BEA 東亞銀行

Economic Research

April 2022

Market Monitor – United States

Ukraine Conflict Raises Expectation of Higher Inflation

Surging inflation and continued labour market improvements provide room for more rate hikes by the Fed

The US labour market continued to see improvement in February, with nonfarm payrolls seeing 678,000 added jobs during the month, which was higher than market expectation and built on an upward revision of 481,000 added jobs in the previous month. At the same time, the unemployment rate dropped slightly to 3.8% in February, down from 4% in the previous month and approaching the pre-pandemic level of 3.5%. Labour earnings continued to see solid growth, with average hourly wages registering year-on-year growth of 5.1% in February.

Meanwhile, higher energy prices, persistent supply chain bottlenecks, and shortages of supplies like semiconductor chips have pushed US inflation to a new 40-year high. Headline consumer price index (CPI) growth rose further to 7.9% in February, up from 7.5% in the previous month. The core CPI, which excludes the volatile categories of food and energy, registered a 6.4% annual growth during the month, which is also the largest yearly rise since August 1982. Inflation is expected to edge higher amid the Russian invasion of Ukraine, which has dented consumer sentiment. The final reading of the University of Michigan Consumer Sentiment Index dropped to 59.4 in March, down from 62.8 in February and now the lowest reading since September 2011.

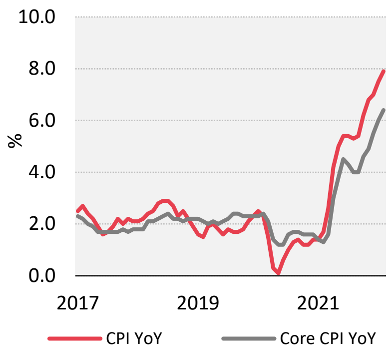
Against this backdrop, the Federal Reserve (Fed) announced at its March meeting that it would raise the fed funds rate target by 25 basis points to 0.25% – 0.5% and signalled more rate hikes ahead in 2022 and 2023. The Fed also cautioned about the additional upward pressure on inflation in the short run caused by Russia's invasion of Ukraine. The Fed's latest midpoint projection of the fed funds rate implies that the target range will rise to 1.75% – 2% by the end of this year, with three to four more 25-basis point hikes envisaged in 2023. The Feds' projection at its March meeting was generally considered by market participants to be more hawkish than previously expected. Fed chairman Jerome Powell also said that the Fed could begin shrinking the USD 9 trillion balance sheet as soon as May.

Fed raises fed funds rate target to 0.25% – 0.5% as expected and signals more aggressive rate hike path than previously projected.

Consumer sentiment worsens further amid higher inflation and the conflict in Ukraine.

Medium term outlook could be clouded by prolonged geopolitical crisis.

US Inflation



Source: Bloomberg, data as of 15/3/2022

Medium-term outlook clouded by risk of prolonged Ukraine conflict

Looking ahead, the Ukraine crisis will add uncertainty to the US inflation outlook and raise the risk of supply chain bottlenecks. The US government has imposed various sanctions against Russia, including a ban on Russian oil, natural gas, and coal imports. If OPEC does not increase production significantly and if more US allies impose similar bans on Russian oil and petroleum products, international energy prices will remain high and inflationary pressure will persist longer.

Amid the risk of a prolonged conflict in Ukraine and with US politicians taking a tougher stance towards China as the midterm elections approach, the financial markets may experience further volatility. In addition, higher interest rates will also increase the likelihood of lower valuations for assets like real estate that have long benefitted from a low-interest-rate environment. These factors will generally serve to reduce consumers' personal wealth and reduce their spending, causing a potential drag on economic growth. With inflation remaining high, the Fed will have limited room to scale back its normalisation process and the US government may face more difficulties when it plans to roll out a large-scale stimulus package. The US economy may face a higher risk of stagflation in the medium term.

Financial markets see increased volatility as the Fed raises interest rates and the Ukraine conflict continues

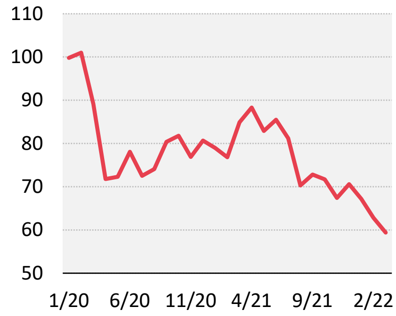
Benchmark equity indices saw volatile performances in March amid the start of rate hikes by the Fed and the crisis in Ukraine. Equity market corrected in the first half of the month but rebounded towards the end of the month, mainly because Russia said that it would reduce military operations near Kyiv after rounds of talks with Ukraine. As of 31st March, Nasdaq index recorded a 3.4% gain compared to the end of February, while the S&P 500 Index rose by 3.6% over the same horizon and the Dow Jones Industrial Average Index by 2.3%.

The US dollar continued to strengthen in March, as the Fed commenced interest rate hikes and investors sought safe havens amid the raging conflict between Ukraine and Russia. As of 31st March, the dollar index stood at 98.312, about 1.7% higher than the level at the end of February.

In the bond market, US treasury yields continued to rise as investors priced in a more aggressive rate hike path by the Fed. The 10-year treasury yield had risen to 2.341% as of 31st March, about 51 basis points higher than the level at the end of February.

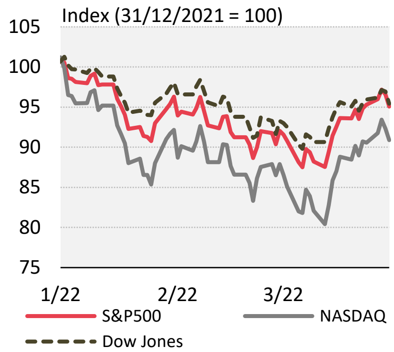
Looking forward, as the Fed continues to raise interest rates at a faster pace, elevated asset valuations like equity and property may face challenges. Meanwhile, the geopolitical risk from the Ukraine conflict will create additional volatility in the financial markets, especially if tensions between the US and its allies and Russia rise further.

University of Michigan Consumer Sentiment Index



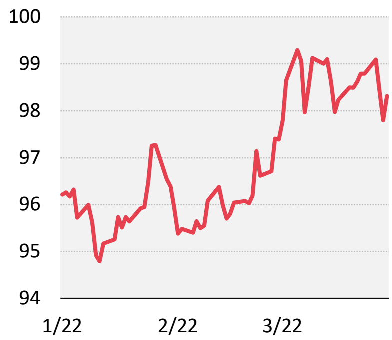
Source: Bloomberg, data as of 31/3/2022

US Equity Indices



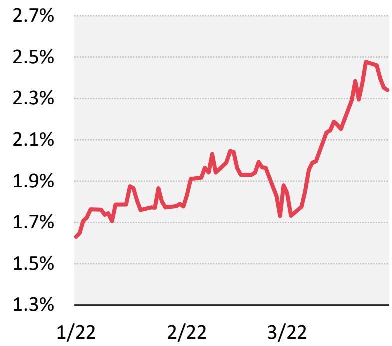
Source: Bloomberg, data as of 31/3/2022

Dollar Index



Source: Bloomberg, data as of 31/3/2022

US 10-year Treasury Yield



Source: Bloomberg, data as of 31/3/2022

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