Oliver's INSIGHTS

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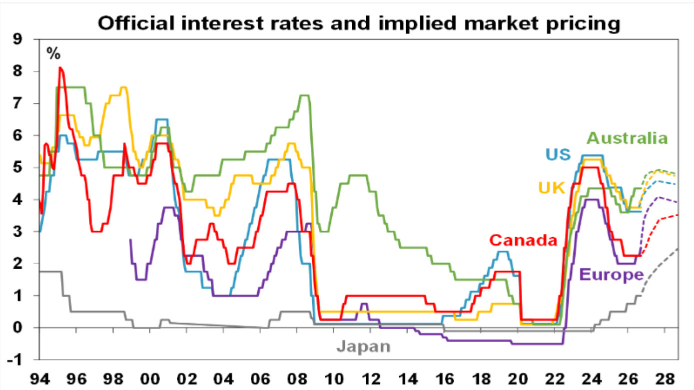
The Fed looks like it's going to hike – implications for investors & Australia

Key points

- The Fed is likely to start raising interest rates to combat sticky inflation and affirm its credibility.
- First Fed rate hikes in a tightening cycle don't normally signal the end of the bull market in shares but are consistent with volatility and the risk of a correction.
- A Fed hike is unlikely to impact the RBA which started hiking before the Fed & was already likely to hike again this mth.

Introduction

After much debate and anticipation, the US Federal Reserve looks likely to raise interest rates at its meeting this week by 0.25% taking the Fed Funds rate to a range of 3.75-4%. This will be its first hike since 2023.

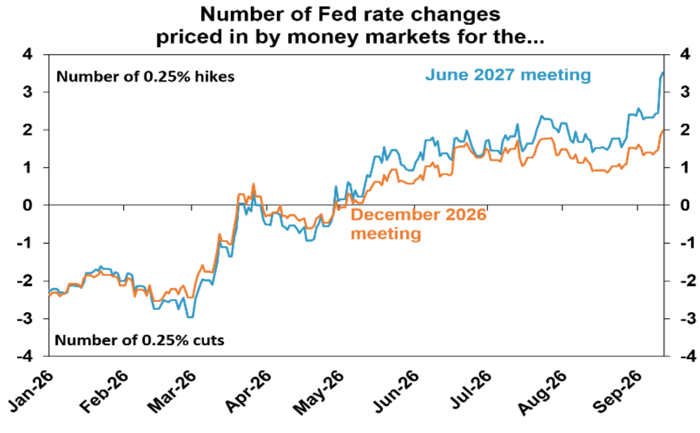


Dashed lines from now show money market expectations. Source: Bloomberg, AMP

In moving to hike the Fed will join numerous central banks in doing so including the ECB and those in Norway, Japan, Korea, Indonesia, and the Philippines, the RBNZ and of course the RBA which has hiked three times.

Why is a Fed hike likely?

As in other countries, the hike is likely because inflation is above the Fed's 2% target with upside risks. Some Fed officials have been arguing for a hike for a while. The Fed's June meeting saw half of the officials on the Federal Reserve's Open Market Committee that sets interest rates flag an expectation for a rate hike this year and the Fed's easing bias was dropped. Recent commentary from Fed officials indicated a need to see a downtrend in inflation to leave rates on hold with new Fed Chair Warsh turning hawkish and effectively backing this in a speech last month. Then underlying US consumer price inflation data for August surprised on the upside pointing to a 0.25% monthly rise in core private final consumption (PCE) inflation for August, which is not consistent with Fed officials' requirement for a falling trend in inflation. At the same time, US economic data has generally been solid and the renewed surge in the oil price has added to upside risks. So, the US money market sees an 86% chance of a 0.25% hike this week, and has factored in 3.5 hikes by June next year.

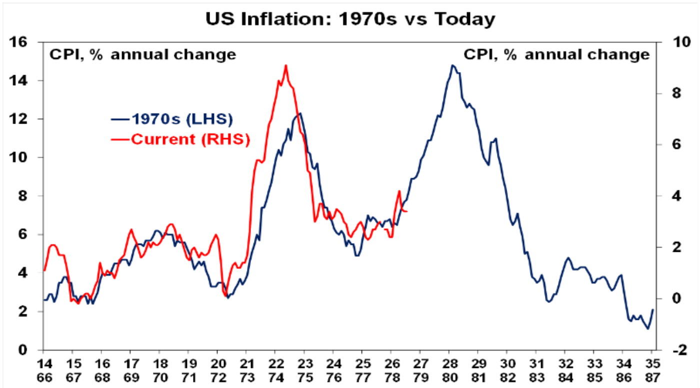


Source: Bloomberg, AMP

Trump's illogical intervention a week ago trying to get the Fed to "LOWER THE RATE" will have only made it more likely that more Fed officials will support a hike in order to reinforce Fed credibility. Were it not for Trump's tariffs and War with Iran the Fed may have cut again by now! Like the RBA, after nearly six years of inflation running above target Fed credibility is now on the line and Trump's interventions are not helping.

How far will the Fed hike?

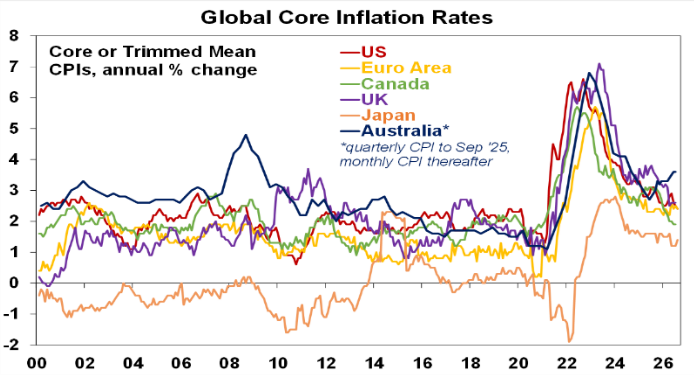
It's often said that central bank rate hikes are like cockroaches "if there's one there's probably more". Fed communication following the meeting is likely to remain hawkish warning of further tightening to come and this is likely to include the so-called "dot plot" of Fed officials' interest rate expectations signalling another hike by year end. And while I am not a great fan of historical overlay charts like the next one for US inflation - the US and the global economy have become more inflation prone thanks to deglobalisation, rising defence spending, bigger government, Trump's erratic pro inflation policy making, etc.



Horizontal axis shows years, starting in 2014/1966. Source: Bloomberg, AMP

And this provides a warning to the Fed to be cautious. After the surge in inflation in the early 1970s the Fed relaxed and then inflation came back with a vengeance, ultimately necessitating a far more aggressive monetary tightening to get it under control. The same could occur again.

Things probably aren't that bad now though given the Fed and other central banks now have firm inflation targets – albeit the risk is there. But to head of this risk the Fed will likely hike again. However, at present it looks more like fine tuning. US inflation is not yet showing a renewed surge and nor is it in most countries. Rather, the concern in the US is that at 2.4%yoy for core CPI and around 3.2%yoy estimated for core PCE inflation, it is just above target rather than necessarily taking off again.

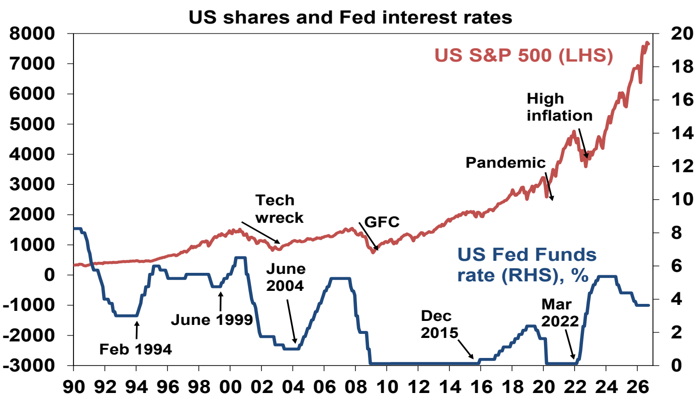


Source: Bloomberg, AMP

So, our base case is for one more Fed hike in this cycle, probably in December - as it's October meeting is just before the midterm elections.

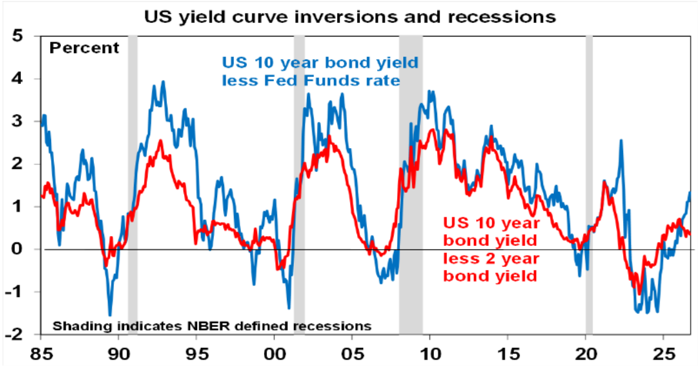
What does it mean for share markets?

The experience of the last 35 years suggests that while first Fed rate hikes in a tightening cycle can cause a dip in shares, the bull market usually resumes until rates become onerously tight, which weighs on profits. This can be seen in the next chart. US shares had wobbles when rates first started to move up in February 1994 (US shares had a 9% correction), in June 2004 (US shares had an 8% correction) and in December 2015 (US shares had a 13% correction) but thereafter they resumed their rising trend and a bear market did not set in till 2000, 2007 and 2020 after multiple hikes. Of course, the 2020 bear market was ostensibly due to the pandemic. Recession did not come for seven years after the February 1994 first hike, for three and a half years after the June 2004 first hike and for four years after the December 2015 first hike. This is because the first rate hike only takes monetary policy to less easy, and it's only when monetary policy becomes tight that the economy gets hit. The start of Fed tightening in the last cycle in March 2022 was different as shares were already in a falling trend and this continued until October 2022 culminating in a 25% fall. But inflation was much higher then – with US core CPI inflation of 6.5%yoy when the Fed started to hike necessitating a more aggressive increase in interest rates whereas now it's much lower.



Source: Bloomberg, AMP

One guide to whether monetary policy is tight or not is the shape of the yield curve (long-term bond yields less short-term rates) – with a period of long-term bond rates falling below short-term rates often preceding recession. Of course, this doesn't always work and it gave a false signal from late 2022 through 2024. At present, different versions of the yield curve are both in positive territory and not signalling recession.



Source: Bloomberg, AMP

Correction risks

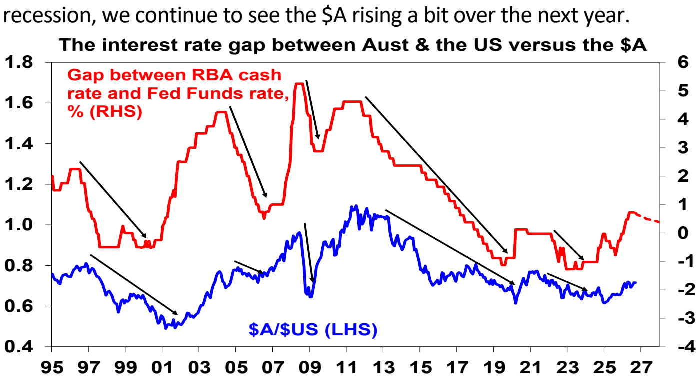
While past experience suggests little reason to be too concerned by the first US rate hike, there are two main risks:

- Correction risk is already high for shares - a Fed rate hike combined with worries about the rebound in oil prices, Trump's latest tariff announcements, rising bond yields, AI bubble worries and concerns about the US midterm elections could combine to further push shares down in the near term in what is a seasonally weak period.
- There is a high risk that Trump turns up both the tariff war (with maybe more countries retaliating) and the Iran War post the midterm elections once political constraints from the midterm elections recede. This would add to inflation.

Impact on Australian interest rates and the $A

The RBA sets rates for Australian conditions and does not just follow the Fed. As the first chart shows the link between US and Australian rates has been tenuous in recent times with the RBA hiking in 2009-10 when the Fed did nothing and the RBA cutting or on hold when the Fed raised rates over 2015 to 2018. They only move together if there is cyclical alignment. However, the RBA led the Fed in hiking starting back in February and is on track to hike probably later this month and maybe once more this year, and the Fed's likely hike this week won't alter that either way.

A Fed rate hiking cycle is not necessarily bad news for the $A because it depends on how much the RBA raises interest rates. Current money market expectations suggest some slight narrowing in the rate differential between Australia and the US which would be negative for the $A. However, our view is that $A is yet to catchup to the widening in the rate differential this year, expectations for 3.5 Fed hikes look too hawkish and solid commodity prices should support the $A. So, unless there is a global recession, we continue to see the $A rising a bit over the next year.



The dashed line from now shows money market expectations. Source: Bloomberg, AMP

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