BEA 東亞銀行

Economic Research

July 2022

Market Monitor – United States

Faster Pace of Tightening as Inflation Reaches 40-year High

US inflation hits a fresh 40-year high, reducing consumer confidence to record lows

Inflation remains the focus of the US economy, with no signs of it easing in May. The year-on-year increase in the headline consumer price index (CPI) edged up to 8.6% from 8.3% in the previous month. Elevated energy and food prices, higher transport costs, and a booming housing market led to broad-based increases in consumer prices and pushed US inflation to its highest level since December 1981. The core CPI, which excludes food and energy prices, rose by 6% year on year in May, down only 0.2 percentage points from the previous month. Fuel oil price rose by 106.7% year on year in May, hitting a new record high, while food prices rose by 10.1% year on year – the biggest rise since March 1981. Shelter costs rose by 5.5% year on year, up from 5.1% in the previous month.

Accelerating inflation has dampened consumer confidence. The final reading of the University of Michigan Consumer Sentiment Index fell to a record low of 50 in June, down from 58.4 in May. Expected inflation a year from now stayed at 5.3% in June, while expected inflation five years from now rose to 3.1%.

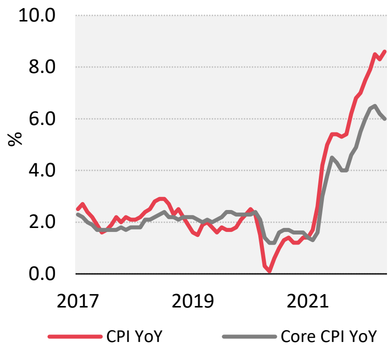
The US labour market remained tight in May, with the unemployment rate staying unchanged at 3.6%, close to the more than half-century low of 3.5% before the pandemic. Nonfarm payrolls saw 390,000 jobs added in May, building on an upwardly revised figure of 436,000 jobs in the previous month. Meanwhile, labour income recorded another solid growth, with average hourly earnings increasing by 5.2% year on year in May.

Headline inflation accelerates to 8.6% year on year in May, mainly due to higher energy and food prices.

University of Michigan Consumer Sentiment Index tumbles to historical low.

Fed raises the fed funds rate by 75 basis points at its June meeting and projects a more aggressive rate hike path.

US Inflation



Source: Bloomberg, data as of 15/6/2022

Worries about the US economic outlook intensify, as the Fed speeds up policy normalisation

In response to inflationary pressure far exceeding targets and a tight labour market, the Federal Reserve (Fed) raised the fed funds rate target by 75 basis points to 1.5% – 1.75% at its June meeting. Based on the latest Federal Open Market Committee (FOMC) median forecasts, the midpoint of the fed funds rate target range will rise by 325 basis points to 3.4% in 2022, and another 50 basis points to 3.8% in 2023. The fed funds rate will be higher than neutral, indicating tightening monetary conditions. Unless the inflationary pressure is alleviated faster than expected, it is expected that the Fed will consider raising the interest rate by another 75 basis points in its July meeting.

Looking forward, the US and other advanced economies are reopening their borders in stages, possibly driving demand for travel-related spending again. In addition, while supply chain disruption could ease somewhat in light of the improved global pandemic situation, the prolonged Russia-Ukraine conflict means that international energy and food prices will stay high for a while longer. With the strong price growth for wages and housing in the US, inflation is expected to remain elevated in the second half of 2022. According to a Bloomberg survey in June, the year-on-year CPI rise will average 7.6% in Q3 and 6.5% in Q4 2022, up 0.4 and 0.6 percentage points, respectively, from May's survey.

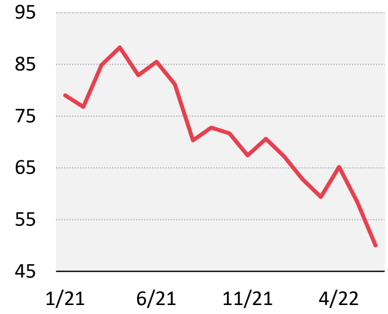
Driven by the expectation of faster normalisation by the Fed, US financial markets saw notably increased volatility. The net worth of US households fell by US$544 billion quarter on quarter to US$149.3 trillion in Q1 2022, even though housing prices saw significant gains. The S&P Case-Shiller 20-City Composite Home Price Index rose by 21.2% year on year in April. However, mortgage rates in the US have already risen sharply, in line with the faster pace of tightening by the Fed, and US property prices may see an increased possibility of correction. US households may face more pressure in the quarters ahead, which will drag on US consumption and economic growth. A Bloomberg survey taken in June shows market expectation is that US GDP growth could reach 2.6% in 2022, 0.1 percentage point lower than in May's survey. As the outlook of consumer spending, which accounts for about 70% of US GDP, clouded by mounting uncertainties, it is expected that the GDP growth for 2022 will be revised downward in the survey released in July.

Equity market slump continues amid higher treasury yields and strong US dollar

Given that US inflation shows no sign of easing in the near term, the markets expect the Fed to normalise its policy more swiftly. US equity markets have recorded significant declines as investors scaled back their risk appetite. As of 30th June, the S&P 500 Index had dropped by 8.4% and the Nasdaq by 8.7%, compared to figures at the end of May. Meanwhile, the Dow Jones Industrial Average had dropped by 6.7% over the same horizon.

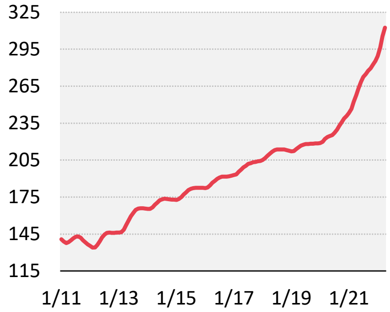
In the bond market, the benchmark 10-year treasury yield at one point reached 3.476%, the highest level since April 2011. Nonetheless, as the worries of recession grow, some investors bet on the peaking of interest rates and the rise in treasury yields eased at the end of June. As of 30th June, the 10-year treasury yield stood at 3.016%, about 17 basis points higher than at the end of May.

University of Michigan Consumer Sentiment Index



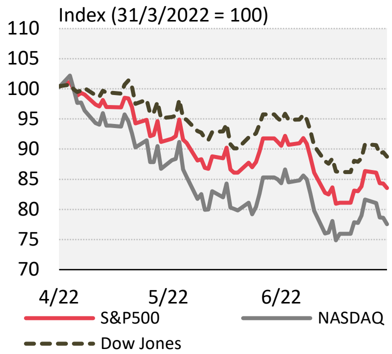
Source: Bloomberg, data as of 30/6/2022

S&P/Case-Shiller 20-City Composite Home Price Index



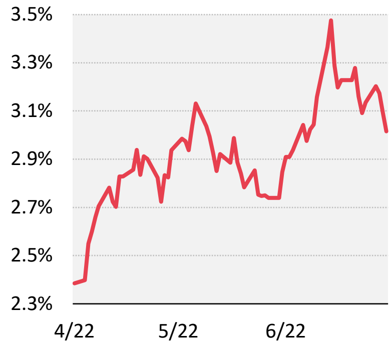
Source: Bloomberg, data as of 30/6/2022

US Equity Indices



Source: Bloomberg, data as of 30/6/2022

US 10-year Treasury Yield

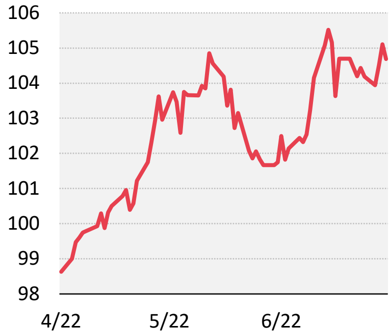


Source: Bloomberg, data as of 30/6/2022

In the foreign exchange market, the US dollar strengthened further, with higher treasury yields and a stronger expectation of tightening. As of 30th June, the dollar index stood at 104.685, about 2.9% higher than at the end of May.

Going forward, the US financial markets are expected to continue seeing higher volatility in response to the Fed's rapid shift of monetary policy stance and uncertainties related to geopolitical tensions and evolving pandemic conditions.

Dollar Index



Source: Bloomberg, data as of 30/6/2022

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