Economic Research

July 2023

Market Monitor – United States

The Fed Signals a Higher Interest Rate is Needed

- The US economy remained resilient, with the annualized quarter-on-quarter (QoQ) GDP growth further revised upwards to 2.0% in Q1 2023.
- Headline inflation continued to ease but underlying inflationary pressure remained high. The headline and core consumer price indices (CPI) rose by 4.0% and 5.3% year-on-year (YoY) in May, respectively.
- The Fed kept the fed funds rate unchanged at 5.00%-5.25% at the June meeting, but signalled a further rise of interest rates will be needed amid sticky core inflation and a relatively positive growth outlook.

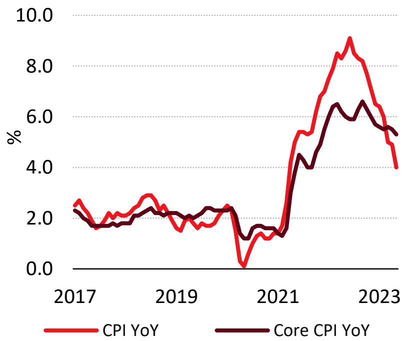
Resilient economic performance and a strong labour market continues to keep underlying inflationary pressures elevated

The US economy expanded steadily in Q1 2023, with its latest GDP growth revised upwards to an annualized rate of 2.0% quarter-on-quarter (SAAR), up by 0.7 percentage points (ppts) from the second estimate. Upward revisions were seen in consumer spending and exports; the growth of personal consumption expenditures was revised up by 0.4 ppts to 4.2% (SAAR) and the growth in exports was revised up by 2.6 ppts to 7.8% (SAAR). The decline of residential investment also narrowed by 1.4 ppts to 4.0% (SAAR).

The US jobs market showed some signs of softening. While initial jobless claims declined slightly to 239,000 for the week ended 24th June from the upwardly revised 265,000 in the prior week, its 4-week moving average (which smooths out week-to-week volatility) climbed to 257,500, the highest level since mid-November 2021. The initial jobless claims suggests some softening momentum in the US jobs market as the number of workers filed for unemployment benefits has gradually trended upward from its post-pandemic low of below 200,000 level.

US headline inflation continued to ease but underlying inflationary pressure remained elevated in May. The headline CPI increased by 4.0% YoY in May, down 0.9 ppts from

US Inflation



Source: Bloomberg

April. However, core CPI stayed elevated, growing by 5.3% YoY in May, down slightly by 0.2 ppts from April. Core services inflation and shelter inflation stayed high in May at 6.6% and 8.0% YoY, respectively. Both measures were roughly unchanged from April. Meanwhile, the core personal consumption expenditure (PCE) price inflation, the Federal Reserve's (Fed) preferred inflation gauge, only marginally moderated in May, with the core PCE price index at 4.6% YoY, slightly down from the 4.7% in April.

The Fed held interest rates unchanged but signalled that a higher terminal interest rate is needed to tackle sticky inflation

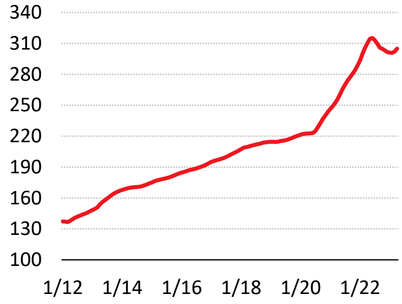
The Fed kept the fed funds rate target range unchanged at 5.00%-5.25% at the June meeting. However, the latest summary of economic projections (SEP) revealed that the median projections of the fed funds rate by the end of 2023 was pushed up to 5.625%, implying a further rate hike of 50 basis points (bps) from the current level. Fed Chairman Jerome Powell indicated that nearly all FOMC participants expects a further hike of interest rates by the end of the year as appropriate, implying more room for future monetary tightening. At the same time, the Fed is relatively optimistic on growth and employment but expects a slower pace of moderation in inflation. In the June SEP, the median forecasts for 2023 GDP growth was raised from 0.4% in March to 1.0%, the unemployment rate was revised down from 4.5% to 4.1%, and the core PCE inflation was revised up from 3.6% in March to 3.9% in June.

Despite the near-term resilience of the US economy, significant downside risks remain. Despite registering a 1.7% YoY decline in April, the S&P/Case-Shiller 20-City Composite Home Price Index stabilized on a month-on-month (MoM) basis, rising by 0.9% in April. Existing home sales also rose by 0.2% MoM in May after declining for two consecutive months from March to April. The resilient performance in the housing market could be attributed to the low levels of housing inventory. With a slower-than-expected easing in inflation, the Fed will need to raise rates higher and for longer. Higher borrowing costs and tighter lending conditions for households and businesses would dampen both the demand and sentiment of the property market, heightening the risks of price correction. If the US property prices were abruptly corrected, the stability of US commercial banks, chiefly small and medium sized ones, would be challenged from the potentially drastic deterioration in collateral values, posing further downside risks to the economy.

US stocks rose while the dollar weakened and bond yields slightly increased

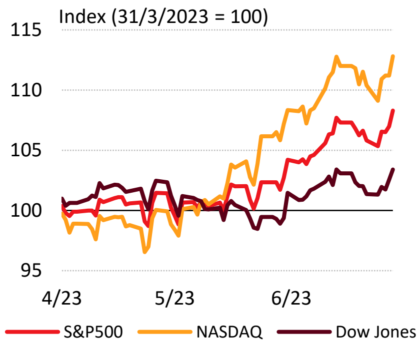
US equity indices rose in June as the economy remained resilient. As of the end of June, the S&P 500 Index, Nasdaq and Dow Jones rose by 6.5%, 6.6% and 4.6% respectively, when compared to the end of May. As the Fed is expected to further raise rates to contain inflation, US treasury yields edged higher**.** As of the end of June, the 10-year treasury yield stood at 3.84%, about 19 bps higher than the level at the end of May. Nonetheless, the US dollar index declined by 1.4% to 102.912 over the same horizon, likely reflecting a lower risk aversion amid the stock market rally.

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



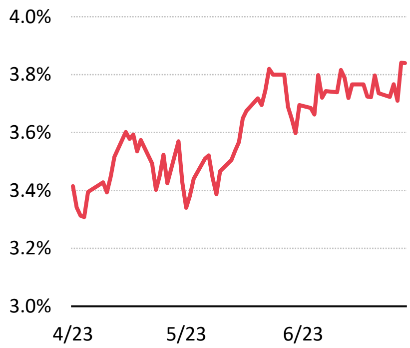
Source: Bloomberg

US Equity Indices



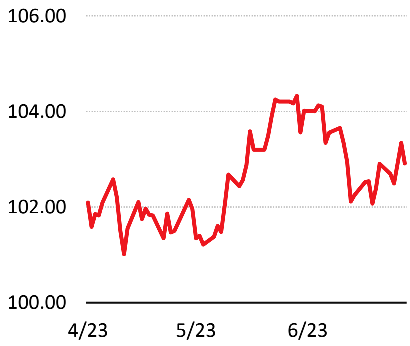
Source: Bloomberg, data as of 30/6/2023

US 10-year Treasury Yield



Source: Bloomberg, data as of 30/6/2023

Dollar Index



Source: Bloomberg, data as of 30/6/2023

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