Fed hikes and signals pause

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As expected, the Fed raised rates by a quarter of a percentage point and opened the door to pausing the rate hiking cycle. But the nearing end of the rate hikes is not a signal for further equity gains, in our view, and we maintain a preference for high-quality bonds over stocks.

The Federal Reserve on Wednesday raised interest rates by 25 basis points, a widely expected move that took the federal funds rate to a range of 5–5.25%.

The Fed also opened the door to pausing the rate hiking cycle. A prior wording in the FOMC statement that said "some additional policy firming may be appropriate" was replaced by more open-ended language, saying "in determining the extent to which additional policy firming may be appropriate..." In his post-meeting press conference, Fed Chair Jerome Powell made it clear that this change was meant to signal that the FOMC would decide whether to hike rates further on a meeting-by-meeting basis.

What do we expect?

The Fed's more dovish tone does not preclude a further rate hike in June, but our base case is that in the end, the Fed will decide to pause. Although the data released so far does not justify a pause on its own, the Fed must consider the lagged impact of the 500 basis points of hikes it has already implemented, the ongoing reduction in the Fed's balance sheet, and the credit tightening resulting from banking system stress.

A pause doesn't mean that the Fed is getting ready to cut rates. Inflation is still too high for the Fed to consider rate cuts yet. With private sector demand still holding up and the labor market yet to show any significant cracks, there's little reason for the Fed to alter its restrictive stance anytime soon. The Fed will likely be content to sit on the sidelines and hold tight for a while, assessing the incoming data before it makes its next move.

A pause is unlikely to mark a shift to a risk-on market regime. The end of the Fed rate hiking cycle has been widely anticipated for months, and market pricing should already reflect that. In past cycles, the S&P 500 typically didn't bottom until after the Fed started to cut rates, not when it merely stopped hiking. However, it looks like equities have priced in not only the Fed pause, but Fed cuts later this year. This means that a pause is not only unlikely to lead to renewed upward

market momentum, but there is downside risk if the pause lasts a long time. The risk is that equities have run ahead in pricing the cuts, but not the economic pain that would likely necessitate them.

The Fed will no longer be an overt source of market volatility. The Fed is now closer to being a neutral factor, and on its way to being a volatility dampener once it starts cutting rates. Equity volatility has declined significantly since its March peak when the banking crisis began—the VIX is down from 26 to around 18.3. The Fed was quick to provide liquidity during the banking sector turmoil. Its aggressive intervention to prevent more banking stress implies that it doesn't want adverse market volatility at this stage of the hiking and economic cycles.

How do we invest?

So, this means that the end of a Fed rate hiking cycle isn't necessarily a tailwind for risk assets, nor does it change the downside risks from existing tightening.

Positioning data suggests there's a lot of money waiting to be put back into equities. That possibility could bias investors to be early rather than late in adding risk, with a decent pullback in equities viewed as a buying opportunity even before the first rate cut. Investors' desire to be early on the Fed rate cuts may prevent equities from declining more than 10%. That would take the S&P 500 a little below our 3,800 year-end target. The net result is that equities still look unattractive relative to high-quality bonds at current levels.

We advise investors to:

Buy quality bonds: We see attractive opportunities in high-quality fixed income given decent yields and the scope for capital gains in the event of an economic slowdown. We prefer bonds relative to equities, and we prefer taking quality exposure to high grade (government), investment grade, and sustainable bonds.

Diversify beyond the US and growth stocks: After a strong start to the year, US equities are pricing a high chance of a soft landing for the US economy. Yet, tighter credit conditions, declining corporate earnings, and relatively high valuations all present risks. By contrast, we like emerging market stocks, powered by a weaker dollar, rising commodity prices, strong earnings growth, and China's stronger-than-expected recovery, alongside select opportunities in Europe. We also advocate reducing exposure to growth stocks after their exceptional year-to-date performance.

Manage liquidity as rates peak: Many investors have held more cash than usual in anticipation of higher interest rates. But rates are now approaching a peak. Although the path to lower inflation may not be smooth, we think investors should stay (or plan to be) sufficiently invested and diversified, act soon to lock in attractive yields before markets start to price much lower interest rates, and avoid unnecessary deleveraging.

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