Global Strategy

The market needs to catch up to the Fed

Global Macro Strategy

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Overview: Taper prospect anchors a hawkish stance, not fully priced

Elevated inflation projections, a upwardly skewed inflation risk profile and higher than expected dots in the Fed's SEP failed to evoke any market reaction until Chairman Powell laid out the prospect of an early and quick taper lent them more credibility. At the time of writing, the Fed's median dots for 2023 and 2024 are still placed 18bps and 64bps above the market's expectations, respectively. There is room for front end rates to make up some of this distance to the Fed if data stays firm. Inflation breakevens are feeling the weight of a Fed that is unwilling to be asleep at the wheel. Additionally, with carry on TIPS falling, we feel more confident about 5y and 10y real rates now moving up in the US. Their progress has been slow, but they have inched up despite the risk wobble, and, perhaps more importantly, despite European real rates slipping lower. 10y US real rates have widened 37 bps to 10y European real rates in the last 2m. Backed by high equity risk premium and still strong earnings momentum, the S&P500 should be able to absorb around 30bps in real rates increases. Elevated volatility and skew point to investors already being long protection, providing some support for cash equities. The impact of rising US real rates on G10 FX may be somewhat limited by other central banks (RBNZ, BoE, BoC, Norges) also being hawkish, as well as overall long dollar positioning, but is more directly negative for EM currencies.

Rates : Almost as hawkish as could have been

Compared to the June SEP the Committee upgraded their inflation forecasts, revealed an expectation for an accelerated policy normalization through the DOT plot, and the Chairman all but committed to formally tapering at the November meeting at an accelerated rate relative to the prior program. Front end rates, particularly on the real yield curve, were higher, breakevens tightened and 5s30s flattened. Despite the move on the curve, we continue to like being short 5y5y real yields paired with short April 22-23 forward breakevens. In particular, carry will turn flat in October and monthly inflation readings should continue to slow from the accelerated rates in the summer months. With the Fed set to taper their asset purchase program, potentially at a faster rate than previously anticipated, the net real duration supply needed to be absorbed by private investors will turn positive. This should pressure real yields to the upside which could cause the non-traditional investor demand to wane or reverse. Finally, the front end of the inflation curve continues to price rates significantly beyond what our own economists expect, making the forward breakeven short attractive. The one thing that could have made this meeting even more hawkish is greater consensus around the 2024 hikes. A strongly bimodal distribution of dots for that year likely suggests a clear path to a dovish pivot if the data surprises to the downside. That is likely the trade after the trade though; for now the market has some catching up to the Fed to do.

Equities: Stronger earnings and high ownership of puts should provide support

A sooner/faster taper than we expected further reinforces our view that less liquidity supports moving up the quality spectrum. The chance for higher short rates than current market pricing supports our long Fins/Banks and select cyclicals while avoiding the highest valuation stocks most sensitive to real yields. We have already incorporated a 1.8% 10y rate in our S&P 500 view (4650 in 2021, 4850 in 2022), and believe the market can absorb roughly a 30bps in real yields (orderly pace), with the decline in the multiple more than offset by a rise in forward earnings. Some investors are concerned that higher costs will hit margins and earnings hard, but current elevated levels in both give us confidence. We expect Q3 earnings to beat consensus by ~10%+ as expectations of a qoq decline vs Q2 provide a very low bar. Post FOMC options show a modest decline in risk premia but further room to compress that is supportive for equity performance. The VIX curve is about 2 points flatter from 1-6 months vs. the intrameeting average but a VIX level above 20 shows markets still in trust-but-verify mode. Skew tells a similar story with the CBOE SKEW index 15 points lower w/w but still in its 96th percentile since 1990. We continue to expect the VIX to average 16-18 in 2H21 while high skew, a steep implied volatility term structure and large implied – realized spreads leaving room for risk premiums to normalize.

FX: Fed now mid table amongst like hikers

The dollar is higher after the FOMC but the move has been moderate. Fast money was already net long USD going into today and real money had cut their dollar shorts significantly relative to three months ago levels. Second, US 2y nominals, the part of the curve USD has been most sensitive to recently, have only moved ~2bp. Indeed, the Fed's hawkish upgrade places it mid-table in terms of a potential hiking sequence in the G10, arguably still behind Norges, RBNZ, BoE and BoC. We think that any tendency for the market to chase the dollar higher from here would be against low yielders, where we would be sympathetic to CHF shorts. But as the 2015-2017 episode showed, the state of the world where the Fed is actually able to deliver on rate hikes is that of a sustainably constructive global growth and risk sentiment. That means we are still inclined to buy the positive stories such as GBP, CAD and NOK.

EM: Between a rock and a hard place

The Fed's more hawkish pivot in June proved to be a turning point for EM assets. Its actions today are likely to reinforce that trend, in our view, with a projection for more tightening through 2024 than markets are currently pricing in, and clear indications of a faster tapering process. Critically, this comes at a time when China's property sector is decelerating rapidly (UBS expects a record drop in real estate FAI y/y over the next 3-4m), global manufacturing PMIs and export growth are peaking, and EM forward EPS estimates are both decelerating and underperforming DM. Our EM risk appetite index remains above risk-neutrality (at 0.66, where 0 is neutral and 1.5 is risk euphoria), amid low levels of EM FX volatility, elevated commodity prices, and tight credit spreads. We continue to see value in holding upside USD/EM protection, which we are currently expressing in USD/ZAR (risk reversals), USD/CNH and USD/CLP (call spreads), and hold a relative value bias elsewhere. We look for clearer signs of Chinese regulatory and administrative or mortgage policy easing as a key signpost to shift to a more constructive stance.