Economic Research

April 2023

Market Monitor – United States

Risk of Financial Instability Rises Amid Continued Monetary Tightening

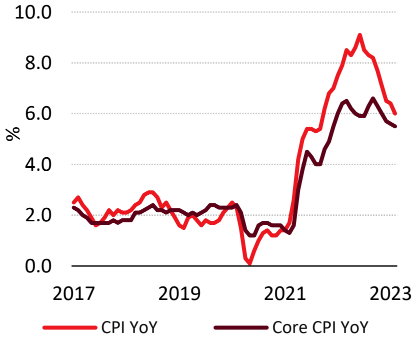
- The US job market remains tight. In the first two months of 2023, nonfarm payroll increased by more than 800,000. In February, the YoY increase in average hourly earnings edged up by 0.2 ppts to 4.6%.
- Consumer sentiment weakened in March, amid rising economic uncertainties.
- The Fed raised the fed funds rate target range by 25 bps to 4.75%-5.00% at its March meeting and shifted the forward guidance from "ongoing increases" to "some additional policy firming may be appropriate".

The US job market remains tight, with inflation easing slower than expected

After adding 504,000 jobs in January, US nonfarm payroll employment increased by 311,000 in February, indicating tight job market conditions. With more people returning to the labour market, the labour force participation rate rose for 3 consecutive months to 62.5% in February, raising the unemployment rate slightly by 0.2 percentage points (ppts) to 3.6% from a nearly 54 year low. Wage growth remained solid in February. While the month-on-month (MoM) growth in average hourly earnings edged down by 0.1 ppt to 0.2% in February (annualized growth rate: 2.4%), its year-on-year (YoY) growth rate was still elevated at 4.6%, up by 0.2 ppts from January.

Driven by slower energy prices, the headline consumer price index (CPI) in February edged down by 0.4 ppts to 6.0% YoY. Despite a slightly lower headline CPI, inflationary pressure remained elevated given a tight labour market and the healthy financial positions of US households. These led to elevated price gains in shelter and core services. In February, the price of shelter and core services accelerated further, growing by 8.1% and 7.3% YoY, respectively. As a result, core inflation stayed at a relatively high level of 5.5% YoY, indicating a slower than expected decline. In addition, retail sales retreated slightly by 0.4% MoM in February after increasing strongly by 3.2% in January, with its annual growth at 6.8% YoY in the first two months of 2023. That pointed to a solid

US Inflation



Source: Bloomberg

expansion in private consumption since the beginning of 2023. However, the University of Michigan Consumer Sentiment Index remained subdued and fell to 62 in March. The 1-year inflation expectation dropped by 0.5 ppts from February to 3.6%, while the 5-year inflation expectation stayed at 2.9% in March. Finally, the third estimate of US real GDP growth was largely unchanged in Q4 2022, revising down by 0.1 ppt to an annualized rate of 2.6%.

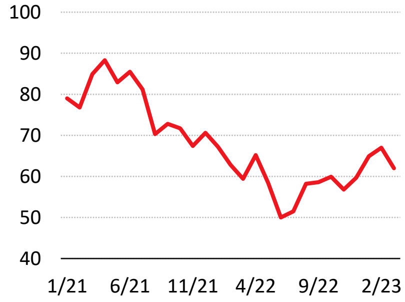
Fed hiked another 25 bps despite liquidity risks of regional banks

Faced with elevated inflationary pressure, the Federal Reserve (Fed) raised its policy rates by 25 basis points (bps) at its March policy meeting, bringing the target range of the fed funds rate to 4.75%-5.00%. At the post-meeting press conference, Chairman Powell said that recent issues in the banking sector may result in a tightening of credit conditions. As the financial tightening affects economic activities, employment and inflation could not be fully assessed at the moment, the Fed judged appropriate to raise interest rates by 25 bps, and revised its forward guidance from "ongoing increases" to "some additional policy firming may be appropriate".

The Fed is caught in a dilemma. On one hand, the slowdown in inflationary pressure is slower than expected and on the other hand, there is financial instability. The latest summary of economic projection (SEP) released by the Fed showed that the median forecast for core personal consumption expenditure inflation (Core PCE) was revised up by 0.1 ppt to 3.6% in 2023, indicating a need for further monetary tightening by the Fed to bring down inflation. Nonetheless, recent deposit outflows and liquidity shortages caused several small and medium-sized financial institutions in the US were seized or closed by regulators. The events have significantly undermined market confidence and unfolded new risks to financial markets. Looking ahead, if recent issues does not result in significant repercussions to the broader financial stability, the Fed is expected to further raise interest rates modestly and maintain a tight monetary environment with elevated interest rates for a longer period to contain inflation. Meanwhile, policy tools like lending facilities are provided to enhance liquidity conditions and financial stability.

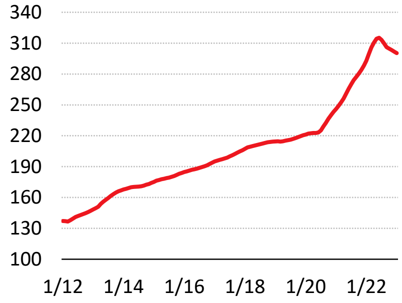
Looking ahead, the downside risks to the US economy have heightened. Even though the US economy has performed better than expected in early 2023 driven by consumer spending and a solid job market, the effects of monetary tightening will gradually emerge as the Fed continues to raise interest rates. For instance, the technology sector, which previously benefited from low interest rates, is expected to face a tougher business environment, especially the financial institutions serving the technology sector faced greater funding pressure after the recent banking turmoil. These developments are likely to weigh on the development of the technology sector, posing greater uncertainties to the job market. At the same time, the US property market continued to cool. The S&P Case-Shiller 20-city Composite Home Price Index kept posting MoM declines since July 2022 with its YoY growth slowing to 2.5% in January 2023 from the peak of 21.3% in April 2022. Given the weakened market confidence in the US financial system, if the property market correction intensifies, financial institutions are likely to see greater pressure, potentially igniting financial stability concerns thereby feeding uncertainties to the US economic outlook. Overall, the US economy is expected to post a modest 0.5% growth in 2023.

University of Michigan Consumer Sentiment Index



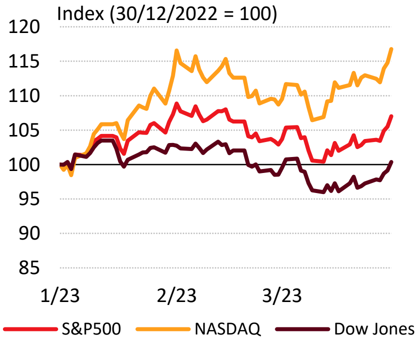
Source: Bloomberg

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



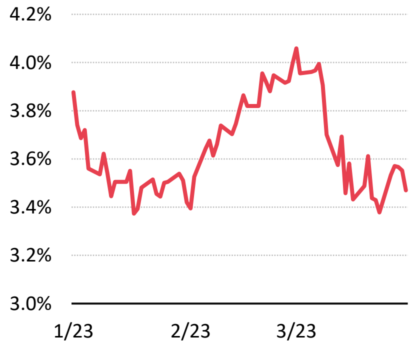
Source: Bloomberg

US Equity Indices



Source: Bloomberg, data as of 31/3/2023

US 10-year Treasury Yield

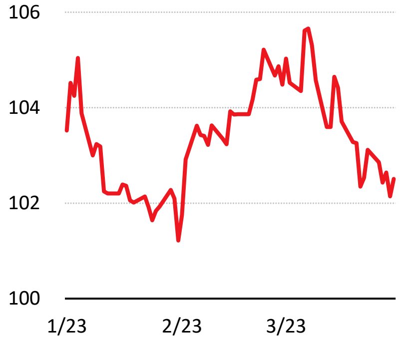


Source: Bloomberg, data as of 31/3/2023

US stock market volatility increased sharply, while treasury yields and the US dollar declined

In March, the takeovers or closures of several small and medium-sized US financial institutions has dragged market confidence in the financial system and caused significant volatility in financial markets. In particular, banking sector stocks experienced a significant sell-off. To avoid further contagion, the Fed and other regulatory bodies introduced measures to stabilize market confidence and the market recovered. As of the end of March, the Nasdaq and the S&P 500 Index and Dow Jones Industrial Average rose by 6.7%, 3.5% and 1.9%, respectively, when compared to the end of February. Driven by safe-haven demand and cooling market expectations of rate hikes, the 10-year treasury yield closed at 3.47% at end-March, down 45 basis points from the previous month. At the same time, the US dollar weakened, with the dollar index closing at 102.506, down about 2.3% from the level at end-February.

Dollar Index



Source: Bloomberg, data as of 31/3/2023

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