

Special Coverage:

Fed strikes a balance by raising rates while providing liquidity

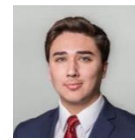
Key takeaways

- ◆ The FOMC raised policy rates 0.25% to a range of 4.75-5.00% and stated that some additional policy firming may be appropriate. We maintain our view of two further 0.25% hikes in May and June to 5.25-5.50%. After this, we don't foresee any rate cuts this year, and align with the Fed on this, in contrast to the market which assumes up to three 0.25% cuts by year end.
- ◆ The FOMC has taken its growth forecasts down in 2023 and 2024, but kept the long-term growth rate unchanged at 1.8%. The Committee made a minor change to its inflation forecast, lifting it to 3.3% in 2023 from 3.1% at its December meeting. The official view has inflation returning to the Fed's symmetric 2.0% target in 2025, and kept the long-term forecast at 2.0%.
- ◆ For bond investors, we maintain our focus on quality and medium duration (5-7 years). Given the current economic and financial backdrop, we are comfortable that we have seen the peak in Treasury yields. For global equity investors, we continue to focus on China's reopening and upside potential in EM Asian markets. For US equity investors, the inevitable end of the Fed tightening cycle could be welcome news. However, earnings downgrades in the financial and technology sectors will continue, resulting in further consolidation in US equities in the near term.



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What happened?

- As expected, the FOMC raised policy rates 0.25% to a range of 4.75-5% at its March meeting. In the press release, the FOMC said it "anticipates that some additional policy firming may be appropriate". This represents a shift from its prior release where the Fed said they expected "ongoing increases" in the funds, indicating that the terminal rate may be closer than some people anticipate. The other piece of good news is that the FOMC also stated that "the US banking system is sound and resilient".
- In its most recent Summary of Economic Projections (SEP), the FOMC has reduced the forecast for growth in 2023 marginally to 0.4% from 0.5% at the December meeting. Significantly, the FOMC's projection of the terminal rate remained unchanged at 5.1%, suggesting the end of the Fed tightening cycle may be close at hand. With this policy move, especially given the recent uncertainty in the financial sector, monetary policy seems balanced. To some, the FOMC's tightening of monetary policy, including quantitative tightening (QT), stands in contrast to the numerous policy initiatives the Fed (along with the FDIC & Treasury) have introduced to help provide the liquidity needed to assist financial institutions in a time of need.
- Importantly, an issue has emerged on the possible future of FOMC activity. The Fed's March SEP suggests that Fed funds will be cut from 5.1% to 4.3% next year, roughly a decline of 75 basis points. This implies less of a cut in rates than was forecast at the December FOMC meeting. This cut in rates would come after the FOMC takes us to 5.25% on Fed funds as the upper bound. The market has a different view. The CME FedWatch tool is already pricing in 70 basis points of easing by year-end 2023 and another 150 basis points by year-end 2024. As the FOMC and CME monitor the incoming data, we expect a real-time realignment of expectations for policy and market rates which could cause further volatility in financial markets.

The outlook for growth and inflation

- The FOMC has taken its growth forecasts down in 2023 and 2024, but kept the long-term growth rate unchanged at 1.8%. The Committee made a minor change to its inflation forecast, lifting it to 3.3% in 2023 from 3.1% at its December meeting. The official view has inflation returning to the Fed's symmetric 2% target in 2025, and kept the long-term forecast at 2%. The one oddity in the March SEP is that the official forecast for the Fed funds rate drops less than in its December forecast. It seems a bit incongruous that policy rates would be cut less given the uncertainty surrounding the fragility of the financial system and the increasing odds of recession.
- Powell was quite clear that the FOMC will be undeterred in taking inflation down to 2.0%, but it may take time. In the middle of this policy initiative, the financial system received the shock that took place among a group of banks. It's important to remember that the financial system seems sound with ample liquidity. That said, Powell noted that there are "serious problems at a small number of banks" and went on to point out that so far "the Fed's programs are 'effectively meeting' liquidity needs and that policymakers are closely monitoring the situation". While he went to great pains to quell any fears of a global financial crisis emerging, he did caution the audience by saying that "events in the banking system" are likely to result in tighter credit conditions," but it's too soon to tell how much this will affect the economy and how monetary policy should respond".
- In addition, on March 19, the Fed, in conjunction with five other central banks, announced a "coordinated action to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements", increasing the frequency of 7-day maturity operation from weekly to daily. This action is designed to enhance liquidity for US dollars globally by having the Fed lend to other central banks more frequently.

The FOMC has shifted its outlook slightly

Summary of Economic Projections, March 2023

Variable	Median			
	2023	2024	2025	Longer Run
Change in real GDP	0.4%	1.2%	1.9%	1.8%
December projection	0.5%	1.6%	1.8%	1.8%
Unemployment rate	4.5%	4.6%	4.6%	4.0%
December projection	4.6%	4.6%	4.5%	4.0%
PCE inflation	3.3%	2.5%	2.1%	2.0%
December projection	3.1%	2.5%	2.1%	2.0%
Core PCE inflation	3.6%	2.6%	2.1%	
December projection	3.5%	2.5%	2.1%	
Memo: Projected appropriate policy path				
Federal funds rate	5.1%	4.3%	3.1%	2.5%
December projection	5.1%	4.1%	3.1%	2.5%

Source: Federal Reserve Summary of Economic Projections, HSBC Global Private Banking and Wealth as at 22 March 2023.

Investment Summary

- For bond investors, we keep our stance on duration at medium. Given the current economic and financial backdrop, it seems likely that we have already seen the peak in bond yields late last year. Therefore, locking in rates for somewhat longer durations might make sense. In addition, given the recent concerns regarding the financial system, we focus on investment grade credit in both developed and emerging markets.
- For global equity investors, we continue to focus on China's reopening and upside potential in EM Asian markets. For US equity investors, the inevitable end of the Fed tightening cycle could be welcome news. As a result of the recent signs of trouble in the financial sector, we anticipate that earnings downgrades should continue in the financial and technology sectors, resulting in further consolidation in US equities in the near term.
- At this point, we still maintain that equity valuations do not properly reflect the economic slowdown that is just beginning and the continued disinflation in the US economy. As a result, we look for earnings downgrades to continue. The tighter financial conditions could also put further downward pressure on earnings. As the fundamentals better align with economic reality and valuations look more compelling, we would increase our allocation to our overweight position in US stocks in the future.
- For the US dollar, we expect consolidation in the short term and weakness in the medium term. Market volatility and uncertainty create a safe haven bid for USD but the approaching end of interest rate hikes is a headwind. This was illustrated by the immediate reaction of EUR/USD, which was a bit stronger after the Fed meeting.

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