The Weekly Snapshot

20 June

ANZ Investments brings you a brief snapshot of the week in markets

Equity and bond markets had another tough week as sentiment continued to wane, with many headlines suggesting the US economy is headed for a recession. These fears were exacerbated when the Federal Reserve raised interest rates by 75 basis points and hinted that some challenges may lie ahead.

In today's Weekly Snapshot, we take a closer look at the Fed's decision and other central bank news from last week.

Fed's biggest interest rate hike in 28 years

The Fed's 75 basis point hike was its biggest increase since 1994 and came as the central bank attempts to rein in inflation that is running at a year-on-year rate of 8.6%.

One key question investors have been asking is whether or not the Fed can engineer a 'soft landing' – a scenario where several interest rate hikes ease inflation over the coming 12 to 18 months, without stifling growth or causing unemployment to rise to uncomfortable levels.

While many are drawing comparison to the 1970s and early 1980s when the Fed jawboned interest rates higher to curb inflation, which caused a nasty recession and surge in unemployment, Fed officials remain confident they can avoid this scenario.

> ***"We're not trying to induce a recession now. Let's be clear about that… We're trying to achieve 2% inflation with a strong labour market — that's what we're trying to do,"*** Fed Chair Jerome Powell said.

Nevertheless, the Fed does see some challenging times ahead. It cut its GDP growth forecast for 2022 to 1.7%, down from the 2.8% it had predicted in March, and raised its unemployment rate projection to 3.7% - although this would still be a historically low level.

Funnily enough, despite the weekly performance, share markets rallied after the meeting. Some investors had felt that the Fed's previous approach was out of sync with inflation data, so its apparent willingness to be more assertive in tackling inflation was well-received by investors. However, this appeared to be short-lived with most equity markets ending the week with more losses.

A few thoughts from our IM team on the Federal Reserve meeting

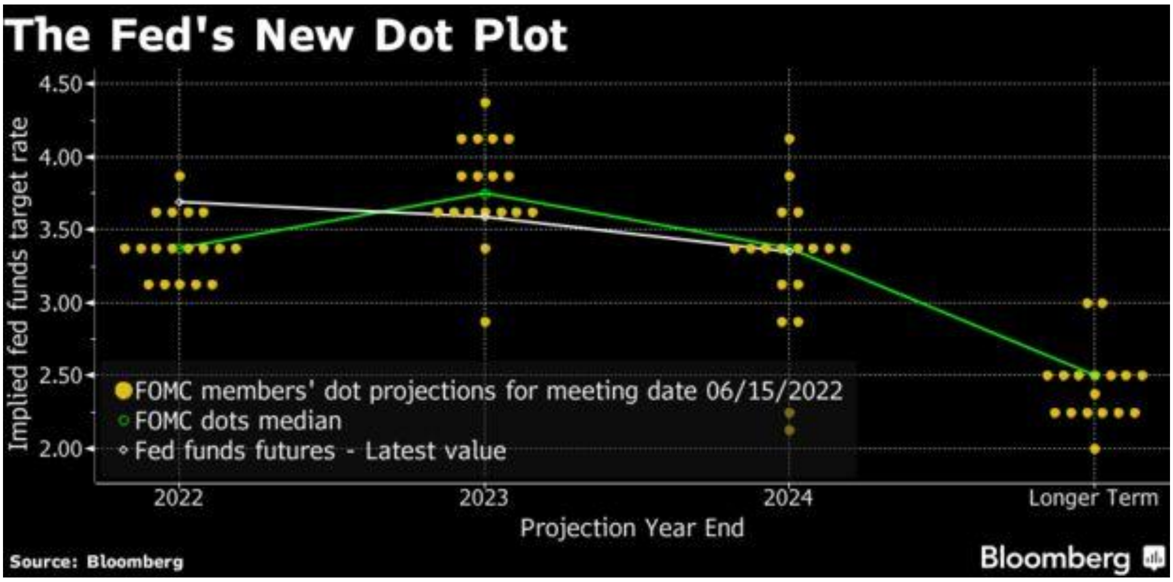
There was a clear emphasis on inflation over and above other factors such as growth and employment. Arguably, today's jumbo hike does little to affect drivers of inflation related to the war in Ukraine and COVID lockdowns in China.

However, higher rates will impact house prices and tighten credit, which could also flow through to slower demand for goods. Softer economic growth should reduce the demand for labour, and thereby reduce wage pressures. There are already signs that demand is starting to soften as the US consumer grapples with rising inflation.

Wednesday's retail sales fell for the first time this year in May, while home sales have fallen for three consecutive months and consumer confidence hit a record low in May/June. We continue to expect inflation to peak, but recognise that monetary policy is likely to tighten considerably (into restrictive territory) before central bankers are comfortable pausing hiking rates. Both bond and equity markets have shifted to reflect more hikes and high inflation – a change in this narrative would produce a strong positive market reaction.

Where do policymakers see the interest rates going?

The Fed's so-called dot plot, where committee members expect interest rates are headed, showed the median year-end rate moved up to 3.4%, while the 2023 year-end rate was lifted to 3.8%.



Swiss National Bank's surprise hike; hints at currency intervention

It wasn't just the Fed that surprised markets last week, the Swiss National Bank (SNB), which has been one of the most accommodative central banks over the past decade raised interest rates by 50 basis points to -0.25%, the first interest rate hike in 15 years.

While inflation in Switzerland is much lower than in most other developed nations, it has been trending higher, and policymakers are looking to get ahead of the curve.

> ***"The tighter monetary policy is aimed at preventing inflation from spreading more broadly to goods and services in Switzerland. It cannot be ruled out that further increases in the SNB policy rate will be necessary in the foreseeable future to stabilize inflation in the range consistent with price stability over the medium term",*** the central bank said in a statement.

Perhaps more surprising, the SNB said it is willing to be "active in the foreign exchange market". To date, the strength of the Swiss franc, notably against the euro, has protected the country from some of the recent inflation – notably, food and fuel imports.

Bank of England hikes again; Japan remains one of the few outliers

In other central bank news, the Bank of England (BoE) raised its cash rate to a 13-year high – its fifth-consecutive rate hike – and said inflation could hit 11% later in the year. Furthermore, the central bank expects the economy to contract by 0.3% in the second quarter.

And finally, the Bank of Japan (BoJ) – an outlier in the policy normalisation environment – maintained its ultra-low interest rate policy after its two-day meeting on Friday. The BoJ pledged its yield-curve control of the 10-year government bond at around 0%. It also raised concerns around the declining value of the yen, which hit a two-decade low versus the US dollar recently, weighing on already rising import costs.

The Japanese economy is in an interesting spot with inflation well below other developed nations (it has spent a lot of the past few decades in a deflationary environment). The prolonged low-interest-rate environment – implemented to spur inflation – has weighed on the value of the yen, hurting an economy that is reliant on fuel and other raw material imports.