BEA 東亞銀行

Economic Research

January 2023

Market Monitor – United States

Fed Scaled Back the Rate Hike Pace But Hawkish Stance Remains

Inflation has peaked but remains far higher than the policy target

The US economy recovered from a brief technical recession in Q3 of 2022. In 1H 2022, the US economy recorded two consecutive quarter of quarter-on-quarter (QoQ) contractions, which were mainly driven by the widening of the trade deficit and a reduction of inventories. With the employment market remaining largely steady and the US economy recovering to a solid 3.2%% annualised QoQ growth in Q3 2022, the National Bureau of Economic Research (NBER) did not define the 1H period of negative growth as a recession.

All eyes were focused on inflation throughout 2022. Multiple factors from the pandemic-related supply chain disruptions and geopolitical tensions drove higher international energy and food prices. Earlier, sharp increase in property prices and solid employment markets was supported by accommodative fiscal and monetary policies, etc., which has then boosted inflation to a four-decade high of 9.1% year-on-year (YoY) in June 2022. There is no doubt that the inflationary pressures has already peaked, with supply chain pressures and elevated energy prices easing after the worst expectations of the pandemic and geopolitical tensions has subsided. With a rapidly tightening monetary policy stance by the US Federal Reserve (Fed), interest rate sensitive sectors, such as property markets, recorded a notable deceleration, though it will take some time for the impact of cooling property price to feed through consumer prices. However, the employment market has remained largely steady and the relatively solid wage pressure is higher than the levels consistent with the inflation target, adding further inflationary pressure. In November 2022, headline inflation fell to a 7.1% YoY, but the core CPI registered a YoY increase of 6.0% with shelter cost and core services prices remaining elevated. Meanwhile, the core personal consumption expenditure (PCE) price index, the inflation indicator favoured by the Fed also stayed unchanged at 4.7% in November. With both inflation measures remaining significantly higher than the Fed's 2% target, further tightening of monetary policy is warranted.

The Fed raises interest rates by 50 bps to 4.25%-4.50% at its December meeting but hinted at a higher terminal rate.

Inflationary pressure eased further in November with headline CPI and core CPI registering 7.1% and 6% YoY increase.

Looking forward, inflationary is expected to have peaked, though returning to 2% policy target is unlikely in 2023.

The solid US job market showed signs of moderation towards the end of 2022. Although the unemployment rate remained at a multi-decade low of 3.5% in December 2022, 0.1 percentage point (ppt) below November 2022 and 2022 average, and down from the 2021 average of 5.4%, the number of newly added nonfarm payrolls slowed to 223,000 in December 2022, down from a monthly average of 562,000 and 375,000 in 2021 and 2022 respectively. Moreover, the average hourly earnings slowed further from a downwardly revised 4.8% YoY in November to 4.6% in December, 1 ppt lower than its peak in March 2022. The moderation of earnings growth could imply some initial alleviation of core price pressure, which is likely to be the US Fed's focus ahead.

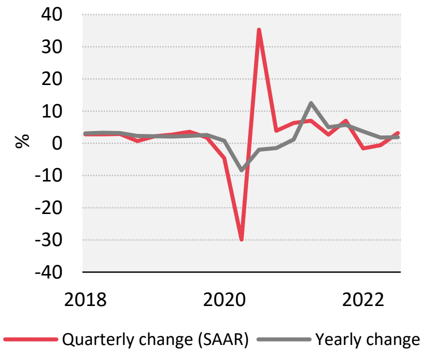
The Fed raised rates by a total of 425 bps in 2022, with more to come in 2023

With inflation once reaching a fresh four-decade high, the US Fed has rapidly tightened its monetary policy, resulting in a total of 425 basis points (bps) hike in 9 months. After four consecutive 75 bps hikes, the US Fed raised another 50 bps at its December meeting, bringing the fed funds rate target range to 4.25%-4.50%. The Fed scaled back its pace of rate hikes mainly because of the somewhat decelerating inflationary pressure, large cumulative rate rise and the rate hike impact taking time to feed through.

Meanwhile, the Fed updated the summary of economic projections (SEP) in a pessimistic direction for growth, unemployment and inflation. GDP growth in 2023 and 2024 are projected to be 0.5% and 1.6% respectively, down 0.7 ppt and 0.1 ppt from September's projection. The unemployment rate is projected to rise by 0.2 ppt from September's projection to 4.6% in both 2023 and 2024. The core PCE is projected to rise by 3.5% and 2.5% in 2023 and 2024 respectively, up 0.4 and 0.2 ppt from September's projection.

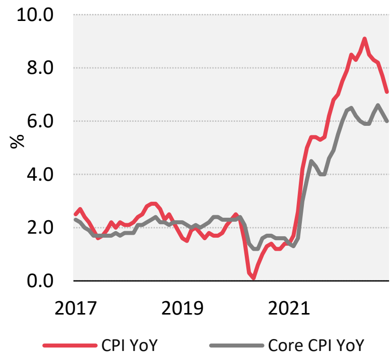
With inflation remaining far higher than its policy target, the Fed maintains its hawkish policy stance. At the post-meeting press conference, the Fed Chairman, Jerome Powell, reaffirmed that they will not cut rates until they have confident that inflation is moving toward the 2% target in a sustained way. At the same time, he also said that the current wage growth is running "well above" what would be consistent with 2% inflation. Against this background, the latest SEP showed the median fed funds rate forecast will rise by another 75 bps in 2023, bringing it to a range of 5.00% to 5.25% and 50 bps higher than the September's projection.

US GDP



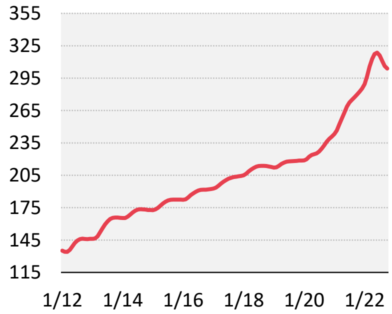
Source: Bloomberg

US Inflation



Source: Bloomberg

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



Source: Bloomberg

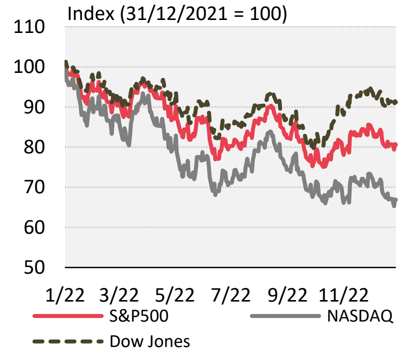
Looking forward to 2023, the US economy is likely to slow further amid tight monetary policy and a gloomy global economic outlook. Given that US inflation remains well above its policy target, the Fed is expected to raise interest rates by at least a couple of times more in Q1 2023 with policy rate remaining elevated for the rest of 2023. This will intensify financial asset and property price volatility, with any negative wealth effect dampening consumption and economic prospects. The net worth of American households decreased by another US$0.4 trillion QoQ to US$143.3 trillion in Q3 2022. The S&P 20-city Composite Home Price Index also fell for four consecutive months, declining by 0.5% month-on-month (MoM) in October after falling 1.3% MoM in September. In addition, the job market is expected to gradually cool, which could result in a deceleration in wage growth and the corresponding consumption sentiment. Together with the gloomy global economic outlook and relatively strong US dollar, the external sector will also be constrained. Whether the US economy reaches a soft landing will still depend on pace of employment and inflation moderation, while lingering impacts from the pandemic, geopolitical tension, supply chain issues, and energy shortage, etc., will be the key risks ahead.

Benchmark equity indices ended 2022 with losses, with much higher treasury yields and a stronger dollar exchange rate

In 2022, the Fed quickly shifted its monetary policy stance to raise rate aggressive, together with the geopolitical tension and gloomier economic outlook, investor sentiment was greatly impacted and resulted in huge financial market volatilities. Major stock market indices posted their worst performance since 2008. At the end of 2022, the Dow Jones Industrial Average, S&P 500 and Nasdaq dropped by 8.8%, 19.4% and 33.1%, respectively, compared with the end of 2021. Meanwhile, the benchmark 10-year treasury yield closed at 3.877% at the end of 2022, 237 bps higher than the previous year.

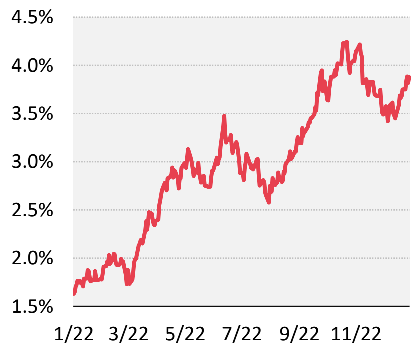
Against the backdrop of aggressive rate hikes, the US dollar also strengthened in 2022. At the end of 2022, the dollar index stood at 103.52, about 8.2% higher than that of 2021. Looking forward to 2023, market expectations usually leads to that of reality, with rising expectations of inflation and interest rate peaking soon, which could soften the uptrend of treasury yields and US dollar. Global and US economic fundamentals and corporate earnings performance will remain the key to US equity market performance.

US Equity Indices



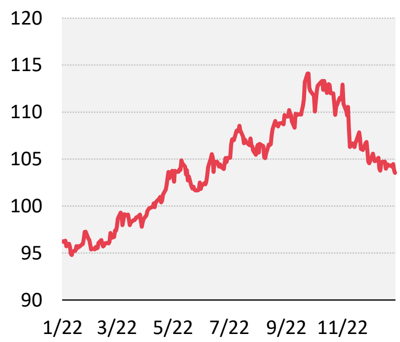
Source: Bloomberg, data as of 30/12/2022

US 10-year Treasury Yield



Source: Bloomberg, data as of 30/12/2022

Dollar Index



Source: Bloomberg, data as of 30/12/2022

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