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Global Markets Research

Research Alert

What happens when the Fed pauses?

Less hawkish Fed speaks recently spurred expectations for a rate pause in November

Fed dot plot continued to suggest a further 25bps hike to 5.50-5.75% by end-2023

Rates to stay higher for longer amid inflation risks; pushing back rate cut to 2H2024

Bigger gains for equities and long-end UST six months after a pause; mixed impact on DXY

Less hawkish Fed speaks vs. Fed dot plot; No change in our view of another 25bps rate hike by end-2023

As we enter the Fed blackout period ahead of the next FOMC meeting on 31-October to 1-November, investors are weighing on the latest Fed dot plot of a 25bps fed funds rate hike to 5.50%-5.75% by end-2023, against a bout of relatively less hawkish Fed speaks over recent weeks. Just a recap, Fed officials, from Vice Chair Philip Jefferson to Dallas and Atlanta Fed Presidents Lorie Logan and Raphael Bostic, have said that the recent surge in long-term bond yields may mean less need for the central bank to tighten again. This was echoed by Federal Reserve Chair Jerome Powell's speech at the Economic Club of New York, where he initially suggested that Fed is unlikely to raise interest rates again in November, a reprieve for investors but later spooked the markets when he said that he didn't see evidence that the policy rate is too tight right now, leaving the door open for further hike.

Given that Powell's comments sent the market whipsawing, the language from the next policy statement on November 1st will be closely scrutinized for future policy path. There is no change in our view of another 25bps Fed funds rate hike to 5.50%-5.75% this year, followed by a pause into 2H2024. With this, we think that it is only timely to share this piece on some clues how financial markets could potentially perform should our expectation for a hawkish pause materialize then, based on past incidences when the Fed paused.

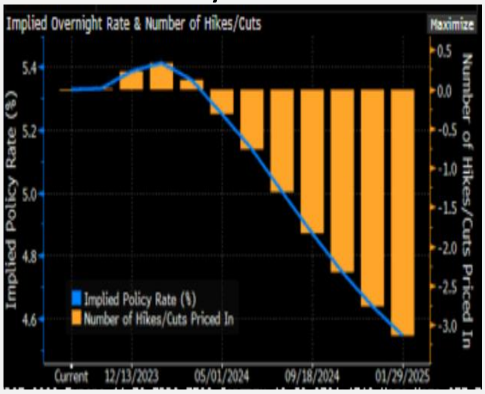
Based on the month-end data for the last 50 years, our study shows that the US Fed Funds Rate has a strong 0.97 correlation with the 2Y UST yields and 0.93 vs the 10Y UST yields. Data also showed that the Fed Funds Rate has a correlation of 0.61 with the US equities market (using the broader S&P 500 as a benchmark). Correlation with the USD is relatively weaker, with our calculation suggesting 0.40 between the Fed funds rate and Dollar Index (DXY) and a 0.67 correlation to the USD/MYR, the latter partially skewed due to the pegging of the Ringgit from 1998 to 2005.

Fed has historically cut rates 5-8 months after a pause

History suggests that the Fed has cut rates as soon as 2 months after pausing, but with a historical average of 5-8 months as the impact from the past interest rate hikes trickled in. Given that we expect the Fed to pause after the November or December FOMC meeting, this is largely in line with our view for a 25bps cut only towards 2H of 2024, ceteris paribus. Market is pricing the first rate cut in May 2024. (Refer to Figure 1).

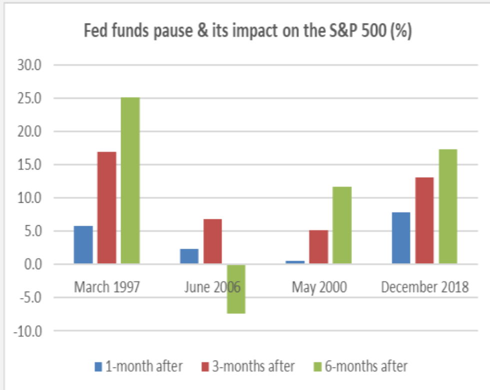
Past data also showed the pause is usually followed by an average of above 300bps rate cut subsequent to that. While we will not address the impact of rate cuts in detail this time, from a theoretically perspective, lower interest rates tend to depreciate the value of its currency, in this context the USD, while steepening the UST yield curve as investors flee to value long-dated bonds to hedge against volatility in the equities market, be it Wall Street or emerging markets. Indeed, the gap between the 2Y and

Figure 1: Fed Funds Futures is pricing in the first rate cut in May 2024



Source: Bloomberg

Figure 2: Impact of Fed fund rate pause on S&P 500



Source: Bloomberg

10Y yields widened from 14-60bps to 17-106bps three months after the cuts in the past three of four cycles.

Higher gains for US equities and long-end UST six months after a pause; mixed impact on FX

In the meantime, while noting that past performance may not be repeated, allocation strategy suggests that investors may shift from front-end of the UST curve to the long-end and equities markets after the Fed pauses in anticipation of falling real rates and a weaker USD. In fact, this is reflected by the higher gains in US equities and 10Y UST three months post the Fed's last rate hike.

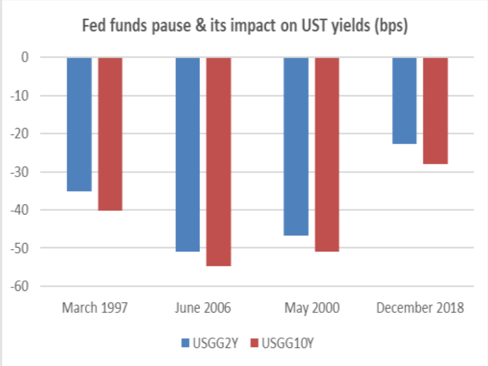
As seen in Figure 2, average equities have consistently trended higher between 5-17% following the last Fed hikes in the previous four cycles., with the momentum of the gain dependent on whether the previous hikes tilted the US economy into/near recession, and a soft or hard landing. When the hikes did not tilt the economy into a recession, equities were generally up by a larger margin. For example, S&P gained 16.9% and 13.1% respectively three months after the Fed paused in 1997 and 2018 when GDP growth averaged above 2.0% q/q in the 1Y-post Fed pause. Gains in S&P 500 was milder at 6.8% and 5.2% respectively in 2000 in 2006 when GDP growth averaged less than 2.0%. During the past four cycles, 10Y UST have also outperformed 2Y, with the yields for the 10Y falling an average of 43bps vs 2Y's -39bps. (Refer to Figures 3)

As mentioned earlier, the impact of a post-Fed pause was less significant in the currencies market, with the DXY printing gains of more than 1.0% three months post a Fed rate pause (Refer to Figure 4). Impact on MYR was less significant, with the MYR appreciating by less than 1.0%, one month after the Fed paused in the past two cycles. (Ringgit was pegged in 1998 until 2005).

Impact from the geopolitical concerns in the Middle East

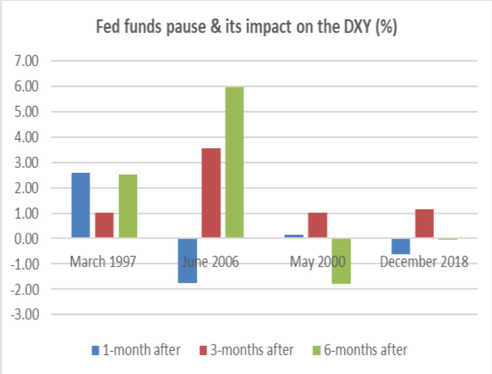
Potentially disrupting Fed's monetary policy is the tension in the Middle East. At time of writing, it is still too early to speculate the extent of the economic toll and its impact on global monetary policies from the Israel-Hamas conflict as it will largely depend on whether the tension widens beyond Israel and Gaza and for how long. Having that said, hostilities have and will send crude oil prices higher, as observed in the past year, and a widened and extended war could realistically disrupt global supply. This will mean higher oil prices and upside risks to inflation globally for a longer time, likely translated into more hawkish central banks in addition to greater economic uncertainty.

Figure 3: Impact of Fed fund rate pause on UST yields 3-months after pause



Source: Bloomberg

Figure 4: Impact of Fed fund rate pause on DXY



Source: Bloomberg

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