Anticipating FFR Hikes : Favor Stock over Bond

Key Takeaways

- The Fed is expected to increase FFR as soon as Mar-22 with 72% probability.
- Historically, global equities and government bond prices were negatively affected by FFR hikes.
- However, equities were less sensitive to FFR hikes compared to government bond as shown by lower correlation value.
- Despite having lower correlation, the impact of US monetary policy on stock market varied across countries.
- Indonesia's government bond market was more sensitive to US monetary policy than its equity market.
- Prefer stock over bond with baseline scenario for FY22F JCI target at 7,150 (+15% EPS/16.4x PE).

Victoria Venny
In Charge Head of Research (Strategist)
victoria.nawang@mncgroup.com

Tirta Widi Gilang Citradi
Economist & Fixed Income Analyst
tirta.citradi@mncgroup.com

The Hawkish Fed

Embarking 2022, markets anticipate earlier rate hikes from the Fed. Persistently higher inflation and improving job market are the main driver for the Fed to take a hawkish stance. The US CPI is projected to rise 7.0% YoY in Dec-21, marking 4 decades high. Meanwhile the unemployment rate fell to 3.9% last month, the lowest level since Mar-20. FOMC's participants seemed to agree that interest rate hikes is needed to fight inflation besides the tapering. Furthermore the Fed's officials also consider to normalize its balance by reducing bond.

The Fed itself sees that inflation is more persistent than they previously thought. PCE inflation is projected to increase 5.3% in FY21E according to the Fed's summary of economic projection, well above CB's target of 2% and Sep-21 forecast of 4.2%. Inflation is estimated to normalize in FY22F to 2.6%. However the figure remain above CB's target and previous forecast at 2.2% (Exhibit 1).

Therefore FOMC's participants see 3x FFR hikes are likely in 2022. This depicted more aggressive US central bank as at Sep-21 projection the Fed was expected to increase benchmark policy rate only 1x. Some US banks even foresee 4x hikes this year. Fed's first tightening cycle is expected to start as soon as Mar-22 with 77% probability of 25-50 bps target range (Exhibit 2). A more hawkish Fed has caused turmoil both in equity and bond market as 10-year UST yield is nearing 1.80%.

Exhibit 1. The Fed sees inflation is more persistent than previously thought

Median	21E	22F	23F	24F	Longer Run
PCE Inflation (%)	5.3	2.6	2.3	2.1	2.0
Sep-21 Projection (%)	4.2	2.2	2.2	2.1	2.0
Implied Changes (bps)	110	40	10	0	0

Source : Fed's Summary Economic Projection Dec-21, MNCS

Exhibit 2. Market sees 72% probability of the first FFR hikes in Mar-22

Fed's Meeting Schedule	FFR Target Range Probability (%)					
	0-25	25-50	50-75	75-100	100-125	125-150
Jan-22	89.5	10.5	0.0	0.0	0.0	0.0
Mar-22	20.1	71.7	8.2	0.0	0.0	0.0
May-22	11.7	50.0	34.9	3.4	0.0	0.0
Jun-22	2.9	21.2	46.2	27.0	2.6	0.0
Jul-22	1.9	14.9	37.6	33.7	11.0	0.9
Sep-22	1.0	8.7	26.7	35.6	21.9	5.8
Nov-22	0.7	6.3	21.1	32.8	26.1	10.8
Dec-22	0.3	2.8	11.9	25.6	30.3	20.3

Source : CME Group, MNCS

US policy normalization is thought to have a bad impact for financial assets particularly in emerging countries. Massive outflows have caused emerging market asset prices to fall and its currency to depreciate against USD. In this report we tried to dig deeper the influence of US monetary policy cycle on financial assets behavior (stocks & bonds) in emerging and developed nations from historical perspective.

Historically stocks were less sensitive to monetary policy cycle than government bond

Our sensitivity model has shown that government bonds were more sensitive to changing interest rates than stocks in the last two decades. The prices of government bond in developed and emerging markets suffered from rising interest rates as indicated by positive yield change (Exhibit 3). We see strong correlation between US and Hong Kong government bond yields with the FFR. We also noted that global stock return were negatively correlated with FFR. However the correlation of stock returns and FFR change was somewhat weak (Exhibit 4).

The cross countries analysis as shown in Exhibit 4 also indicate country's stock markets (Europe & UK) that have high correlation to US market suffer more from Fed's monetary tightening. While countries with low correlation to US stock market and global equities such as China can absorb the shock better.

Some emerging countries stock market such as Argentina, Thailand and Philippine were also more affected by global monetary policy. Indeed we understand that this may be associated with countries specific risk such as chronic high inflation and political stability that may escalate the downside risk and triggering foreign outflows.

Exhibit 3. Government bond sensitivity to Fed's monetary policy

	FFR	US	Europe	UK	Japan	Hong Kong	China	India	Brazil	Mexico	Russia	Indonesia	Malaysia	Thailand	Philippines	Singapore
FFR																
US	0.69															
Europe	0.48	0.89														
UK	0.52	0.93	0.98													
Japan	0.48	0.84	0.96	0.94												
Hong Kong	0.68	0.97	0.86	0.90	0.80											
China	0.12	0.43	0.46	0.49	0.42	0.39										
India	0.06	0.07	0.09	0.10	0.16	-0.05	0.34									
Brazil	0.01	0.28	0.32	0.33	0.33	0.18	0.03	0.47								
Mexico	0.53	0.76	0.61	0.65	0.53	0.75	0.30	-0.32	-0.04							
Russia	-0.39	0.01	0.05	0.07	0.00	0.01	0.01	-0.09	0.29	0.06						
Indonesia	0.48	0.77	0.75	0.78	0.70	0.77	0.16	-0.18	0.26	0.73	0.19					
Malaysia	0.22	0.70	0.58	0.63	0.50	0.66	0.48	0.06	0.33	0.65	0.35	0.59				
Thailand	0.52	0.85	0.88	0.89	0.90	0.79	0.52	0.30	0.32	0.53	0.00	0.68	0.66			
Philippines	0.43	0.80	0.78	0.79	0.71	0.82	0.35	-0.27	-0.03	0.87	0.16	0.78	0.68	0.67		
Singapore	0.53	0.90	0.74	0.81	0.67	0.89	0.39	0.03	0.37	0.68	0.18	0.75	0.83	0.76	0.71	

Notes : data used to construct correlation matrix were monthly benchmark 10-year local currency denominated bond yield from each countries during 2003-2021. Sources : Bloomberg, MNCS

Exhibit 4. Stock sensitivity to Fed's monetary policy

	FFR	US	MSCI World	Europe	UK	Japan	Hong Kong	China	India	Brazil	Argentina	Indonesia	Malaysia	Thailand	Philippines
FFR															
US	-0.13														
MSCI World	-0.10	0.96													
Europe	-0.08	0.84	0.86												
UK	-0.08	0.81	0.85	0.88											
Japan	-0.13	0.60	0.65	0.64	0.56										
Hong Kong	-0.02	0.67	0.77	0.64	0.64	0.50									
China	0.14	0.30	0.36	0.29	0.23	0.28	0.49								
India	-0.05	0.55	0.65	0.56	0.53	0.49	0.63	0.30							
Argentina	-0.14	0.44	0.50	0.42	0.38	0.34	0.41	0.25	0.42	0.48					
Indonesia	-0.07	0.48	0.58	0.45	0.48	0.39	0.52	0.24	0.62	0.44	0.41				
Malaysia	-0.05	0.42	0.49	0.46	0.39	0.27	0.47	0.32	0.49	0.46	0.37	0.49			
Thailand	-0.13	0.56	0.62	0.50	0.54	0.45	0.51	0.18	0.59	0.56	0.44	0.61	0.47		
Philippines	-0.09	0.46	0.50	0.41	0.43	0.31	0.45	0.21	0.57	0.40	0.40	0.64	0.40	0.59	

Notes : data used to construct correlation matrix were monthly stock index return from each countries during 2003-2021. Sources : Bloomberg, MNCS

Looking forward, the impact of Fed's policy normalization on global financial market will vary across countries and sectors. The degree of magnitude will also depend on how effective the Fed communicate their policy to the market. Any unanticipated surprise is likely to trigger shock.

Indonesia : Betting on Economic Recovery & Higher Growth Lead Us to Favor Equities over Bond

Fed's tapering 2013 gave us a clear picture that how US monetary policy normalization affect domestic financial market. Bernanke's speech on plan to rollback liquidity injection surprised market sending UST yield higher and stock price to plummet. At that time JCI dropped, 10-year Indo GB yield rose and IDR suffer from depreciation against the greenback. However domestic stock market recovered faster while government bond yield keep rising.

We noted at least in the last 2 decades, domestic stock performance has shown to be less sensitive to Fed's monetary policy compared to government bond. The correlation value between stock returns and FFR was negative but weak (R=-0.07). Meanwhile Indonesia's government bond yield and FFR seemed to have moderate correlation (R =0.48). In addition, the 10-year Indo GB and UST yield was strong (R=0.77).

Indeed that past performance does not necessarily predict future results. However we see that domestic financial market fundamental is strengthening and better than in nearly a decade ago. Therefore, we believe Indonesia is more prepared to face Fed's tightening agenda this year.

We expect ample FX reserves will help cushion IDR from large depreciation. While potentially lower budget deficit and MoF-BI coordination through SKB-III should be translated to lower government bond supply risk. Combined with benign inflation outlook and rising domestic investors, this should help limit the upward pressures on government bond yield. Yet, we still like equity over bond on the back of economic recovery and higher growth that may further lower stock-bond correlation. We expect Indonesia's GDP to expand 4.9-5.3% in FY22F. Our regression analysis showed that GDP significantly influenced EPS and JCI. Our baseline scenario for FY22F : JCI target at 7,150 (+15% EPS/16.4x PE) and 10-year Indo GB yield at 6.77% (Exhibit 5).

Exhibit 5. Forecast for JCI & 10-year Indo GB yield Target FY22F

Asset Class	Benchmark	FY22F		
		Bear	Base	Bull
Equity	JCI	6,775	7,150	7,650
Bonds	10-Yr Indo GB (%)	6.45	6.77	7.07

Sources : Bloomberg, MNCS

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

PT MNC SEKURITAS
MNC Financial Center Lt. 14 – 16
Jl. Kebon Sirih No. 21 - 27, Jakarta Pusat 10340
Telp : (021) 2980 3111
Fax : (021) 3983 6899
Call Center : 1500 899