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Global Markets Research

Research Alert

Downplaying Premature Rate Hike Expectations

- **Rate hike expectation from inflationary risks is likely overdone**
- **Output gap will still take precedence in monetary policy decisions, by and large**
- **The Fed and RBA could potentially be among the first to consider hiking in 2023**

Background

Improving macro conditions, optimism from accelerated vaccination programs in numerous major economies, and massive stimulus bills in the US have significantly shifted the global recovery outlook, and hence inflation expectations. Rising commodity prices – specifically energy – have also added fuel to fire, fanning market speculations that heightened inflationary risks will prompt monetary policy tightening sooner than expected. This was evident in the spike in global bond yields (Figure 1) by as much as 74bps (10Y UST) in the first quarter of the year. Futures have also begun pricing in rate hikes as early as end-2021, causing some volatility in the global financial markets. Such expectations and rally in bond yields have since retreated somewhat.

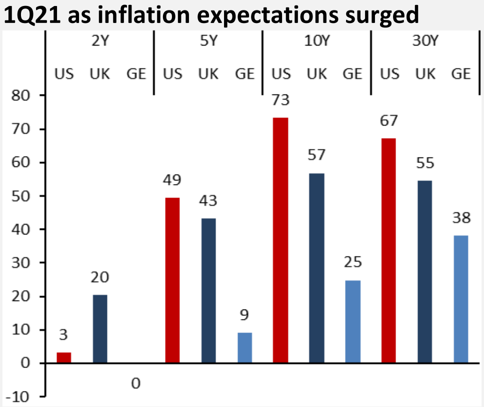
Rate hike expectations poorly justifiable

We, however, opine that these rate hike expectations are ill-justified at this juncture. GDP has yet to return to pre-pandemic levels (Figure 2), and the current recovery trajectory remains uneven and still susceptible to downside risks from possible resurgence in infection rates in selected regions. Europe, and some parts of Asia, continue to see new outbreaks and lockdowns despite the former being in the forefront of vaccination programmes roll-out. Undeniably, we still have to contend with the efficacy of vaccine in successfully containing the spread Covid-19. This implies that the road to recovery will remain bumpy, although statistical lifts will inflate the growth numbers this year, from last year's recessionary levels. IMF projects that the world economy would recover and expand 6.0% this year, after contracting 3.3% in 2020, before normalizing to a growth of 4.4% in 2022 (compared to long run average of +3.7%).

Inflation for real?

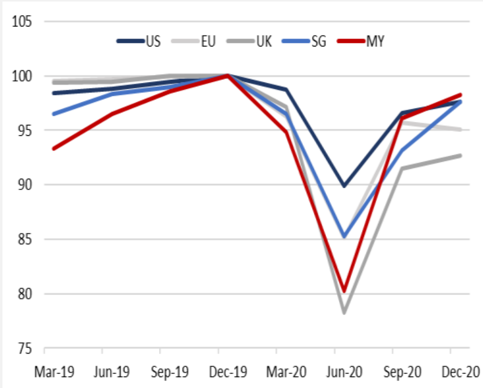
Downside risks to growth aside, inflation, the root cause of the whole euphoria, are exaggerated in our view. While we may be seeing rising headline inflation, which is primarily energy-driven, core inflation has remained relatively subdued and well-contained in the US (Figure 3) and in other parts of the world. Recognizing that the recent surge in headline inflation was also partly attributable to supply chain disruptions and pent-up demand, it would be a matter of time before inflationary pressure begins its descent again unless real demand emerges to push up prices. Another possible risk to this is energy and commodity-related cost-push

Figure 1: Massive curve steepening in 1Q21 as inflation expectations surged



Source: Bloomberg; HLBB Global Markets Research

Figure 2: GDP remains below pre-pandemic levels



Source: Bloomberg; HLBB Global Markets Research inflation at the producer level may be passed down to the consumer level, which are product and industry specific in our view.

Monetary policies to remain loose

Until we see more sustainable growth and real inflationary threats, major central banks will unlikely tighten the current accommodative monetary stance, which could otherwise risk derailing the recovery. On the flip side, risk of persistently low interest rates that could lead to asset bubbles and excessive debt levels would mean the central banks may have to appropriately adjust the degree of monetary accommodativeness to avoid the build-up of any financial imbalances in the system. PBoC may be a case in point.

- ***The Federal Reserves (The Fed)***

We expect the Fed to stay pat this year, and probably begin tapering its QE programme in the second half of 2022 should the current growth outlook turn out as projected, before eventually contemplating raising rates in 2023, the earliest. On 11-April, Fed Chair Powell commented that a rate hike this year is "highly unlikely", which should reverse futures pricing for a slight increase this December.

In its latest FOMC meeting and from Fed Chair Powell's comments in various occasions, the Fed has maintained its pledge to keep an accommodative policy stance until its economic outcomes (maximum employment and inflation moderately above 2% for some time) were achieved. Fed officials noted that the risks to the outlook for inflation were broadly balanced, and that the US economy is not facing an imminent risk of surging inflation. The notable rise in longer-term US treasuries yields is generally viewed as a reflection of the improved economic outlook. The overall financial conditions were accommodative.

Fed officials assessed that the US economy "remained far from the Committee's longer-run goals and that the path ahead remained highly uncertain" with the pandemic continuing to pose considerable risks to the outlook. This provides a strong hint that the Fed is not bending towards any policy tightening and/ or rate hike in the near future.

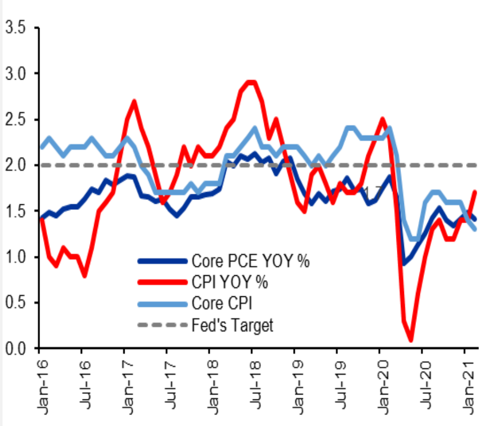
- ***The European Central Bank (ECB)***

The ECB will probably lag the rest of the major central banks in normalizing/ tightening and we do not foresee any such move before 2023. Economic fundamentals are fragile and the still-rampant resurging Covid-19 new cases and lockdown will further widen the gap of its recovery with those of its peers. It continues to observe continued economic weakness in the first quarter of 2021 driven by the pandemic and related containment measures and expects real GDP to contract again in the first quarter.

At its latest March policy meeting, the ECB has announced its decision to frontload its bond purchases at a significantly higher pace over the next quarter under its €1.85 trillion pandemic emergency purchase programme (PEPP) in a bid to combat rising bond yields. All key interest rates were kept unchanged.

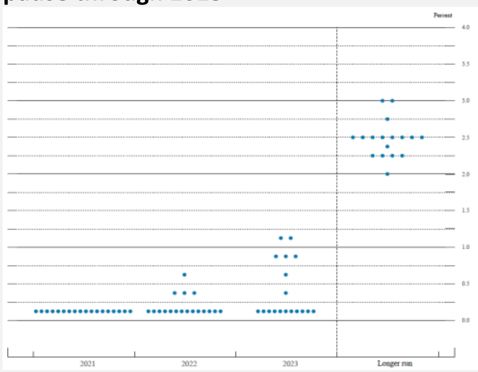
Even though downside risks remain in the immediate future, the ECB however highlighted that the risks surrounding the euro area growth outlook over the medium term have become more balanced. The ECB

Figure 3: US headline and core inflation diverges



Source: Bloomberg; HLBB Global Markets Research

Figure 4: The Fed dot plot projects rate pause through 2023



Source: The US Federal Reserve

also expects headline inflation to increase in the coming months but some volatility is expected*.*

- ***The Bank of England (BOE)***

Diverging slightly from the ECB, the BOE shrugged off the impact of rising bond yields, and left all its interest rates and asset purchases unchanged. It highlighted that prices of risky asset have remained resilient and the UK's financial conditions have been "broadly unchanged". The central bank also turned more optimistic over the UK's economic outlook, citing falling Covid-19 infections and hospitalisations and rapid vaccination pace as well as support from new policy announcements in Budget 2021. Inflation is expected to return to around the 2.0% target in the spring.

It concluded cautiously by reiterating its readiness to take "whatever additional action" necessary, should outlook for inflations weaken. This offers clues that any near term rate hike is not on the cards. With the elimination of the previous Brexit event risk, we are of the view that the UK economy is better positioned to move forward, and should outperform its European peers especially if the Covid-19 contagion is successfully brought under control.

- ***The Bank of Japan (BOJ)***

There was little change to the BOJ ultra-loose monetary policy except that it is now providing more flexibility in allowing a ±0.25% fluctuation around its yield-curve-control target of 0%; and has dropped its annual ETF and J-REITs annual buying target. The upper limit of the ETF and J-REITs purchases are kept unchanged at ¥12 trillion and ¥180 billion respectively. However, the annual buying targets of ¥6 trillion for ETF and ¥90 billion for J-REITs were abandoned, matching Governor Kuroda's previous remarks of buying ETFs "flexibly".

The BOJ also maintained its 2.0% inflation target as it reaffirmed its goal of having the CPI-ex fresh food exceeding 2.0% and staying above the level in a stable manner. With national CPI currently at -0.4% y/y and CPI ex-food and energy at +0.2% y/y in February, far below the BOJ target, in addition to its frail macro condition, we see little chance of any tightening in BOJ policy in the next 2-3 years, or even beyond.

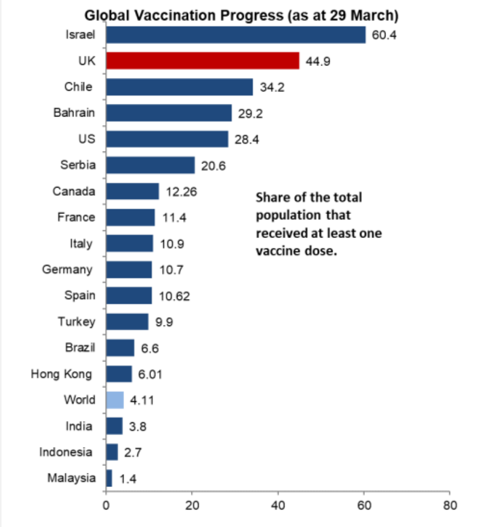
- ***The Reserve Bank of Australia (RBA)***

RBA could potentially be among the first few major central banks to withdraw policy support in our view. The country has shown some remarkable results in containing the outbreak since last September. Even though the recent hiccups on the use of AstraZeneca vaccine could delay the timeline of achieving herd immunity, we expect recovery in the Australian economy to pen out nicely.

Recent indicators spanning manufacturing, services, household spending, labour market and the housing boom should all augur well with recovery prospects. This observation is in line with RBA's official take, saying that "the economic recovery in Australia is well under way and is stronger than had been expected". "The recovery is expected to continue, with above-trend growth this year and next".

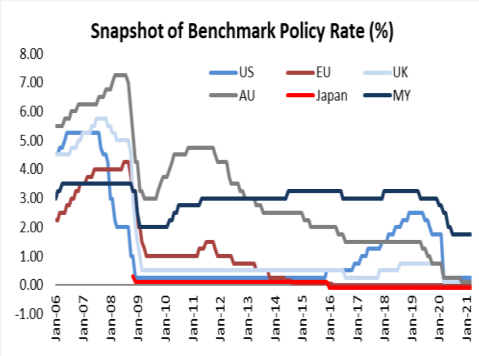
Singing the same tune with other central banks, RBA also highlighted that underlying inflation is expected to remain below 2.0% over the next few years (RBA trimmed mean core CPI +1.2% y/y), reaffirming our expectation that the spike in inflation will just be transitory. The only

Figure 5: UK has the second highest vaccination rate



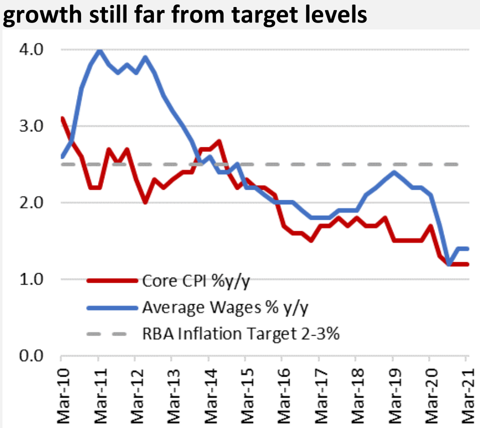
Source: Ourworldindata; HLBB Global Markets Research

Figure 6: Key interest rates to stay low for longer



Source: Bloomberg; HLBB Global Markets Research

Figure 7: Australia inflation and wage growth still far from target levels



Source: Bloomberg; HLBB Global Markets Research caveat we have to our view is that RBA stressed that it would not increase the cash rate until actual inflation is sustainably within the 2-3% target range, and that it is important for wages growth to be materially higher current level. It does not expect these conditions to be met until 2024 at the earliest.

- ***Bank Negara Malaysia (BNM)***

We do not expect any adjustment to the current level of OPR of 1.75% this year, and probably through 2022. Comments on monetary policy remained neutral in our view, focusing on supporting a sustainable recovery amid modest price pressure. BNM reiterated that policy stance will remain data dependent and that sufficiently accommodative monetary policy stance will be maintained given uneven pace of recovery and the downside risks to outlook.

What is worth reiterating is that BNM highlighted that the MPC will be mindful of premature withdrawal of policy support, which should dispel talks on any potential rate hike, given that the spike in inflation and hence negative real interest rates, will be transitory.

- ***Monetary Authority of Singapore (MAS)***

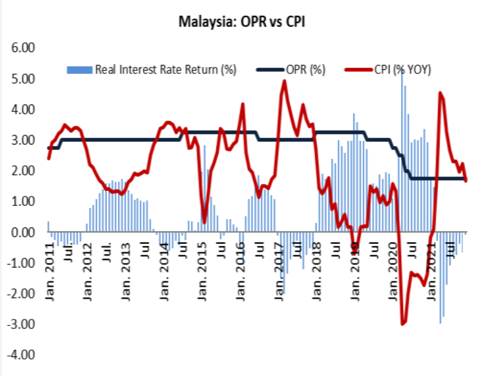
We think that the MAS may tighten monetary policy earliest April 2022. This is as the MAS operates an exchange rate, rather than interest rate, monetary policy. Domestic short-term interest rates are likely to stay low below 1.0% (current 3-month SIBOR around 0.4375%), as a result of US maintaining its policy rates at record lows until at least 2023. However, rising underlying inflation rates and closing output gaps may provide the MAS with the impetus to move to a modest and gradual appreciation policy of the Singapore Dollar Nominal Effective Exchange Rate sometime in 2022.

Summary of Policy Rate Forecast

Policy Rate (%)	2Q-21	3Q-21	4Q-21	1Q-22
Fed	0.25-0.50	0.25-0.50	0.25-0.50	0.25-0.50
ECB	-0.50	-0.50	-0.50	-0.50
BOE	0.10	0.10	0.10	0.10
BOJ	-0.10	-0.10	-0.10	-0.10
RBA	0.10	0.10	0.10	0.10
BNM	1.75	1.75	1.75	1.75
MAS	Hold	-	Hold	-

Source: HLBB Global Markets Research

Figure 8: Negative real interest rates likely to be temporary



Source: DOSM, BNM, HLBB Global Markets Research

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