Special Coverage:

Hawkish tightening to restore balance

Key takeaways

- As expected, at its September meeting, the US Federal Reserve raised the federal funds rate by 75bp to a range of 3.00 – 3.25%. Chairman Jerome Powell said that his message had not changed from Jackson Hole, with the overarching focus being to get inflation back down to 2%.
- We now expect the FOMC to raise the Federal funds rate another 75bp in November, 50bp in December and a final 25bp hike in February 2023, taking the federal funds target range to 4.50-4.75%.
- The hawkish surprise and upward move in the dots lifted short-dated bond yields, which we believe are at attractive levels, especially for investment grade. As for equities, the headwind from rates may ease as much is now priced in, and the focus may now increasingly turn to earnings and growth. We continue to prefer US stocks, and focus on quality companies that are well-positioned for somewhat slower growth, especially as we will move into the earnings season. We remain focused on sectors where pricing power remains like energy and food. For fixed income, as real rates on cash are still negative, we instead prefer floating rate notes which offer a credit spread.

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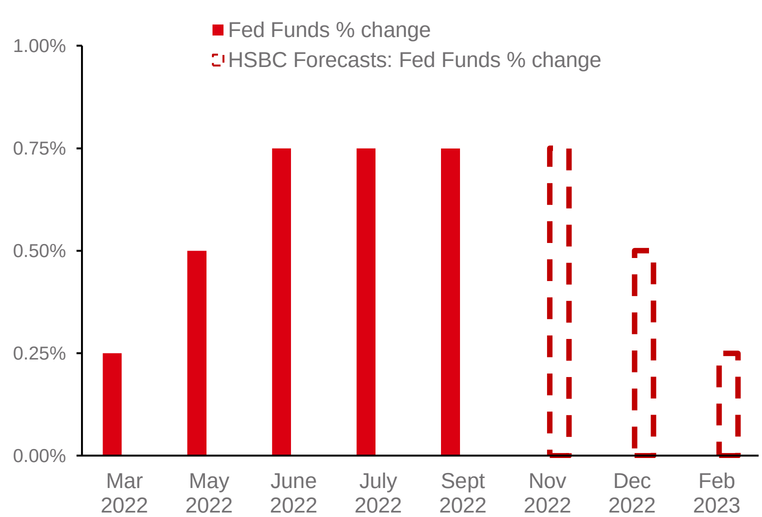
What happened?

- As expected, at its September meeting, the US Federal Reserve raised the federal funds rate 75bp to a range of 3.00 – 3.25%. This was the third consecutive 75bp hike in the policy rate by the FOMC, and Chairman Powell reiterated that policy would remain "sufficiently restrictive" to get inflation back to 2%. He also asserted that higher interest rates and unemployment are the price to be paid to restore balance in the goods and labour markets, as well as the broader economy. This hike in interest rates leaves policy rates at their highest level since 2008.
- The FOMC also issued its latest Summary of Economic Projections (SEP), which now forecasts policy rates at a higher terminal rate of 4.4% by year end, and 4.6% in 2023. The 4.4% dot is just two meetings away and comes very close to forward guidance. We now expect the Fed funds rate to rise by another 75bp in November (50bp previously), 50bp in December (25bp previously), and a final 25bp hike in February 2023. This would take the federal funds target range to 4.50-4.75% in February, 50bp higher than our previous forecast for a peak of 4.00-4.25%. In turn, the FOMC projects that those higher rates are likely to push the unemployment rate higher and keep economic growth below trend over the next two years.

The Fed continues to hike but is set to slow the pace of tightening moving forward



Source: Federal Reserve, Bloomberg, HSBC as at 21 September 2022.

Reading between the dots

- The September SEP showed significant changes from the June forecasts. The FOMC continues to project slower inflation in the next two years, but from a slightly faster initial pace. The Fed does not expect core inflation to approach 2% until 2024, when it drops to 2.3%. This provides two explanations: 1) why it needs to keep rates in restrictive territory for some time, and 2) why no rate cuts are foreseen in 2023.

- The Fed also forecasts that higher rates have a negative effect on economic growth. It now expects real GDP to edge up only 0.2% in 2022, which is down noticeably from the June projection of 1.7%. Economic growth is forecasted to significantly print below trend through 2024. Higher interest rates is also expected to impact labour markets, as the Fed forecasts the unemployment rate to climb to 4.4% in 2023 (up from 3.9% projected in June).

- While the Fed is not the only central bank tightening rates, it is doing so at an aggressive pace. In the six prior tightening cycles, the Fed raised policy rates at an average of 0.15% per month. In this business cycle, the Fed has been raising rates at an average monthly rate of 0.43% per month. Even if it raises rates by another 75bp in November, the Fed may rapidly approach the terminal rate for Fed funds. Moreover, the average monthly change in the funds rate should slow precipitously as the Fed gets more comfortable with slowing inflation and wage rates in the US economy.

Median of the FOMC economic projects, June 2022

Variable	Median (%)				
	2022	2023	2024	2025	Longer Run
Change in real GDP	0.2	1.2	1.7	1.8	1.8
June projection	1.7	1.7	1.9		1.8
Unemployment rate	3.8	4.4	4.4	4.3	4.0
June projection	3.7	3.9	4.1		4.0
PCE inflation	5.4	2.8	2.3	2.0	2.0
June projection	5.2	2.6	2.2		2.0
Core PCE inflation	4.5	3.1	2.3	2.1	
June projection	4.3	2.7	2.3		
Memo: Projected appropriate policy path					
Federal Funds rate	4.4	4.6	3.9	2.9	2.5
June projection	3.4	3.8	3.4		2.5

Source: Bloomberg, Federal Reserve, HSBC Global Private Banking as at 21 September 2022.

Restoring balance

- The Fed has a dual mandate to maintain steady inflation and a healthy unemployment rate. With the latter at 50-year lows, the Fed may be more aggressive in restoring price stability. Labour markets should remain healthy even if the unemployment rate were to rise to 4.4%. Slower wage gains could be a sign of more stable labour markets. In August, average hourly earnings rose 5.2% on a year-on-year basis. This is significantly down from a post-Covid peak of 8.0%, but remains far above wage gains of 2.5% in the prior business cycle.

- The Fed has often said it needs to lower inflation expectations. According to the University of Michigan Surveys of Consumers, both short-term and long-term inflation expectations have declined significantly. This is due to lower commodity prices, lower shipping costs, and a diminished demand for goods resulting in retail discounts.

- One area of historic inflation has been in the US housing markets. In the post-Covid economy, home prices have risen at the fastest pace ever. Given higher interest rates, home prices have peaked and begun to decline in many markets. Even rents are set to drop – historically, rental prices tend to fall along with the price of homes, but with about a six-month lag. This should help alleviate part of the budget squeeze for the US consumer as the price of housing and rentals should slow in the coming months.

Investment implications

- The upward move in the Fed's dot plot has pushed short-dated yields higher. Yet as the market has continued to move in advance of Fed policy, we do not feel there is a lot of upside to short-term rates. At the long end of the curve, decelerating inflation and risk aversion due to the rising risk of economic slowdown or outright recession in several markets, along with a strong US dollar, should keep Treasuries well bid. We continue to favour investment grade over high yield in an environment of slowing growth and market volatility, but bonds play a key role as a diversifier as the market attention turns more to a slowing cycle.

- The hawkish tone of the Fed should support USD, and we think it will continue to benefit from its relatively attractive yield, the relative resilience of the US economy and the volatile markets.
- For equity investors, the hawkish Fed meeting may continue to generate some rate related volatility, but we think the main focus will gradually shift to growth and earnings. It is interesting to note that the rate-sensitive Nasdaq performed roughly in line with the S&P yesterday, as the growth-vs-value trend is more linked to longer dated bond yields than the Fed funds rate itself. The Fed Chair has made it clear that “restoring price stability will likely result in maintaining a restrictive policy stance for some time” but that at some point “it will become appropriate to slow down pace of rate hikes”. As the Fed begins to slow the pace of tightening, much of the repricing of US equities in a slower growth scenario should be behind us.
- We maintain our overweight in US equities due to stability of earnings and healthy balance sheets in both the consumer and corporate sectors, compared to other markets. Quality companies should be favoured though, especially those that generate free cash flow and maintain low levels of debt. While several sectors may struggle with higher rates, there are sectors where pricing power remains. Chief among them are the food and energy sectors, where supply constraints persist and demand remains inelastic.
- In addition, we look toward total return strategies to help lift portfolio returns. At this point in the business cycle, dividend yield strategies have historically performed well in an environment where growth is being re-priced. As we begin the fourth quarter, third quarter earnings reports should factor in the emerging fundamentals highlighted above, providing a solid base for investors.

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