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Rising risk of a Fed rate hike

A Fed rate hike looks increasingly likely, but multiple hikes are unlikely. Fed Chair Warsh has raised the chance of a rate hike this year, but no expectation on follow-up increases.

Setting the stage for a hike

At Jackson Hole, Fed Chair Warsh signaled a possible rate hike, noting that rates are not restrictive, employment remains near full and underlying inflation is still elevated. There could be a 50% chance of a rate hike, potentially on 16 September, if key US data before then are supportive – specifically, if August payrolls are positive, unemployment stays near 4.1% and core inflation is at least 0.2% m/m. If these conditions are met, not hiking could trigger another long-end bond selloff and undermine Warsh's credibility.

Little scope for multiple hikes

Even if the Fed delivers a 'defensive' hike, there's a little scope for further increases as US inflation should ease towards the 2% target next year when tariff and oil-price effects fade. New York Fed President Williams' refusal to pre-commit to even a September hike reinforces uncertainty over any significant policy tightening. Moreover, repeated rate increases could prove counterproductive by lifting already record US government borrowing costs as the Treasury continues shortening the maturity of its bond issuance, compounding fiscal pressures.

Buy on dips strategy

Rising bond yields have added to seasonal weakness in September and pre-midterm election blues to weigh on equities this week. Also, while bond yields have risen, bond market volatility (reflected in the MOVE index) has remained rangebound.

Gradually extend maturity in bonds

The latest rise in short-to-medium term bond yields is an opportunity to gradually extend maturities in bond portfolios. Preference continues in corporate bonds over government bonds and would look for any yield spike and maturities to lock in yields.

AUD top pick among currencies

The AUD appears best placed to benefit from further hawkish repricing among global central banks. A potential RBA rate hike is only partly discounted. Although EUR and JPY retain hawkish policy support from their respective central banks, expected hikes are already priced. It would require stronger guidance from the ECB and BoJ, respectively, to extend gains in the two currencies. NZD’s upside risk is limited after RBNZ rates guidance disappointed this week. GBP is less favored as the BoE might deliver fewer rates hikes than currently priced by markets amid a slackening labor market.

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