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Stocks and bonds rally as Fed slows pace of rate hikes

02 February 2023, 1:09 pm CET, written by UBS Editorial Team

US equities reversed early losses to close higher, and bonds extended initial gains after the Federal Reserve opted to slow the pace of monetary tightening.

What happened?

As widely expected, the Fed further reduced the pace of rate hikes, raising the federal funds target range by 25 basis points to 4.5–4.75%.In December, the Fed raised rates by 50bps, following four consecutive 75bps increases. The bank's statement said that it anticipated "ongoing increases" in rates, but referred to the "extent" of future hikes, rather than the pace—suggesting that additional changes will be in 25bps increments.

The S&P 500 closed 1.1% higher and the 10-year US Treasury yield dropped by 10bps to 3.41%. The peak fed funds rate implied by futures markets eased by 2bps to 4.89% for June 2023. The US dollar index (DXY) fell by 0.9%. With yields falling, the equity rally was led by the tech and consumer discretionary sectors. The Nasdaq closed 2% higher.

US economic data released on Wednesday pointed to weakening momentum, but a still very tight labor market. The ISM manufacturing index dropped to 47.4 in January from 48.4 in December, a third month in contraction territory (below 50). The new orders component was weak, falling to 42.5 from 45.1, but prices paid rebounded to 44.5 in January from 39.4 in December.

US job openings unexpectedly increased in December. Job openings in the JOLTS survey grew by 572,000 to 11 million, compared with a consensus estimate for a decline to 10.25 million. The quits rate was unchanged at 2.7%, lower than the record level of 3% seen at the end of 2021, but still higher than levels prevailing for the majority of the last 20 years. There are currently 1.9 job openings for every unemployed person.

What do we expect?

The smaller rate hike was in line with expectations, so the focus was on the Fed's language regarding future policy changes, where there was no dramatic shift from the December meeting. The Fed remains concerned about the risk of doing too little, and Chair Jerome Powell said it has the necessary tools should it prove to have overtightened.

Powell also said the job of fighting inflation was not fully done, and that it would be very premature to declare victory. He did, however, refer to a "couple more rate hikes" that would take the federal funds rate to the 5–5.25% range implied by the December "dot plot" projections, giving the impression that the hiking cycle is drawing closer to the end.

According to the December FOMC minutes, Fed officials "expected that a sustained period of below-trend real GDP growth would be needed to bring aggregate supply and aggregate demand into better balance and thereby reduce inflationary pressures." Based on 4Q numbers, which showed a 2.9%annualized expansion in GDP from the previous quarter, growth remains above trend. But Wednesday's economic data signal a clear weakening in the rate-sensitive manufacturing and housing sectors.

The US economy is moving in the direction that the Fed wants to see, but the strength of the labor market will make it more difficult for it to stop hiking and start cutting rates. High-frequency data suggest job openings may be falling faster than the JOLTS data, but with the official figures going back up, it will be difficult for the Fed to ignore. The high level of the quits rate is not consistent with moderating wage growth, and the Atlanta Fed wage tracker shows that job switchers achieved 7.7% year-over-year growth in December.

The rebound in the prices paid component of the ISM manufacturing index, while still in contraction territory, shows that some of the factors that have been pulling inflation lower at the consumer and wholesale level may be waning. For example, used car and lumber prices cannot keep falling sustainably at the same rate as in recent months.

January's US equity rally was supported by a combination of technical (such as light investor positioning), China's reopening, and hopes that the Fed is close to the end of the tightening cycle. But, in our view, it will be difficult for the Fed to feel comfortable pausing hikes until there is a better supply-demand balance in the labor market. We think it is still too early to expect the Fed to pivot policy, so the risk is that the US rally may not prove sustainable.

How do we invest?

The backdrop remains one of high inflation, rising rates, and slowing growth. But we recognize that some parts of the market will reach inflection points before others, meaning dispersion between different geographical markets and sectors is likely to be elevated. We therefore think selectivity will be rewarded, and our positioning reflects that.

We like strategies that provide exposure to equity market upside while adding downside protection. We incorporate a combination of defensive (consumer staple and healthcare), value, and income opportunities that should outperform in a high-inflation, slowing-growth environment, alongside select cyclicals that should perform well as and when markets start to anticipate the inflections.

In equities, we maintain a least preferred stance on US equities and the technology sector. Instead, we prefer emerging markets—including China—and German equities, which we expect to be among the main early beneficiaries of China's reopening and an inflection point in global growth in 2023.

In fixed income, despite recent strong returns, the more defensive, higher-quality segments of fixed income remain appealing, given the all-in yields on offer and as inflation risks transition to growth risks. We maintain a preference for high grade and investment grade bonds. China's reopening is likely to contribute to global growth dynamics. Emerging market bonds benefit both directly and indirectly from this and the recent downshift in the pace of US rate hikes, and we hold a most preferred view on the asset class.

In currencies, with the Fed likely closer to the end of its hiking cycle than the European Central Bank, we expect narrowing interest rate differentials to weigh on the dollar this year, while the better growth outlook ex-US supports other currencies. We suggest reducing excess USD exposure and prefer the Australian dollar.

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Content is a product of the Chief Investment Office (CIO).

Original report - [Stocks and bonds rally as Fed slows pace of rate hikes, 2 February 2023.]

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