SK Market Insights

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What lies ahead for US interest rates, equities, commodities and the US Dollar

▼ Summary

- **The US Federal Reserve recently increased the Fed Funds rate in an effort to curb inflation but unemployment remains low and there is a shortage of skilled labour in the US**
- **This means that further rate increases are likely unless unemployment figures rise.**
- **Interest rates and the US dollar have been trending upwards but have recently undergone corrections.**
- **Analysts predict a potential recession on Wall Street and slower demand for goods and services in the tech sector.**
- **Inflation is also increasing the cost of doing business.**
- **Demographics in the US are a challenge, with a shortage of labor in certain age brackets and many people having retired early due to COVID-19.**
- **This may make it difficult for the Federal Reserve to control inflation.**
- **Equity prices are expected to adjust to the new economic reality next year with targets ranging from 3600-3000 for the S&P 500.**

▼ Investors should prepare for higher interest rates ahead

The US Federal Reserve raised the fed funds rate by another 0.5% to between 4.25-4.5% last week in their continuing effort to tame inflation. Equities rallied initially, albeit momentarily and subsequently sold off. This raises the question as to where we stand with respect to inflation and its effect on the various markets.

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The Fed Chair was resolute in his view that further work needed to be done to tame inflation and additional increases, in the fed funds rate north of 5%, was in his cards. Unemployment remains stubbornly low and there is a shortage of skilled labour in the US. Further rate increases are likely unless unemployment figures rise. In other words, supply of labour needs to exceed demand before inflation is tamed.

In the next few charts, I lay out why such a task could be daunting and why investors should prepare for higher interest rates ahead. Starting with the weekly 10-year US Treasury interest rates, updated since the last issue, it is clear that a top is now in place at 4.4%. The correction that ensued in November to date has run its course and the rate now sits at 3.48% and on its 30-week moving average. This was also its support earlier in August. Interest rates are unlikely to move lower until the path of inflation becomes clearer. At best over the next several weeks we can expect interest rates to move sideways to slightly higher until further data becomes available.

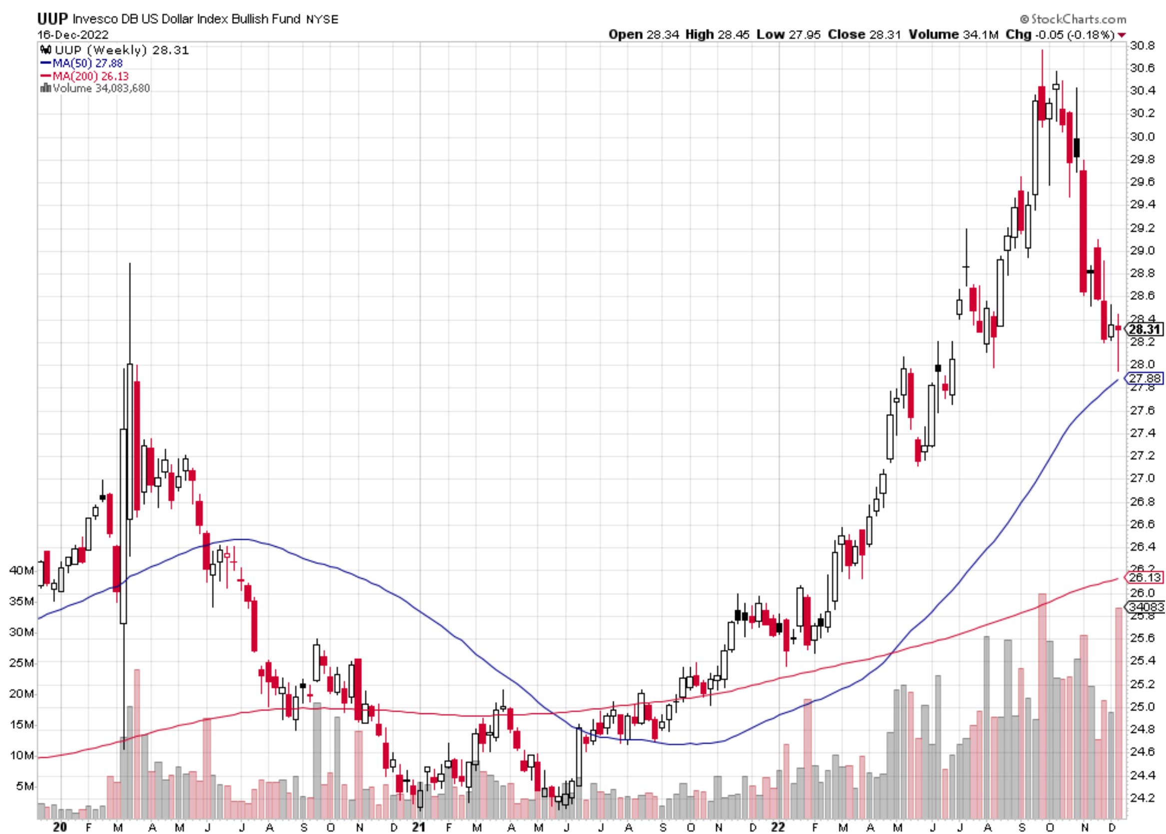
Figure 1: A top is now in place for the 10-year US Treasury at 4.4% however interest rates are unlikely to move lower for now

https://stockcharts.com/h-sc/ui?s=%24TNX&p=W&yr=3&mn=0&dy=0&id=p81467129214&a=1279599344&r=1671437150798&cmd=print

Source: SK Market Insights, StockCharts.com

Taking its cue from falling interest rates, the USD has been correcting since early November and this correction is also coming to an end as seen from the weekly chart of the ETF "UUP" . This chart shows price being supported for now at the 50-day moving average.

Figure 2: The USD has been correcting since early November and this correction is also coming to an end



▼ In the big scheme the uptrend in rates and the USD is still alive

The key takeaway from both these charts from a bigger perspective is that the uptrend in interest rates and the USD since 2021 is alive and well. However, the correction in both has offered bonds, commodities and emerging markets a welcome relief rally, that has since run its course.

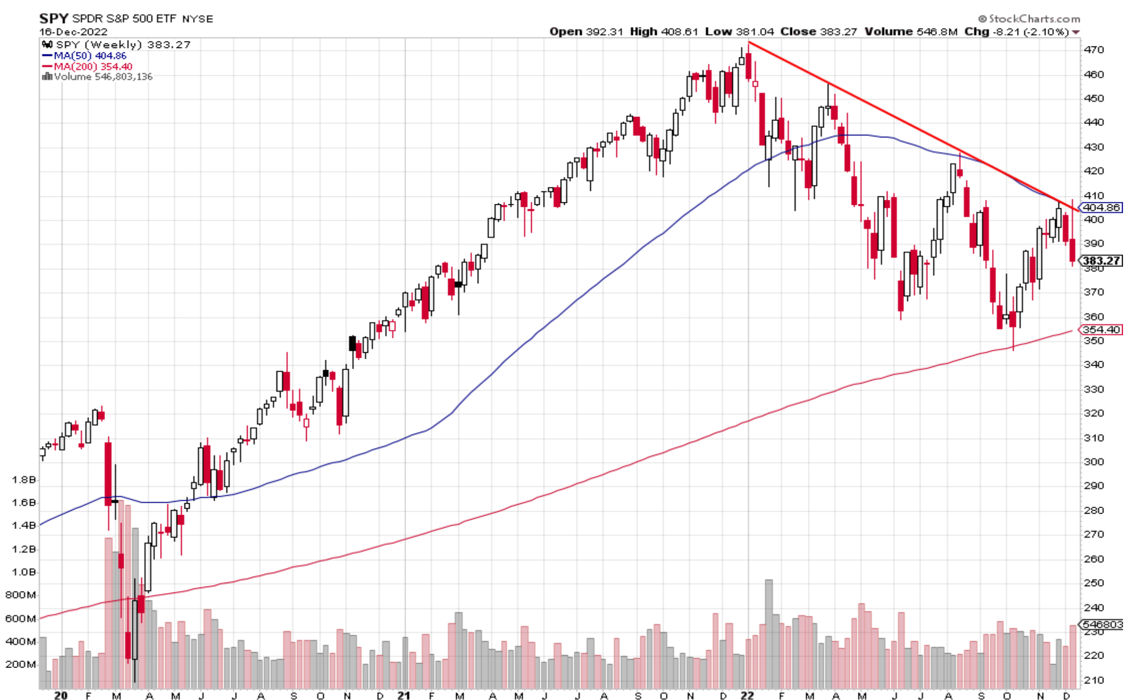
A review of US equities tells a similar story. Using the ETF SPY as a proxy for the S&P500 we can see that the downtrend in prices is intact after a further test during mid last week, as seen from the chart below. Prices

have now tested the downtrend line since January thrice and failed! Lodged between the 50 day and the 200 day moving averages, price need to make a decisive break out either up or down. This is where a view of the fundamentals come in to play.

▼ The S&P 500 is headed lower as a Wall Street recession begins

Analysts predict a Wall Street recession with companies having given advance notice of lower earnings in the 4th quarter. Demand for goods and services are slowing down in the tech sector as companies reassess their hardware and software requirements going forward. Inflation is increasing the costs of doing business due to cost of goods and wages. The war in Ukraine has put a floor on commodity prices and the economic uncertainty in China remains. Given these circumstances it is likely that equity prices will readjust to the new reality. A range of targets is being proposed for the S&P 500 between 3600-3000 in 2023. However, any rallies from the lows are going to be tempered by rising inflation as the following analysis will show.

Figure 3: The SPY is adjusting to the new economic reality with prices likely to trend lower between 3600-3000 next year



Source: SK Market Insights, StockCharts.com

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▼ The challenging US Demographic picture is keeping the labour market tight and could prevent inflation returning to 2%

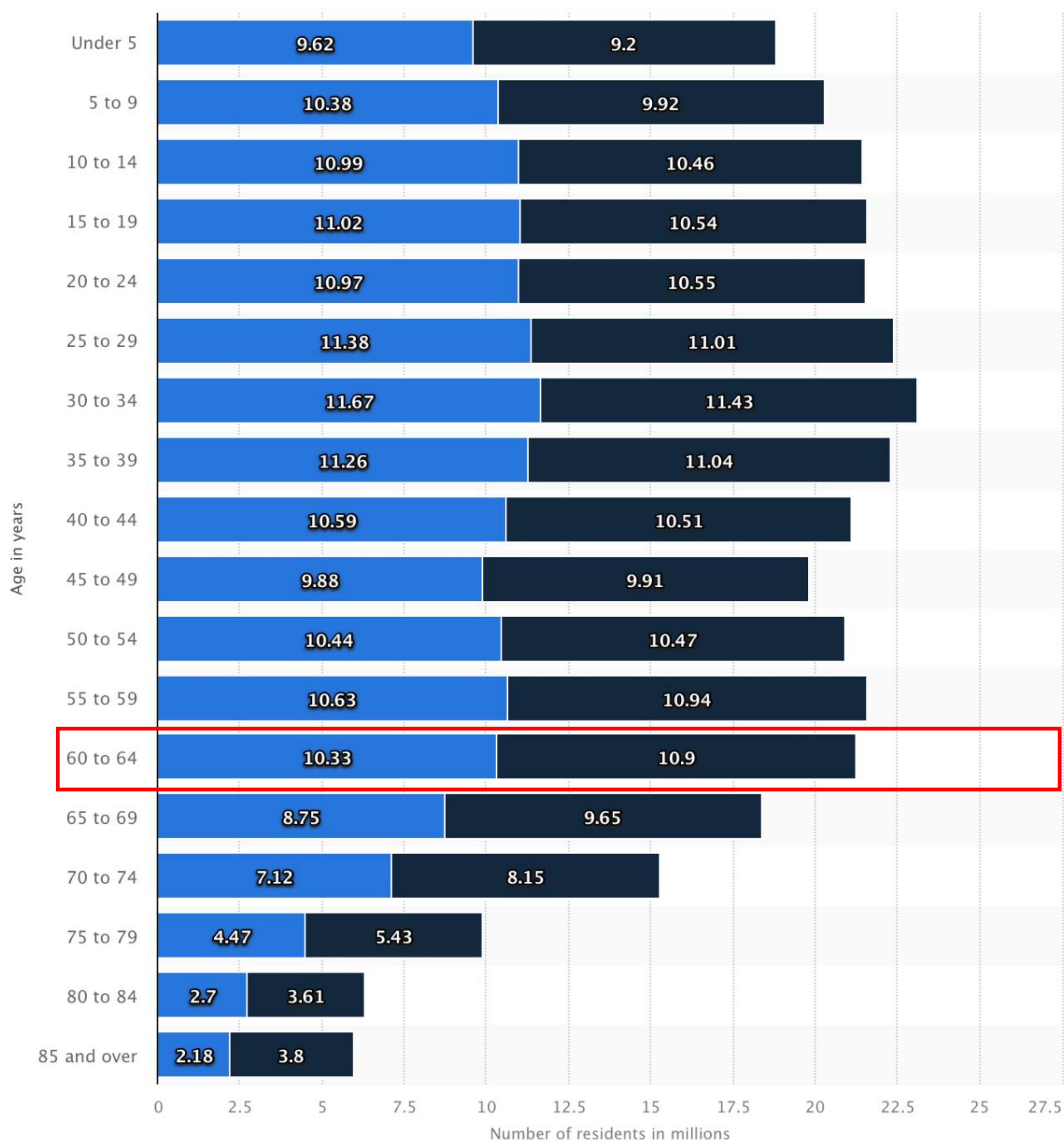
Demographics in the US remains a challenge going forward. As the attached chart of US population, broken down by half decades shows, the last of the baby boomers (those born between 1946 and 1964) will reach 60 years of age in 2024. However, their retirement was brought forward by COVID and they are unlikely to return. Looking at the cohort behind them, there is a dip in available labour until we reach the 25–35 year-olds who are just entering the labor market. Many in other age brackets have also availed themselves of the generous handouts from the US Govt. and are unlikely to return. This only aggravates an existing tight market. Things do get better beyond that, but much later.

This explains the tight labour market seen by the Federal Reserve and the difficulty they face in taming inflation. Inflation may never get to their target of 2% baseline, and we may have to live with a higher figure between 3-4% for a while. This could be further compounded by higher commodity prices as China returns to the market.

▼ We may be in for a long period of mediocre return from equities with short-term Treasuries looking more attractive

Higher inflation eats into returns and is a headwind for equities. It is however a boon to savers as they begin to enjoy higher risk-free returns through US govt. securities. We may be in for a long period of mediocre returns from equities for the foreseeable future simply because there has been a generational paradigm shift from near zero interest rates that encouraged speculation in equities to one where risk free returns via short term US Treasuries have started to look attractive. Given that there may be further downside to equities during the next six months, this could be a good place to be.

Figure 4: The last of the baby boomers will reach 60 years of age in 2024



Source: SK Market Insights, Statista

▼ The worst is not over yet. Stick with defensive equities.

Defensive sectors such as staples, utilities and healthcare offer attractive alternatives during this period while growth equities get repriced. Commodities such as Copper and Silver may also be attractive going forward.

2022 has been a tumultuous year for equities and bonds, however, this story is far from over. We may well see a rebalancing to the new reality where returns from fixed income are going to pose a challenge to equities by raising the bar on returns expectations. This may well result in a period of muted equity returns.

Please feel free to contact me for any further questions or clarification.

Wishing all readers a happy holiday season! 🌟 🎄 🎅 🦌

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Sowmi is a Chartered Market Technician (CMT)and a member of the CMT Association, N.Y., U.S.A.; as well as an Associate Member of the Society for Technical Analysts, U.K. After completing a 35 year career with Mobil/ExxonMobil in a variety of roles in the across U. S. A., Asia Pacific and Europe, including an 8 year stint in a number of oil trading roles for Mobil in Asia Pacific, he has decided to embark on a new career in technical analysis, leveraging on his prior experience. In addition to his CMT, Sowmi has a Ph. D in Chemical Engineering and an M. B. A. in Finance. He is an avid sports enthusiast and has a keen interest in golf.

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