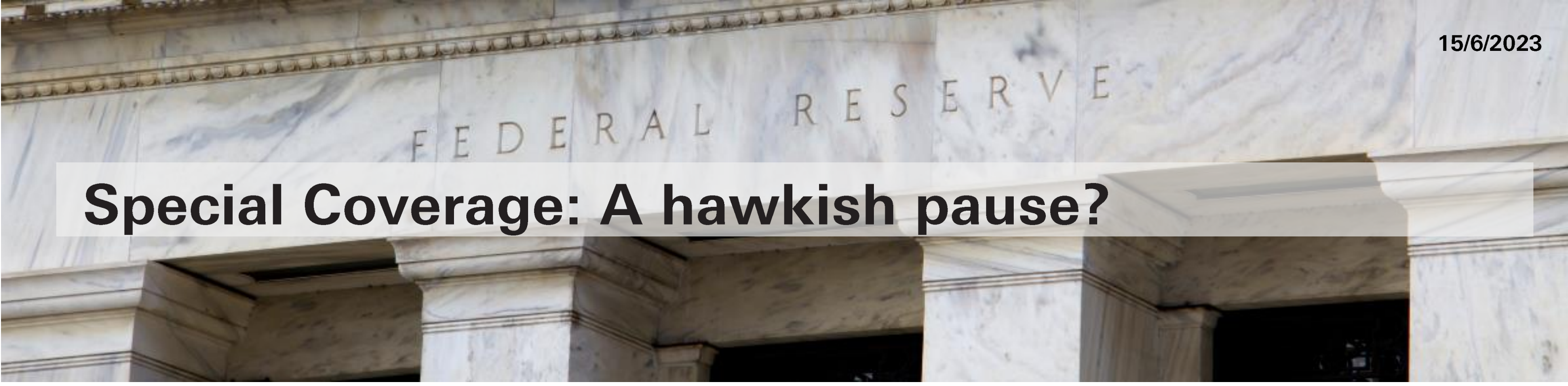

15/6/2023

Special Coverage: A hawkish pause?

Key takeaways

- As expected, the FOMC chose to skip the June meeting by not raising policy rates, leaving the Fed funds rate in a range of 5.0% to 5.25%. The recent release of the new Summary of Economic Projections (SEP) indicated that the Fed feels we may see 0.5% more of tightening. We still expect the Fed to have a final 0.25% rate hike in July and then pause.
- The combination of better economic growth and a lower unemployment rate suggests the Fed believes that the economy can avoid outright recession, even in the face of further rate hikes. As housing inflation is expected to cool significantly in the following months, this should put downward pressure on core PCE inflation and make the Fed feel more comfortable with the inflation outlook.
- Although the current bull market should continue, equity investors should prepare for some consolidation as valuations have risen, and the potential of further Fed tightening may cut into future earnings estimates and valuations in the short term. For fixed income, we maintain a focus on quality because of growth slowdown and higher interest rates crimping budgets. We prefer to maintain a medium duration by acquiring assets with solid yields that may decline in the coming months.

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What happened?

- As expected, the FOMC chose to skip the June meeting by not raising policy rates, leaving the Fed funds rate in a range of 5.0% to 5.25%. The most recent Summary of Economic Projections (SEP) revised upwards its outlook on real GDP for 2023 to 1.0% from 0.4% at the March meeting.
- In March, the FOMC calculated the median projection for the Federal funds rate to be 5.1% in 2023. With the recent release of the new SEP, it is clear that the Fed feels we may see 0.5% more of tightening, as they increased their outlook for the Federal funds rate to 5.6% by year-end 2023. Half of the Committee shifted its forecast to 0.5% of further tightening at the June meeting.
- The FOMC also raised the target rate for Fed funds to 4.6% in 2024 and 3.4% in 2025 and aims for a long-term target of 2.5%. It also reduced its forecast for the 2023 unemployment rate, suggesting it would rise to 4.1% before year-end and then rise to 4.5% next year and stay there through the end of 2025.
- The combination of better economic growth and a lower unemployment rate suggests the Fed believes the economy can avoid outright recession, even in the face of further rate hikes.
- The SEP forecasts were slightly more optimistic on overall inflation in 2023 suggesting inflation could get to 3.2% by year-end.
- The problem around inflation, according to the Fed's forecasts, is that the core rate of inflation could actually rise more rapidly than they thought in March. The FOMC increased its forecast for the core PCE deflator from 3.6% to 3.9% at the June meeting.

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- We would suggest that one of the problems with the core PCE deflator has been the price of home purchases and the rental market. Based on the data we see from market activity, and the historic lags between market data and the government's calculation of the CPI, we should expect housing inflation to cool significantly in the following months, which could put downward pressure on core PCE inflation and make the Fed feel more comfortable with the inflation outlook.

- Headline CPI rose 0.1% in May. The y-o-y rate fell to 4.0% from 4.9%. Inflation is down from its peak of 9.1% in June 2022.

- Core CPI rose 0.4% in May. The y-o-y rate fell to 5.3% from 5.5%. Core inflation is down from its peak of 6.6% in September 2022.

Median of the FOMC economic projections, June 2023

Variable	Median			
	2023	2024	2025	Longer run
Change in real GDP	1.0%	1.1%	1.8%	1.8%
March projection	0.4%	1.2%	1.9%	1.8%
Unemployment rate	4.1%	4.5%	4.5%	4.0%
March projection	4.5%	4.6%	4.6%	4.0%
PCE inflation	3.2%	2.5%	2.1%	2.0%
March projection	3.3%	2.5%	2.1%	2.0%
Core PCE inflation	3.9%	2.6%	2.2%	
March projection	3.6%	2.6%	2.1%	
Memo: Projected appropriate policy pate				
Federal funds rate	5.6%	4.6%	3.4%	2.5%
March projection	5.1%	4.3%	3.1%	2.5%

Source: Bloomberg, HSBC Global Private Banking and Wealth as at 14 June 2023.

- The PPI in May fell -0.3% m-o-m, bringing the year-over-year rate to 1.1%, the smallest advance since the end of 2020. Producer prices are down drastically from their peak of 11.7% y-o-y in March 2022.

- Core PPI increased 0.2% m-o-m in May and was up 2.8% y-o-y. Core PPI is down from its peak of 9.7% y-o-y in March 2022.

Investment implications

- For fixed income investors, we maintain a focus on quality as growth around the world seems to be slowing, and higher interest rates will crimp budgets. However, given that we are still near the end of the Fed's tightening cycle, we prefer to maintain a medium duration by acquiring assets with solid yields that may decline in the coming months. While we understand the allure of higher short-term interest rates, an extension of duration seems to make sense given the economic and financial backdrop.

- For equity investors, the current bull market, which began last October, should continue. But investors should prepare for some consolidation as valuations have risen, and the potential of further Fed tightening may cut into future earnings estimates and valuations in the short term. However, as we have noted repeatedly, we feel the Fed is closer to the end of its monetary policy tightening cycle, and this should bode well for US equities. Historically, when the Fed pauses its monetary policy tightening cycles, US equity markets tend to do very well and usually outperform global indices. In the prior six Fed tightening cycles, the S&P has produced an average return of 19% in the 12 months following a Fed pause. Moreover, we are at the beginning of a technology-led revolution, both lowering the cost of doing business and expanding revenues through the creation of new markets.

- For the US dollar, a more hawkish Fed pause suggests that current weakness may not continue in the short term. In fact, if the fear of further Fed tightening were to derail equities in the short term, we could see global investors, in a flight to quality, purchase dollar-denominated fixed income assets, which could provide some upside for the USD. However, given that we believe the Fed is closer to the end of its tightening cycle and its European counterparts at the Bank of England and the European Central Bank may tighten longer, further dollar weakness remains our base case.

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