US Federal Reserve brings forward first rate hike

Last night, the US Federal Reserve (Fed) moved the timing of its first rate hike from 2024 to 2023, signalling the beginning of the end of 'crisis-era' policy. Key developments at last night's Fed meeting are:

- As expected, the Fed funds rate was unchanged at 0.00% - 0.25%.
- However, the Fed's 'dot plot' showed the median expectation for the first rate hike was moved earlier into 2023 (from 2024), with 13 of 18 members (up from 7 in March) expecting a first hike in 2023.
- The growth and inflation outlooks were both upgraded. For 2021, growth was lifted to 7.0% from 6.5% (unchanged at 3.3% in 2022), while core PCE (Fed's preferred inflation measure) was raised from 2.2% to 3.0% (but eases back to 2.0% in 2022, the Fed's target).
- There were no updates on the Fed's quantitative easing (QE) program and tapering timing, but Chair Powell did say at his press conference that while progress is still a way off, this was the "talking about talking about" tapering meeting.

How did markets react?

Overnight, US equity markets weakened modestly, with the S&P 500 index off 0.54% (still above 4,200) and US 10-year bond yields rose 8bps to 1.58% (still below 1.62% earlier this month or 1.74% back in March this year). The US dollar jumped 0.8% (more than the equity weakness). Within equities, there was a modest rotation back to 'growth' despite the rise in yields (S&P Growth index was down half as much as the S&P 500 Value index), with cyclical stocks underperforming given Fed moves, at least theoretically, aimed at leaning against the pace of future growth.

Time will tell whether this relatively minor reaction holds or if the market, as it often does, is taking time to digest the changes. It could be argued that the limited response is not inconsistent with recent developments, where decisions or hints about central bank tapering (Bank of Canada, Bank of England, Reserve Bank of New Zealand, Reserve Bank of Australia (RBA) and Fed) have been well absorbed by markets, potentially as it signals central banks are not getting too far behind the curve and better rate management can elongate the cycle. Some easing of the frenetic pace of growth (as we noted in our recent *Core Offerings*), with recent US data seeing several 'misses' and China past peak growth, has eased concerns the latest jump in inflation will prove persistent.

What does this mean for central bank policy?

It is important to keep in mind, as Powell noted, that even after some adjustments ahead, policy will still be highly accommodative. Moreover, as the CIO team has noted, periods of slowing—but still strong—growth (PMIs above 50 but falling) have typically continued to see equities (and credit) deliver moderate returns (and outperform bonds). To date, central banks are doing a stellar job of managing markets, moving policy less abundant, but avoiding negative reaction in the process. Formal tapering announcements from the Fed are still unlikely before Q4. And it is worth remembering that relative to 2013's 'taper tantrum', the Fed is buying about half the bonds that it was at that time, suggesting the impact of a staged withdrawal should be less unnerving for markets. Powell continues to signal that substantial notice will be provided ahead of when QE withdrawal starts, and when it does, it will be '…orderly, methodical and transparent.'

The key will be inflation

The key at this juncture in the cycle, in the end, still rests with inflation. If inflation proves persistent (and rises further), forcing policy to move more restrictive than expected (and no longer 'highly accommodative'), this will spell trouble for both bond and equity returns. In contrast (as we expect), if somewhat stickier-than-expected inflation through mid-2021 still recedes into end-year, tighter global central bank policy is unlikely to materially dent the growth outlook (with equities and bond yields likely to continue to grind higher, with a decent dose of volatility).

The coming months will be critical in assessing the persistence of inflation, and the extent to which there are signs of easing pressures. Key will be whether there are unexpected signs of rising wage pressures, the current drivers of higher inflation become less narrow and inflation expectations start to rise toward 3.0% (from 2.5% now). Challenging this likelihood is the reality that US unemployment remains well above pre-COVID-19 levels at 5.8% versus 3.5% (unlike in Australia, now just 0.5% from the pre-COVID-19 trough). We expect that while inflation may positively surprise, there will be enough evidence to support the Fed's view that current pressures are 'transitory', and there is time before "substantial progress" has been made by the Fed in achieving its goals. In this scenario, policy globally is likely to remain highly accommodative, growth will be strong (though peaking H2 2021) and moderate gains in equities (with a preference for non-US markets) and credit are likely to outperform bond markets, where 10-year US and

Australian yields are likely to continue to rise toward 2% (driven by rising real rates and shifting short-term policy rate expectations). However, while growth should remain strong through 2022, we should be under no illusion that this is the beginning of the end of 'crisis-era' stimulus policy. And with that will likely come greater bouts of asset price volatility (and more moderate returns for listed assets as the cycle evolves).

For Australia, the drop in the exchange rate overnight has (for now) broadly protected against the modest equity weakness. The Fed's signal that it is approaching 'talking about' tapering, likely at its next meeting, will give the RBA some cover to likely announce its own tapering of QE in the first week of July (as does a now lower exchange rate). The earlier timing of Fed rate hikes (still a long way out in 2023) will also challenge those who still believe the RBA's cash rate will be at its lows of 0.1% in 2024. While the US economy, due to a faster pace of vaccinations, is a few steps ahead of the rest of the world, we continue to expect the baton of growth to be passed to non-US economies through H2 2021, including Europe, the UK and the (non-China) emerging markets. This is likely to mean the current weakness in the Australian dollar is short-lived, and likely to reverse somewhat over the balance of the year (despite a likely lower iron ore price ahead).