02 February, 2023

U.S. Fed hikes rates by 25 bps - signals more hikes to come this year

Key Highlights:

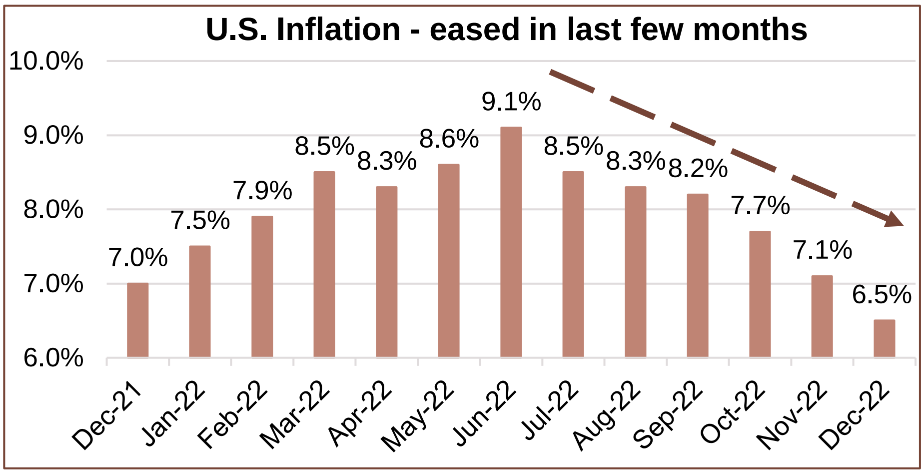
- The U.S. Federal Reserve (Fed) **raised its target interest rate by 25 bps to a range of 4.50%-4.75%**
- This 25 bps points hike has now taken the interest rates to a **15 year high i.e. since Sep 2007**
- That is just a half percentage point away from the Fed's estimated end point, or **terminal rate range of 5% to 5.25%.**
- In Dec 2022, **CPI inflation rose to 6.5%** over the year.

Current Update:

- The Fed delivered a **slower pace of rate hike of 25 bps** after announcing one 50 bps hike and four-straight rate hike of 75 bps in 2022 as part of its aggressive battle to bring down the rising inflation that is plaguing the U.S. economy.
- The U.S. policy makers voted unanimously to lift their key rate to a **target range of 4.50% to 4.75%, its highest level since Sep 2007**.
- That is just a half percentage point away from the Fed's estimated end point, or **terminal rate range of 5% to 5.25%.**
- **"We think we've covered a lot of ground,"** Powell told reporters after the meeting. **"Even so, we have more work to do."**
- "The committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of **monetary policy that is sufficiently restrictive to return inflation to 2% over time**," the Fed said in the statement.
- With inflation still high and demand in the economy stronger than many anticipated, Powell said it **remains unclear just how much higher rates will need to go.**

U.S. Inflation peeking:

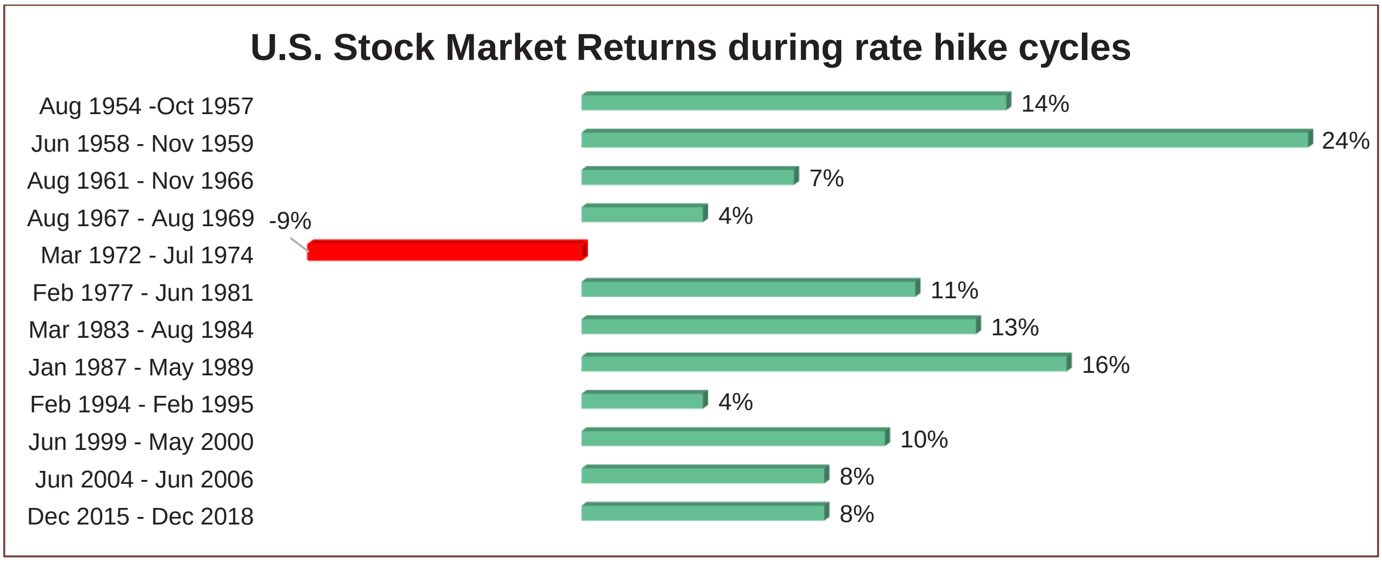
- U.S. inflation data has shown a moderate decrease in Dec compared to Nov 2022 on Y-o-Y basis. **In Dec 2022, CPI inflation rose to 6.5% over the year.**
- U.S. Consumer Price Index peaked at 9.1% Y-o-Y in Jun 2022 but it failed to come down as quickly in recent months as Fed officials had hoped.



Impact on U.S. Markets:

- U.S. markets rose following the press conference, indicating the investors expect a more dovish Fed going forward, **the S&P 500 gained 1.05% to close at 4,119, while the Nasdaq Composite too gained 2.00% to finish at 11,816 on February 1, 2023.**

History of 12 U.S. rate hike cycles have proven that the S&P 500 has risen by an average annualised rate of 9.4%



Source: Moneycontrol; Returns less than one year are absolute and greater than one year

To Conclude:

The U.S. Fed policy rates may remain at the higher levels for longer till core inflation comes down towards 2%. While, **Indian market expects the RBI to increase its policy repo rate by 25 bps in the upcoming monetary policy scheduled in February 2023 before taking a pause.** In India, the rising U.S. interest rates present challenges for the RBI Governor. When the Fed raises its policy rates, the difference between the interest rates of India and the U.S. narrows. This makes India less attractive for the currency carry trade. Further, a weakening rupee will put pressure on inflation via higher cost of imported goods and services.

We believe **Global equity markets, including the Indian markets will stay volatile for the time being, till the rate hike cycle continues globally amid Ukraine & Russia conflict, and its effect on global inflation**. The yield curve which measures the difference between long-term and short-term Treasury yields, shows **U.S. treasury yield curve inverts to depths not seen since 1980's**. Also, with further rate hike are on the cards for most of major developed economies across the world fear of **"stagflation"** are at their highest since the onset of the Great Recession in 2008.

Investment Approach:

Investors should not try to time the market and **investors should follow the desired asset allocation** to avoid unfavourable portfolio outcomes in case of any volatility that flows in the Indian markets due to tapering.

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