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23rd September 2022

Elston Insights

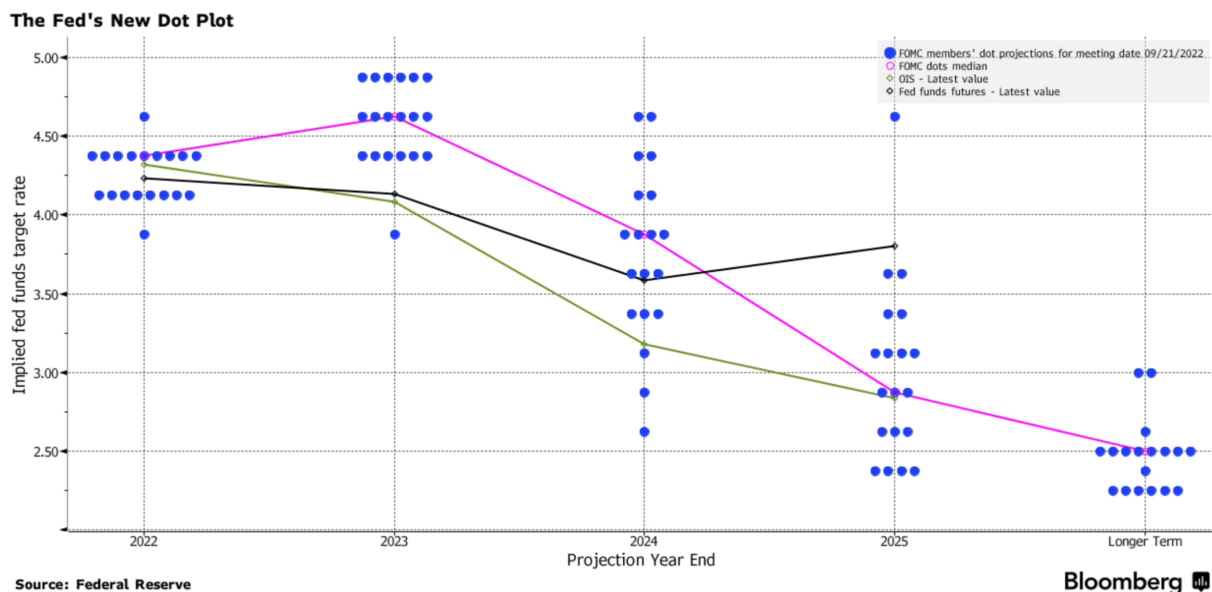
US & UK rate rises

- Bumper US Fed rate rise of 0.75% taking total to 3.25%
- Bank of England pushes rates higher to 2.25%
- US Dollar strengthens to its highest level in 20 years

Fed chair Jerome Powell channels his inner Volcker

The US Federal Reserve delivered its third consecutive 75 basis-point hike this week, putting it on track for one of the most aggressive tightening programmes since the 1980s. Back then, Paul Volcker earned his place in the history books as the Fed chair that slayed the inflation beast. It is perhaps no coincidence that today's incumbent Jerome Powell used Volcker's exact words in his speech: "We will keep at it". The Fed seems fully committed to bringing inflation down via a series of aggressive rate hikes and has indicated that it will hike rates by another 125 basis-points by year end.

Fig.1. Fed funds rate dot plot (Fed projections)



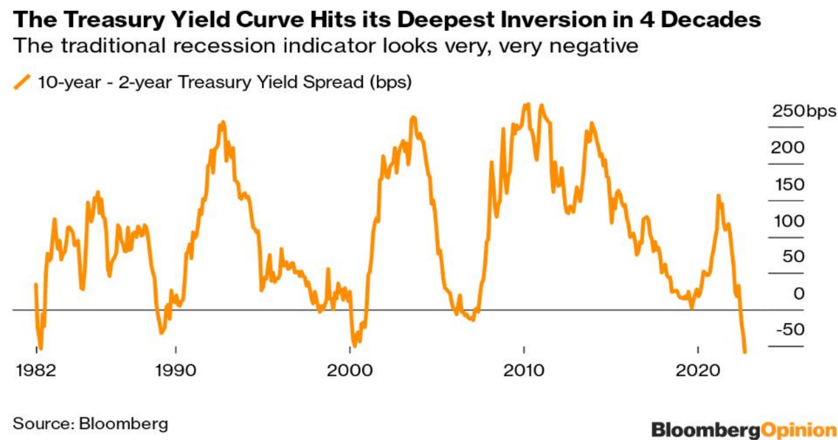
Source: Bloomberg

The chart above demonstrates strong consensus among Fed members to raise the funds rate to 4.5% by year-end 2022 and to 4.75% in 2023. The new slogan now is "higher for longer" as inflation expectations are becoming more entrenched in the US and global economy.

Yield curve inversion

The US treasury yield curve slipped further into inversion with US 2-year bond yields closing at 4.2% while the 10-year bond yield closed at 3.7% on Friday. The curve inversion of recent weeks is as wide as any seen since 1982. When the yield curve inverts ie, investors see future returns as being below near-term returns, it traditionally indicates an imminent recession.

Fig.2. US treasury yield curve

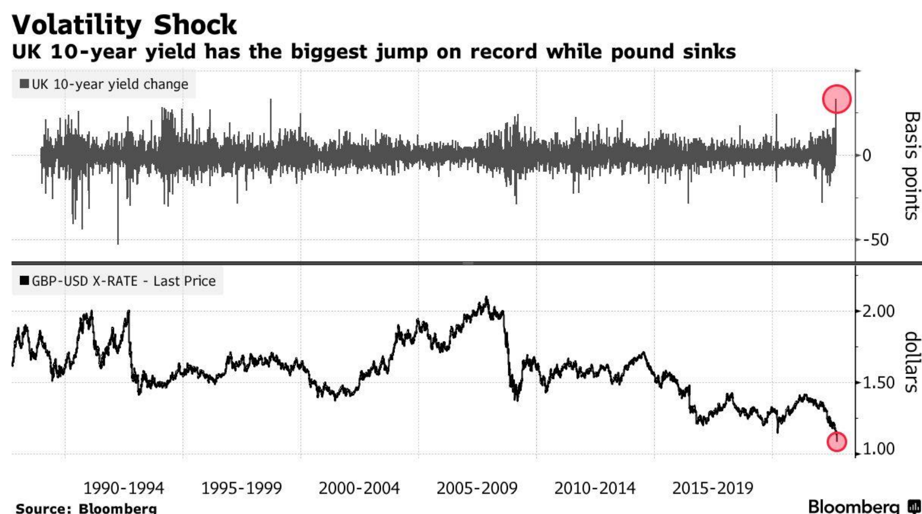


The chart above shows the difference in yield between the US 2-year and 10-year bond.

UK mini-budget has maxi impact

On Friday 23 September 2022, the UK chancellor of the exchequer, Kwasi Kwarteng, delivered a massive unfunded fiscal boost by cutting tax rates. The eye-watering figures compare to the biggest give away since Prime Minister Ted Heath in 1972. Markets quickly delivered their verdict as UK 10-year gilt yields underwent their biggest move in over 30 years, while Sterling hit a low of 1.08 vs USD. The extraordinary decision NOT to publish estimates of how the UK will balance its books to accompany the tax cut has led to a loss of confidence in both Sterling and Gilts.

Fig.3. UK Gilt and GBP/USD FX rate



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Summary

With Central Banks willing to do “whatever it takes” (read: rate hikes and quantitative tightening) to bring soaring inflation under control, equity markets are waking up to the reality that the near-term risk to growth is acute. “Do not fight the Fed” is the word on the street and risk assets such as equities face high uncertainty over the near term while bond markets fail to provide stability against rising inflation and interest rates.

As short-term interest rates approach 4%-5% levels, the risk-free rate is now starting to rise to respectable levels after almost two decades of near zero-rates. This raises hurdle rates for all risk assets.

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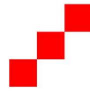

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