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UOB Investment Insights

Thinking Ahead

3 November 2022

Making Sense of the Fed Rate Hike and Upcoming US Midterm Elections

- The US Federal Reserve (Fed) raised interest rates by 0.75% (or 75 basis points) once again at its latest meeting. Fed Chair Jerome Powell suggested the pace of rate hikes may slow down soon, but he indicated that rates may end up higher than markets previously expected.
- Voters head to the polls for the US midterm elections on 8 November 2022. We examine three likely outcomes and what they mean for investors.

US economic growth rebounded in Q3

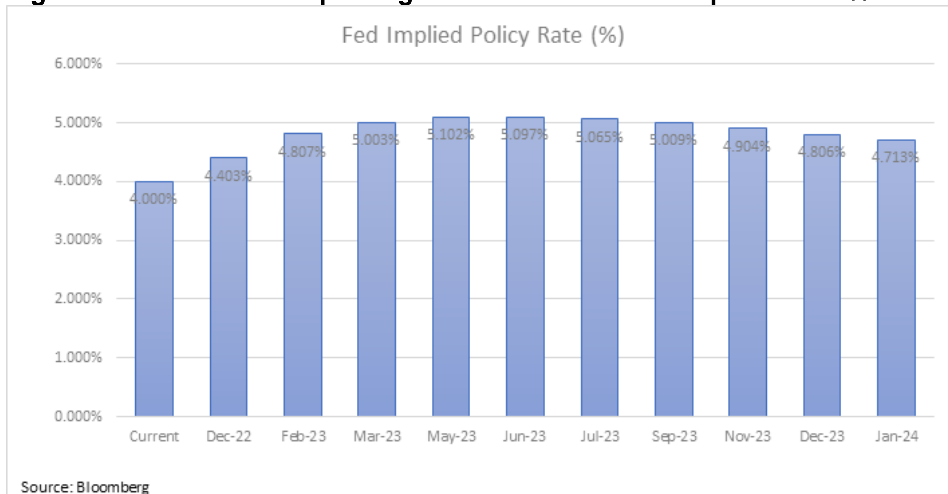
- As a backdrop, the US economy returned to growth after contracting for two consecutive quarters, with Q3 GDP rebounding 2.6% quarter-on-quarter (annualised).
- While this is encouraging, a closer look at the finer details suggests this recovery was due largely to a pick-up in net exports.
- Consumer spending and business capital expenditure remain under pressure due to high inflation. Specifically, the growth in consumer spending, which accounts for more than two-thirds of US economic activity, slowed to 1.4% in 3Q from 2.0% in 2Q.

US Federal Reserve rate hikes – "slower for longer"?

- The Fed delivered a 0.75% (or 75 basis point) rate hike at its fourth consecutive meeting. This pushed its target range for short-term borrowing rates up to 3.75% - 4%, the highest level since 2008. This marks the Fed's most aggressive tightening cycle since the 1980s, as its focus remains firmly on combating inflation.
- The Fed faces a communication challenge, as it tries to walk the tightrope of balancing potential economic risks with its mandate of controlling inflation.
- In response to persistently high inflation, Fed Chair Jerome Powell signalled that rates could end up higher than previously expected and stated that it is "very premature" to think about pausing policy tightening.
- On the other hand, being mindful of the time lag of the impact of monetary policy, the Fed policy statement indicated that the central bank "would be prepared to adjust the stance of monetary policy as appropriate if risks emerge", and Powell suggested it may be appropriate to slow the pace of rate hikes "as soon as the next meeting or the one after that".
- ***Reading between the lines, this suggests Fed tightening may shift to a "slower for longer" approach.*** Our view is that the Fed is trying to keep all options (be it a continuation of jumbo hikes or a slower path) firmly on the table for now, pending upcoming economic data. Note there are two more consumer price index (CPI) – or inflation – and employment reports to be released before the December Federal Open Market Committee (FOMC) meeting.
- ***All things considered, the market is currently driven by narratives, and this suggests more volatility ahead as investors engage in the dangerous game of deciphering the Fed's intentions.***
- For now, the market is spooked by the signal that the Fed's target range will top out higher than expected. However, whether the downbeat reaction continues is questionable, as the market has only shifted up their

terminal rate forecast to 5.1%, which is not meaningfully higher than the forecast of slightly under 5% priced in at the end of October.

Figure 1: Markets are expecting the Fed's rate hikes to peak at 5.1%

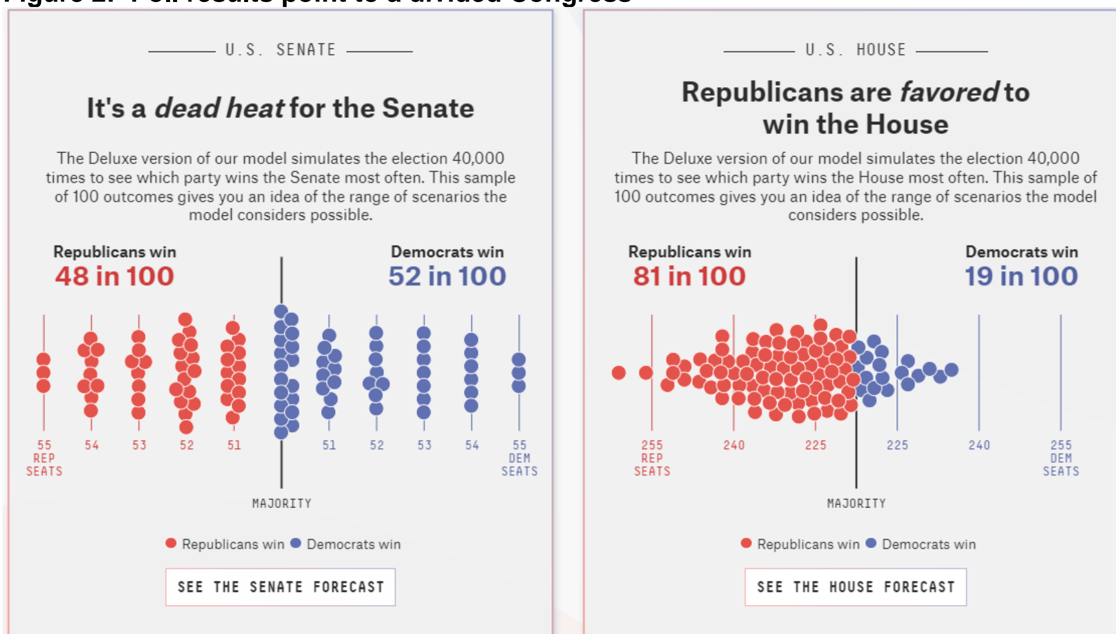


- If Fed officials do not indicate over the coming weeks that interest rates need to head even higher, market sentiment may shift to the possibility of smaller rate hikes as early as Dec.
- We retain our existing forecast for a 0.50% (or 50bps) rate hike in December. However, we have revised our 2023 projection and now expect two more 25bps hikes, one in February and another in March. We are forecasting rates to peak at a higher range of 4.75% - 5% (as compared to our prior forecast of 4.50% - 4.75%) by end-Q1 2023. Thereafter, we expect a pause to the rate hike cycle until Q1 2024.

All Congressional House seats up for grabs in the US midterm elections

- The US midterm elections take place on 8 November 2022. All 435 US House seats and 35 of the 100 Senate seats are on the ballot, with the latest polls pointing to a divided government as the most likely outcome (Figure 2).

Figure 2: Poll results point to a divided Congress



Source: FiveThirtyEight.com, as of 30 October 2022

Scenario-painting the possible outcomes

Scenario 1: Democrats win both the House and Senate

- In the unlikely scenario where the Democrats retain control of both chambers, they will try to push on with more of President Joe Biden's fiscal agenda, although any fiscal legislation may be narrow in scope if inflation stays high.
- If the US were to fall into a recession, major fiscal support is likely, and measures to support the labour market should find widespread support among Democrat lawmakers.
- Even if the US economy can avoid a recession, the Democrats may attempt to push through some fiscal legislation to boost their chances in the 2024 Presidential election. However, the size of any package may be limited if inflation remains high.

Scenario 2: A divided Congress

- If the Republicans win the House while the Democrats hold on to the Senate, policy inaction is likely for the next two years.
- There will also be a risk of a debt ceiling crisis around July 2023, with the Republicans potentially "weaponising" the issue to weaken President Biden's re-election chances.
- In the event of a recession, public pressure may eventually force a bipartisan compromise, but a support package may be small in scale.
- This, however, has a counter-intuitive impact on monetary policy, as policy inaction during a recession could force the Fed to pause its tightening cycle or unwind some of this year's rate hikes.
- As such, the net impact of a divided Congress may skew slightly positive overall.

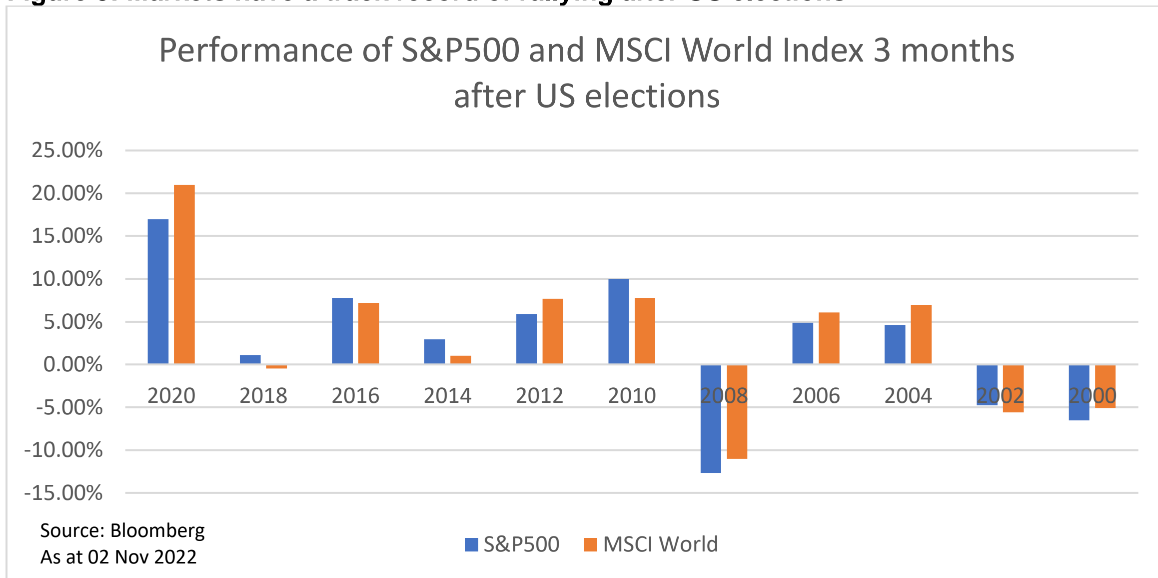
Scenario 3: Republicans win both House and Senate

- Republicans gaining control of both chambers appears to be the worst-case scenario.
- Effectively, it would mean Joe Biden becoming a lame duck President for the last two years of his term, with the Republicans possibly going all out to obstruct policy making.
- If the US economy falls into a deep recession, Republican lawmakers may be persuaded into passing some fiscal stimulus but this may be limited to tax breaks or incentives.
- On the whole, this looks to be the outcome that may trigger a knee-jerk negative reaction from markets.

Historical trend of post-election market rallies may not apply now

- Looking back at history, US equities have usually gained ground post-elections, once political uncertainty is removed.

Figure 3: Markets have a track record of rallying after US elections



- There have been some exceptions:
  - 2008 was because of the Global Financial Crisis.
  - 2002 was because of a prolonged structural bear market stemming from the dot-com crash.
  - 2000 was because of the dot-com crash.

- Interestingly, even a divided government has not historically proven negative for US stocks, as a division of power meant increased checks and balances against fiscal policy mistakes. However, we need to mention a big caveat that US politics was never as polarised in the past as it is now since the Trump era.

- As such, the trend of a post-election rally may not be repeated now.

- While market reaction may be negative if the Republicans take control of both chambers, possibly leaving Joe Biden to be a lame duck President, it is unlikely to be long-lasting.

- Instead, we think the markets will quickly return their focus to Fed policy, inflation, the economy and geopolitical developments.

- ***The political implications may only come into play in H2 2023 if the US economy falls into a mild recession, as the focus will then shift to the scale of fiscal support measures depending on the balance of power in Congress.***

What should investors do?

- US stocks have rebounded after a historically bad quarter, on the hope that Fed tightening turns less aggressive over the coming months. Having said that, investors should not chase the rebound as market volatility may remain high if inflation stays elevated. Furthermore, our house view is of a potential US recession starting from mid-2023.

- Above all, clients should make investment decisions based on UOB's Risk-First Approach and their own risk appetite.

- For now, we recommend that investors stay defensive with Core investments. Locking in higher yields in investment grade bonds could generate consistent income flow and provide potential capital appreciation in the future.

- Opportunistic investors with higher risk appetites can opt for structured products focusing on beaten-down quality stocks or invest in our identified Megatrends.
- Nonetheless, investors should be mindful that before looking at structured products, which are Tactical investments, their portfolios should already be anchored in Core solutions as a base.
- Speak to a UOB advisor on how best to position your portfolio according to your risk appetite.

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