Economic Research

July 2021

Market Monitor – United States

Federal Reserve Pencils Rate Hike in 2023

Federal Reserve tilts towards hawkish amid stronger growth outlook and higher inflationary pressure

The US labour market has continued to improve, with 559,000 jobs added to nonfarm payrolls in May. The leisure and hospitality sector continued to contribute to the job gains over the past two months, as business restrictions continued to ease amid the downward trend in new Covid-19 cases. Unemployment also dropped to a new pandemic low of 5.8% in May.

With rounds of government stimulus and easing business restrictions amid the decline in new Covid-19 cases, US consumers are regaining confidence and increasing spending, pushing up inflation. Headline CPI rose 5% year-on-year in May, the highest in nearly 13 years after a 4.2% rise in April. Core CPI also climbed 3.8% during the month, the largest rise since June 1992. The substantial annual rise in consumer prices in recent months was mainly due to a low base comparison, a surge in demand, and supply chain bottlenecks. For instance, used car price increased over 20% year-on-year in both April and May. New car production was distorted by a global chip shortage, prompting consumers to purchase used cars instead.

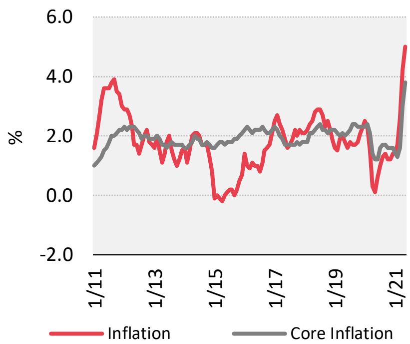
The US Federal Reserve (Fed) kept the fed funds rate target at its current level at its latest meeting in June. It also maintained its USD 120 billion asset purchase programme. It issued an upbeat economic projection, expecting GDP growth to accelerate to 7.0% in 2021, up from a projection of 6.5% in March. Inflation for core personal consumption expenditure for 2021 is projected to be 3.0%, significantly up from the previous projection of 2.2%. Meanwhile, 13 of the 18 Fed officials at the meeting indicated they would raise interest rates by 2023. The latest median projection is that the fed funds rate target range will increase by 50 basis points by the end of 2023.

Fed plans for rate hike in 2023 with improved economic outlook and mounting inflationary pressure.

Upcoming global tax policy reforms and normalising monetary policies pose challenge to elevated stock valuations.

US dollar strengthens as interest rate normalisation comes earlier than previously projected.

US Inflation



Source: Bloomberg, data as of 15/6/2021

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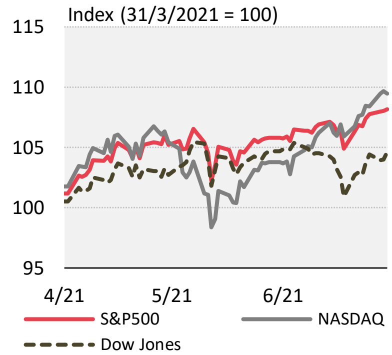
Inflationary pressure mounts as supply chain bottleneck persists

As of 30th June, about 54% of the US population had received at least one dose of Covid-19 vaccine and about 46% of the population were fully vaccinated. The 7-day average of new cases also dropped to around 12,500. Looking ahead, the country is making continued progress on vaccination and is on track for a relaxation of business and social restrictions in the second half of 2021. The US economy is likely to recover to close to its pre-pandemic level by the end of 2021. Nonetheless, with supply bottlenecks of chips and other raw materials, as well as the labour market mismatch related to the generous unemployment benefits during the pandemic, the supply of goods and services is very likely to continue to fail to meet the surge in consumer demand. In addition, the Biden administration has been pressing to raise the minimum wage to USD 15 per hour by 2025. These factors will intensify inflationary pressure in the medium term.

US Equity Indices



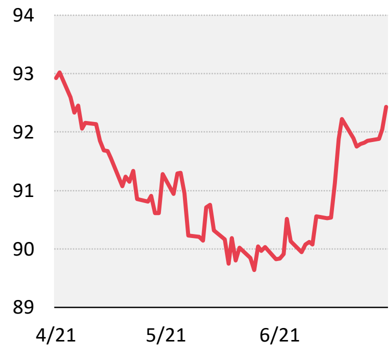
Source: Bloomberg, data as of 30/6/2021

Equity market supported by potential stimulus despite upcoming tapering

Although the Fed has not yet revealed when it will start tapering off its asset purchase programmes, market participants generally believe that it will announce the plan in August or September and begin to wind down purchasing in the first quarter of 2022. Despite the upcoming tapering, equity market was bolstered as President Biden reached a deal on infrastructure bill with a group of centrist senators. As of 30th June, the Nasdaq recorded a 5.5% gain from the level at the end of May, while the S&P 500 Index rose by 2.2% over the same horizon. Nonetheless, the Dow Jones Industrial Average fell by 0.1%.

Looking ahead, the high valuations currently seen in the stock market will face other challenges apart from the monetary policy normalisation. On 5th June 2021, the G7 countries agreed to a global minimum tax of 15% on corporate earnings and proposed to give local market jurisdictions the right to tax the largest and most profitable multinational companies that exceed set profit margin thresholds. It is expected that US multinational companies, especially the tech giants, will be impacted by this tax reform. The Biden administration also plans to raise the US corporate tax rate from 21% to 28% to finance his long-term spending plans. These measures pose a challenge to the profit margins of large corporations. It has been reported that companies will increase their leverage ratios when faced with a higher corporate tax rate. This will pose additional risks to earnings prospects when monetary policy is normalised.

Dollar Index

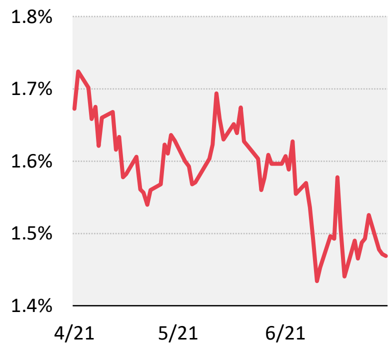


Source: Bloomberg, data as of 30/6/2021

US dollar strengthens as Fed signals earlier rate hike

The US dollar reversed its downward trend in June as the country's economic outlook improved, and the Fed hinted at an earlier interest rate hike during its June meeting. As of 30th June, the dollar index had risen by 2.9% from the level at the end of May.

US 10-year Treasury Yield



Source: Bloomberg, data as of 30/6/2021

Despite higher inflation and the Fed planning an earlier rate hike, the 10-year treasury yield edged lower in June, as investor unwinding trades that were betting on higher inflation and demand for US treasuries remained solid. As of 30th June, the 10-year treasury yield stood at 1.469%, about 13 basis points lower than the level at the end of May. However, treasury yields are expected to edge higher in the long run as the Fed tapers off its asset purchase programme and normalises the target range of the fed funds rate. The US dollar will also continue to strengthen with improving economic fundamentals and the expectation of higher interest rates.

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