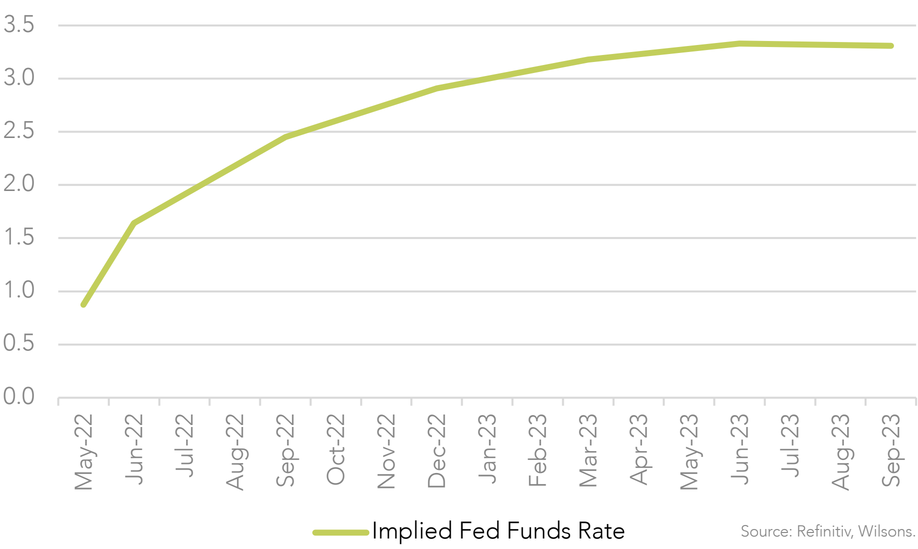
Source: Refinitiv, Wilsons.

Figure 4: US headline CPI is at 40-year highs. Pressures should ease from here



Source: Refinitiv, Wilsons.

Figure 5: Market continues to price a rapid US hiking cycle this year and first half 23



Source: Refinitiv, Wilsons.

The fact that Chair Powell's comments did not turn out to be incrementally hawkish, and indeed, Powell pushed back on some of the market's more hawkish fears around a 75bps tightening, was a relief to markets. Powell also suggested that prospects for the US avoiding a recession were good. The likelihood that we have reached peak Fed hawkishness has the potential to support both equities and bonds. However, there is still a large degree of uncertainty around the path of inflation (US inflation is at a peak in our base case) and the Fed's policy response.

Fed Still a Long Way from Dovish

Chair Powell did state that restoring price stability is essential and that the Fed is prepared to move the policy rate above its neutral level (2.5% is the Fed's best guess) if conditions require. Of course, there is still a risk that the Fed will have to take policy well past neutral (risking a recession) but this is not our central case over the coming year.

We believe price pressures are likely to moderate somewhat over the balance of the year, which should remove the need for the Fed to tighten more aggressively than current market expectations. Indeed, it may well allow the Fed to tighten a bit less over the next 12 months than currently priced.

There is also potential to see a Fed funds rate peak closer to the Feds' estimate of neutral later in 2023 rather than the current implied futures peak of 3.3%.

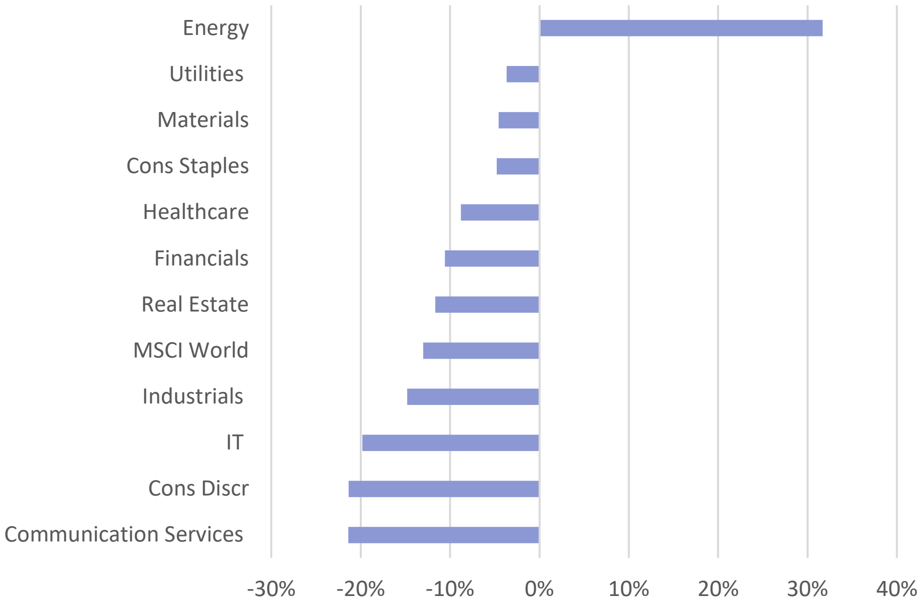
The potential for some ebbing in inflation and Fed policy dynamics ultimately suggests that conditions could well fall into place for equities to rally over the coming year as inflation, interest rates and growth fears all dissipate somewhat. Of course, geo-politics is still an important wildcard in the investment mix, but we believe inflation and the Fed remain the key.

Does "Peak Fed" Suggest Re-weighting into Growth Stocks?

Peak concern around inflation and the Fed could also lay the foundation for renewed interest in growth stocks after their significant retracement over the past 6 months. We will watch upcoming inflation readings (May 11th is the next US CPI print) as the key indicator as to whether we have really hit peak Fed concerns.

Our central case remains that some of the key drivers of US inflation, e.g., food and energy and also core goods inflation will start to show some easing from as early as the May 11th CPI release. Of course, there are still risks to the view of ebbing inflation, particularly with the US labour market tight. The global supply chain is showing some improvement but is facing fresh challenges from China Covid lockdowns as well as the Russia-Ukraine conflict. QT may also keep upward pressure on long bond yields, even if Fed rate expectations stabilise.

Figure 6: Global sector price performance YTD. Tech related "growth" sectors under pressure



Source: Refinitiv, Wilsons.

Investors also need to recognise that earnings delivery is becoming increasingly important for high PE growth stocks. The current US reporting season has thrown up some mixed performances in respect of high multiple tech meeting earnings expectations.

So, while the backdrop for the growth style may be on the cusp of improving, there remains a high degree of macro uncertainty. Moreover, with earnings delivery coming to the fore, investors will likely need to be much more selective, even with an improved macro backdrop.

Figure 7: Australian inflation (headline CPI) spikes to a 22 year high

Source: Refinitiv, Wilsons.

The RBA – A Belatedly Hawkish Shift

Closer to home last week, the RBA decided to increase the cash rate target by 25bps to 35bps. This is the first time the RBA has hiked rates in almost 12 years.

While the RBA had previously indicated a willingness to wait for evidence that wages are accelerating (the next wages print is May 18th), the recent above consensus CPI number accelerated the impetus to start the hiking cycle.

The RBA formed the view that it was the right time to begin withdrawing some of the emergency monetary support that was put in place to help the Australian economy during the pandemic.

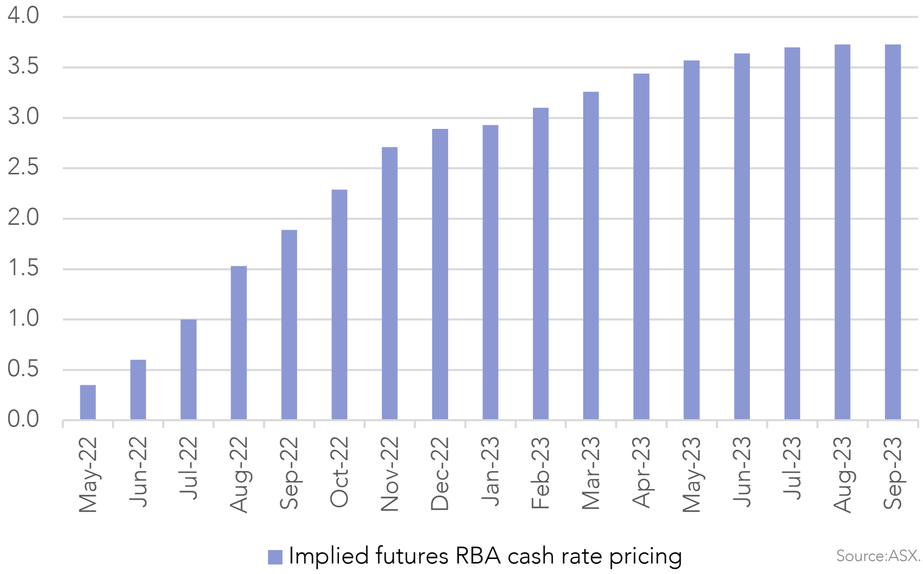
The above consensus CPI result has prompted the RBA to significantly lift its inflation forecasts. The RBA is now expecting December 2022 CPI of around 6% (was 3¼%) and underlying CPI around 4¾% (was 2¾%). Both are now assumed to take some time to moderate to around 3% by mid 2024. This assumed stickiness in the inflation profile surprises us somewhat, particularly the assumption that inflation stays very high in 2023.

We still think market pricing of ~3½% cash rate by late 2023 is too high. While the RBA hiked more than expected last week, their guidance is for a peak cash rate late next year of 2.5% compared to the market's pricing of a peak of 3.7%. We retain our 2.0% peak rate forecast. We would expect a follow-up 25bps hike in June, after the (higher) wages data.

Longer term domestic bond yields pushed to new highs off the back of the RBA announcement. They had already been rising sharply this year, mirroring their global peers as expectations for US Fed tightening increased. The Australian 3-year rate, which is sensitive to interest rate expectations, has climbed to 3.00% for the first time since April 2014. The Australian 10-year bond rate pushed up to 3.38%, a level last recorded in late 2014 (as at May 5th).

The RBA's abrupt hawkish turn was something of a surprise to the economist consensus. However, futures market pricing still looks too aggressive in our view. As per our US view, we expect some easing in global supply side inflation pressure through the year and eventually lower overall Australian inflation, particularly as comps become more difficult in 2023. This should keep the RBA on a measured path, but the RBA's new-found concern around more stubborn inflation and subsequent overtightening can't be completely discounted. The wages data on May 18th will be closely watched, as will the trends in global inflation in coming months.

Figure 8: Futures market implied cash rate pricing (a very aggressive profile)



Source:ASX.

We see emerging value in domestic government bonds and think the equity market can cope with higher rates given a solid profit backdrop. Global factors (particular the path of US inflation and US interest rates) are likely to be the key to the direction of our local equity market for the balance of the year. We remain tactically cautious, but a 12-month view remains constructive. Domestic monetary policy will become progressively important for both the housing market and the equity market as cash rates grind higher into 2023.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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