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Special Coverage:

Fed dovishly enters restrictive territory

Key takeaways

- The FOMC lifted the Fed funds rate by 0.25% to a range of 5–5.25% at its May meeting, which brings the rate above the current level of inflation and therefore in restrictive territory. We expect one more 0.25% hike in June, leaving rates at that level (5.25%-5.5%) till Q2 2024. Tightening of bank lending standards, the debt ceiling and macro data will potentially influence their future decisions.
- Powell made it clear that the FOMC must balance its desire to reduce inflation to 2% with the need to maintain liquidity and stability in the banking system and the broader financial markets. Overall, the Fed's decision and message was large in line with expectations. Whether the Fed pauses now, or after its June meeting, it seems clear that the tightening of monetary policy is largely behind us. This is positive for bonds but also for equity valuations.

Jose Rasco
Chief Investment Officer, Americas, HSBC Global Private Banking and Wealth

Michael Zervos
Investment Strategy Analyst, HSBC Global Private Banking and Wealth

- We maintain a mild risk-on positioning as we approach peak policy rates. Given the recent concerns regarding the financial system and the economic slowdown, we focus on investment grade bonds while locking in current yields. As we anticipate mild further earnings downgrades in the financial, real estate, and technology sectors, US equities will see some consolidation in the near term. However, as the fundamentals start to better align with economic reality, we could see attractive returns in H2.

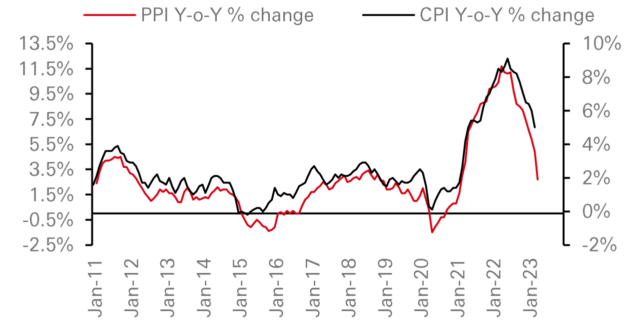
What happened?

- As expected, the FOMC lifted its policy Fed funds rate by 0.25% to a range of 5–5.25% at its May meeting. The vote was unanimous in maintaining a more restrictive monetary policy. In addition, the FOMC announced that it "will continue reducing its holdings of Treasury securities" to further reduce the size of its balance sheet and liquidity in the financial system. We believe the Fed will raise rates one more time by 0.25% to a range of 5.25–5.5% at the June meeting.
- The Fed is facing a few major problems, such as inflation, a slowing economy, a suddenly fragile financial system, to name a few. Whether the Fed pauses now, or after its June meeting, it seems clear that the tightening of monetary policy may be largely behind us. This would suggest that the peak in market rates may also be behind us (we believe Treasury yields peaked in November).
- One inconsistency between the Fed and the markets is that the market is looking for three rate cuts from the FOMC by the end of Q1 2024. The Fed has made it clear again that if inflation remains above its forecast of 3% by the end of 2023, it'll keep policy rates on hold for longer than usual to ensure that inflation slows back to its long term target of 2%. Historically, the Fed begins to ease about six months after it pauses its monetary policy tightening programs. In this business cycle, the desire to force inflation lower may keep the Fed on hold with higher rates for longer than people anticipate.
- At the March FOMC meeting, the Fed seemed pretty confident that further tightening was necessary. As the banking crisis has expanded, it now seems that the Fed will become even more data dependent, taking into account the strains on the banking system, in determining whether future Fed policy tightening is warranted. Forward guidance is clearly less certain.
- The US labour markets remain tight and employment gains look relatively healthy. Although job openings have declined, the increase in the participation rate suggests that demand for labour remains strong. Wages have also slowed from its peak of 7% last March to 5.1% this March. That said, Chairman Powell noted that wages and inflation do tend to rise together. Therefore, a decline in wage gains back towards the 2.2% average in the prior business cycle would be helpful in moving overall inflation lower.

- The outlook for inflation is somewhat mixed. US consumer inflation has slowed precipitously in the last few months from a peak of 8.9% last June to 5% this March. But US labour markets remain tight and job creation remains healthy, which keeps demand healthy and wage gains stronger than normal. Also, some fear that the Chinese reopening has the potential to put upward pressure on commodity prices (we think this risk is overstated as the Chinese growth pickup is more consumer and service-led than in the past).

PPI suggests that headline CPI inflation should fall

PPI Y-o-Y % change (advanced 1-month) vs. CPI Y-o-Y % change



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 3 May 2023.

- History teaches us that a higher Fed funds rate and higher market interest rates do have a deleterious effect on the economy. Moreover, as higher rates slow consumer and investment spending, the unemployment rate rises, and wages also slow. Significantly, US consumer inflation has suffered from the rise in home and rental property prices. But in most surveys, home prices have been declining steadily for months and rents have also declined from their peaks. Historically, there has been a lag between market index prices and how it gets accounted for in the inflation data. Most economists estimate that we should start to see declines in the housing-related inflation data which could help push inflation lower than many estimate.
- The Fed, the Treasury department, and the Federal Deposit Insurance Corporation (FDIC) have taken steps to improve liquidity in the banking system and prevent a systemic banking crisis. Powell made it clear that the FOMC must balance its desire to reduce inflation to 2% with the need to maintain liquidity and stability in the banking system and the broader financial markets. Even in the face of continued higher policy rates, the Fed has provided a great deal of loans to the banking system and created the Bank Term Funding Program (BTFP) designed to prevent the banks from short-term funding issues, given unrealised losses on their balance sheets.
- The current stalemate regarding the debt ceiling issue in the US is also problematic for the Fed. While fiscal and monetary policy should remain independent of each other, the Fed may find it difficult to continue raising interest rates in a scenario where funding issues and lack of credit could quickly begin to adversely affect the economy. While experts disagree as to the drop-dead date for a resolution on the debt ceiling crisis, it's clear that weaker receipts for the federal government will put pressure on a faster resolution. Significantly, given that the government needs to remain responsive to the liquidity issues surrounding regional banks, a resolution to the debt ceiling crisis seems more important. The FDIC's coffers must be replenished if they're to continue to provide adequate support to the banking system. Further debt issuance is one clear way for the government to provide that liquidity.

Investment Summary

- It seems likely that we're closer to the end of the monetary policy tightening cycle. This should support bond yields around the current level and we believe we are past the peak in Treasury yields (likely already reached in Nov).
- For bond investors, we maintain our medium duration stance (5-7 years), as locking in current high market rates might make sense. Given the recent concerns regarding the financial system, we focus on investment grade bonds in both developed and emerging markets.
- As a result of the recent signs of trouble in the financial sector, we anticipate that earnings downgrades should continue in the financial, real estate, and technology sectors, resulting in further consolidation in US equities in the near term. Earnings estimates may need to come down a bit further to fully reflect the economic slowdown that is just beginning and the continued disinflation in the US economy. Therefore, we continue to focus on companies with strong market positions and margin power, and those that manage costs or raise productivity through smart investments. As the fundamentals better align with economic reality and valuations look more compelling later this year, we foresee more significant upside in H2.
- In terms of the US dollar view, the market is likely to run with the theme of a peak in Fed policy rates justifying a clear peak in the US dollar and an ongoing reduction in the currency's long-term overvaluation.

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