



### **“No hard landing” view takes hold**

- Latest US numbers point to moderating inflation and still-strong employment
- The pause in US interest rates further adds to hopes that a deep global recession can be avoided
- However, given liquidity and other risks, we remain neutral on global equities

### **Glass half empty, glass half full**

After 10 consecutive rate hikes since March 2022, the US Federal Reserve finally took a breather this week. But Fed Chair Jerome Powell warned that this was not the end of the story, and simply a break to better assess the situation. In fact, to get inflation closer to the Fed’s 2 percent target, Powell signalled that more rate hikes may be needed before year-end, even though the pace of hikes was now less important.

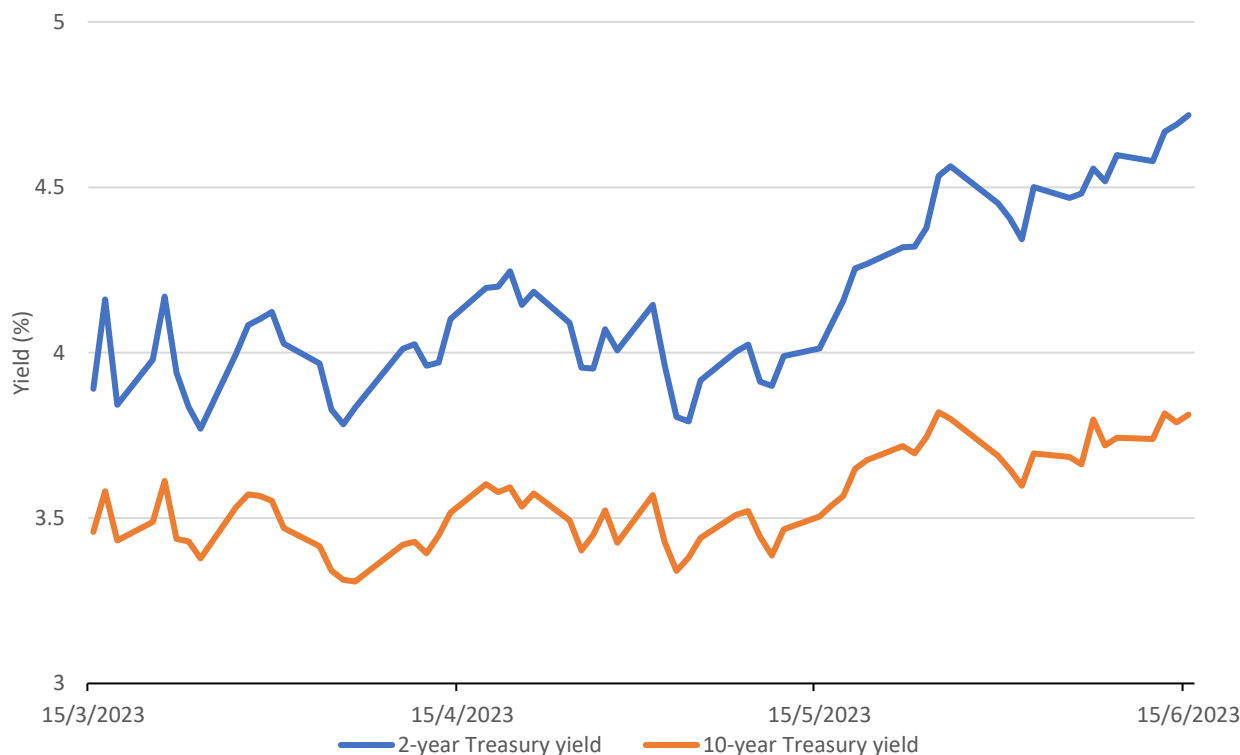
Analysts note that Powell speech was masterfully both hawkish and dovish at the same time. Coupled with mixed inflation data also released this week, investors seem to be moving in many different directions.

Equity investors seem more willing to be optimistic, with the S&P 500 up by 5.7 percent over the past month. The futures market too is sceptical about more rate hikes this year and continues to forecast rate cuts next year.

In contrast, bond investors seem more focused on the possibility of future rate hikes. After the Fed announcement, 2-year US Treasury yields gained 7.9 basis points to reach a three-month high of 4.78 percent, while 10-year yields rose for the third time this week to 3.84 percent.



**Figure 1: 2Y and 10Y Treasury yields, March 2023 – June 2023**



Source: Bloomberg, data as of 15 June 2023

## Two-speed Inflation

Much of the Fed's interest rate announcement was underpinned by this week's US inflation data. Not surprisingly, the two-tone approach to interest rates reflects concerns about the US's two-speed inflation picture.

On the one hand, annual headline inflation (that is, inflation figures including food and energy prices) has fallen to 4 percent. This is its slowest rise in over two years, driven by the softening in energy prices. Over the past year, WTI Crude prices have almost halved from close to US\$120 per barrel to about US\$70 per barrel<sup>1</sup>.

On the other hand, core inflation (that is, excluding food and energy), at 5.3 percent year-on-year, seems to be what is keeping Fed officials up at night. Month-on-month, May's level is 0.4 percent higher than April. A drill down into the drivers of this rise point to three items: shelter, used car prices and motor vehicle insurance.

<sup>1</sup> Oil price.com as of 14 June 2023

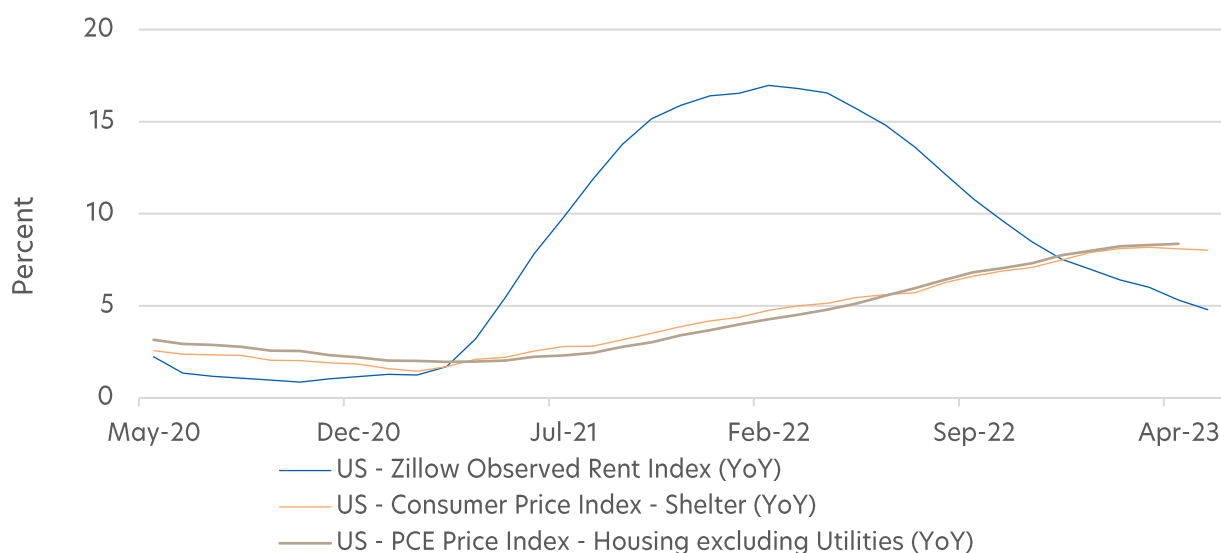


## Inflation data may be lagging

Given the outsized contribution from these three sectors, we have been carefully monitoring their path for many months. We would note that there is a divergence between the formal data as shown by the US Consumer Price Index (CPI) versus that provided by independent sources.

For example, shelter is the largest factor contributing to inflation stickiness. However, more targeted indices from Zillow, a widely-used source of housing data, points to far weaker rental prices than indicated by current CPI data.

**Figure 2: US Rent CPI vs PCE Price Index vs Zillow Rent index, May 2020 – April 2023**

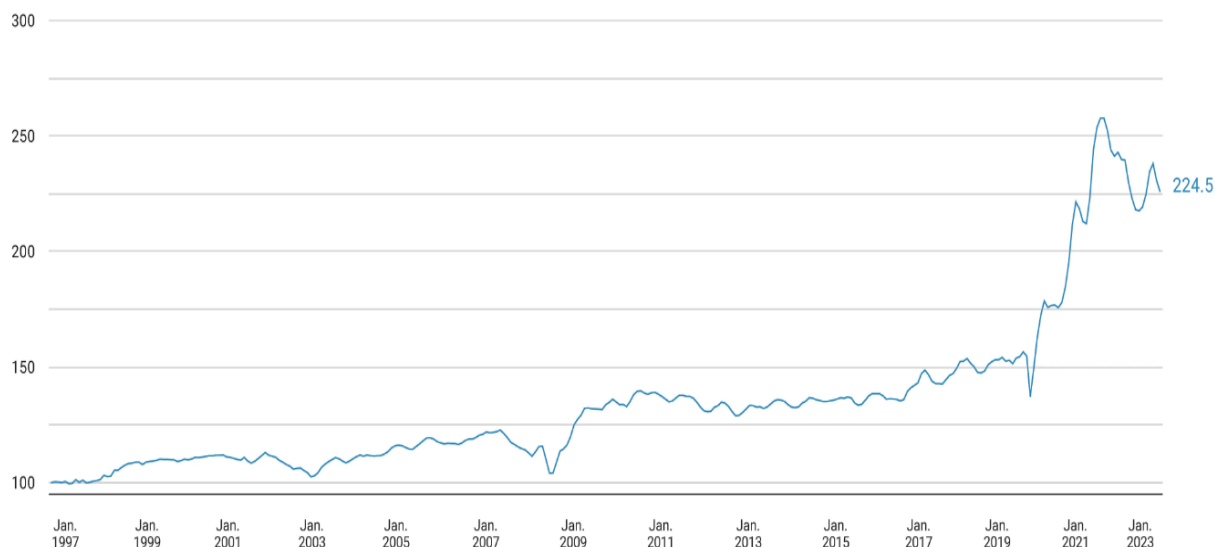


Source: MacroMicro, <https://en.macromicro.me/collections/5/us-price-relative/49740/us-cpi-rent-zillow-rent-yoy>

Similarly, the Mannheim index, which tracks more than 5 million used car transactions annually, is showing that prices have peaked.



**Figure 3: Mannheim used vehicle value index, May 2023**



Source: Mannheim Consulting, <https://publish.mannheim.com/en/services/consulting/used-vehicle-value-index.html>

It appears therefore that there is room for inflation surprises on the downside. This would enable the Fed to further delay interest rate hikes or halt hikes altogether.

### Liquidity risks ahead

Despite this potential for good news, some equity risks remain. In particular, post-agreement to raise the debt ceiling, US lawmakers are now faced with a possible super-sized drain on liquidity.

Having drawn down the Treasury General Account from around US\$ 580 billion earlier this year to less than US \$40 billion as of May 30, the US Treasury Department must now top this up again. They are likely to do this by issuing short term Treasury bills. Altogether, new bill issuances are expected to reach about \$1 trillion before the end of August and \$1.4 trillion by the end of 2023.

Rather than keeping their money in bank deposits, individuals and businesses may choose to buy these bills instead. Given that there is also a Quantitative Tightening (QT) programme in place, there are justifiable fears that liquidity could be drastically reduced, thereby threatening the US financial system. In a worst-case scenario, this could result in a bank run not unlike that seen with Silicon Valley Bank.

Of course, the Treasury department will be watching the situation carefully and have the tools to moderate its worst effects. Many think, for example, that the current QT exercise could be paused or stopped.



**Neutral call on global equities**

Nevertheless, these near term uncertainties should cause investors to limit their aggressiveness in the equity markets. We perceive that there will be more broad based equity opportunities closer to the end of the year, and already the upside risks appear to outweigh the downside risks.

As such, for those investors only holding fixed income investments, they may want to consider adding more equity exposure up to a neutral level that is in sync with their risk profile. That said, investors may not want to go overboard given that equity risks remain over the near term.



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