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FUNDAMENTAL FLASH

Fed Turbocharges Interest Rates by 75bps

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This week, the US Federal Reserve (Fed) raised benchmark interest rates by 75bps which is its biggest increase since 1994 as part of efforts to tame soaring inflation.

Esther Teo, Senior Director of Fixed Income shares her insights on the macro outlook post-Fed rate hike and impact to Malaysia.

Flashpoints

- The Fed hiked benchmark interest rates by 75bps following May's red-hot inflation print.
- The current dot plot signals that US interest rates could rise to 3.4% by end 2022.
- Impact to Malaysia expected to remain manageable due to large foreign reserves and low USD-denominated external debt.
- Large subsidies on food and fuel could stem upward pressure on domestic inflation, though it exerts fiscal pressure on the country.
- As long inflation remain manageable, BNM could stay measured and gradual in raising rates.

1. Walk us through the Fed's recent rate hike decision and where we stand currently on monetary policy outlook?

Following last week's red-hot inflation print, where May's Consumer Price Index (CPI) figures rose 8.6% y-o-y which dashed expectations that inflation has reached its peak, the Fed hiked the Federal Funds or benchmark interest rates by 75bp at its FOMC meeting.

However, the hike was largely priced-in by financial markets after the May CPI figures were announced.

Looking at the dot plot (*Fed Fund rate projections*) by the Fed members, the expectation is that US Fed Fund rates may rise to 3.40% by end of 2022, and touch 3.80% by end of 2023 before coming down in 2024.

The Fed guided that it would remain data-dependent and that the path of interest rate decisions will hinge on economic data in the coming months.

Furthermore, the Fed has embarked on quantitative tightening starting 1 June 2022 in order to shrink its balance sheet which ballooned at the onset of the pandemic due to stimulus measures.

All these points to tightening financial conditions in the US which will have an impact to the rest of the world including Malaysia.

2. How do you see the Fed's aggressive monetary policy affecting Malaysia?

The impact to Malaysia's economy and financial markets is expected to remain manageable given our relatively large foreign reserves (USD116bn), low USD-denominated external debt (0.9% of GDP) and a large domestic liquidity base.

Malaysia also benefits from higher commodity prices, as we are a net commodity exporter. The challenges we face are similar to our regional neighbours and even globally. These include the supply chain bottlenecks due to China's zero-COVID strategy (i.e. lockdowns), high commodity and food prices due to the ongoing Ukraine war and weakening Asian currencies resulting from a strong USD. All these challenges can lead to a higher inflation outlook, as we have seen in many developed and emerging economies.

The key reason Malaysia's CPI is still under control is due to the large subsidies on food and fuel. However, these subsidies is also a fiscal burden as the subsidy bill balloons, and will give us less fiscal headroom to manoeuvre in the event of an economic shock.

Another downside risk in the near-term is the weakening growth outlook in China's economy. Beijing's zero-COVID policy is having a large impact on China's employment and growth outlook, and the property sector in China is seeing rising defaults and liquidity stress. We expect China's government to ease policy more aggressively in the 2H'2022 to support growth including the property sector. Its strict zero-COVID policy has to be further loosened for the economy to get back on track.

3. Do you see Bank Negara Malaysia (BNM) following in the Fed's footsteps to also hike rates aggressively?

While the US is embarking on an aggressive rate hike cycle in order to tame its high inflation, we believe BNM does not need to hike rates as aggressively domestically. This is because the dynamics of inflation is different between the US and Malaysia.

Malaysia's inflation is expected to rise, but still range within 2.5%-3.5% which is much lower than the 8% CPI print in the US. This is mainly because over 40% of our CPI component are subsidised, whereas the US is very much market-driven.

Malaysia is also in the early stage of a sustained recovery after reopening from the COVID lockdowns. BNM's surprise interest rate hike of 25bps in May was a pre-emptive move to contain inflation.

Going forward, we expect a gradual and measured pace of interest rate normalisation to continue in Malaysia with another 25-50bps OPR hikes for the rest of 2022 and another 50bps OPR hikes in 2023. This will bring the OPR to pre-pandemic level of 3.0% by the end of 2023.

This is based on our view that inflation will remain manageable in Malaysia with no change to fuel and food subsidy policy, and that the 2022 GDP forecast of 5.50% is achievable.