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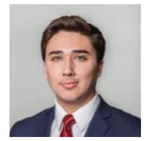
Special Coverage:
Smaller Fed hike sparks risk-on rally

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



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

Key takeaways

- The Federal Reserve slowed the pace of its tightening cycle again by raising the Fed funds rate by just 25 basis points to the 4.5-4.75% range, as expected. We believe that the Fed will hike once more in March, lifting the rate to 4.75-5% and then keep it there throughout 2023.
- The press conference was seen as somewhat dovish, on balanced. However, the Fed remains concerned about wages that are rising at almost double the rate of the prior business cycle. If labour markets remain tight, the concern is that the Fed may continue to lift policy rates slightly above 5% or (in our view, more likely) keep rates at 5% for an extended period of time. To a large extent, resilient labour markets are responsible for high service price inflation, which is an area where the Fed wants to see some disinflation too.
- The imminent end of rate hikes is clearly positive for fixed income and we maintain our overweight on investment grade and EM corporate bonds. While we adopt a short-to-medium duration for now, the opportunity to lock in somewhat longer rates might make sense very soon as we approach the peak in rates. For equities, progress is being made on the inflation front with still resilient growth and labour markets, while valuations look compelling. We maintain our overweight in the US and global neutral stance on equities. For the US dollar, the slowing rate hikes are a signal that the dollar rally is behind us, leaving the currency to underperform other developed currencies due to improving global risk appetite and bottoming economic growth expectations outside of the US.

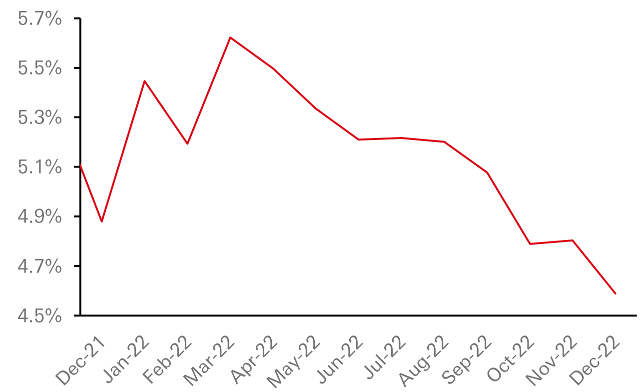
What happened?

- As expected, at its first meeting of the year, the Fed slowed the pace of its tightening cycle again by raising the Fed funds rate 25 basis points to the 4.5-4.75% range. This was a smaller hike than the 50 basis point increase at its December 2022 meeting. In its press release, the Fed stated that "ongoing increases in the target range will be appropriate" which demonstrates the FOMC's resolve to continue lifting rates to drive inflation toward its 2% symmetric target. The Fed attempted to strike a balance so that the smaller increase in policy rates was offset by policy statements that indicated the Fed's job is not yet finished. The Fed also mentioned several times that policy rates would remain elevated for a sustained period of time to ensure inflation approaches the 2% target rate.
- Despite repeated assertions that the Fed's "job is not done", the FOMC provided plenty of data points that suggest they may be nearing the end of the tightening cycle. In its press release, the FOMC stated that it "will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity, and inflation". Moreover, the committee reiterated that they would be highly data dependent, and would monitor economic and financial developments in determining the course and pace of future monetary policy.
- Equity markets rallied after the press conference, as despite certain hawkish statements, markets viewed the slower rate hikes as a signal that the Fed would not look to tighten financial conditions too much. Risk assets drove markets, led by technology, discretionary, and communication services shares. Fixed income markets rallied as well, as a potential Fed pause (a peak in policy rates) could signal the peak in market rates. While we remain focused on short to medium term duration assets, the peak in market rates could be a signal to extend duration in the near future. Longer duration assets could be more interesting if the disinflationary environment persists.

- In terms of the economy, Fed Chair Powell pointed out that recent data have shown signs of a slowing economy. That said, in its press release, the FOMC reiterated that it would "be prepared to adjust the stance of monetary policy as appropriate if risks emerge" that could impede its ability to deliver on its dual mandate of stable labour markets and inflation.
- The FOMC stated that the disinflationary process has started. Powell suggested that "this is the first time the Fed can say that", and "this is a good thing". In the press release, the FOMC stated that "inflation has eased somewhat, but remains elevated". Prices remain elevated due to "supply and demand imbalances, higher food and energy prices, and broader price pressures" in the global economy.
- The Fed remains concerned about wages that are rising at almost double the rate of the prior business cycle. In addition, Powell pointed out that he is concerned about the rise in job openings in the recent JOLTS data, which suggests that labour market tightness may persist. If labour markets remain tight, the concern is that the Fed may continue to lift policy rates to bring about a rise in the unemployment rate and slower wage gains. So far, however, Powell said "it is gratifying the disinflationary process is now getting underway and we continue to get strong labour market data".

Wage growth is still high but has been steadily declining

Average hourly earnings (AHE) Y-o-Y % change



Source: Bloomberg, Federal Reserve, HSBC Global Private Banking as at 1 February 2023.

- Powell repeatedly suggested that while the disinflationary process has begun, they are not seeing sufficient disinflation in the services sectors yet to say that they can pause the tightening cycle. The FOMC must maintain a position that seems more hawkish (to continue to raise rates), and to maintain a high level of interest rates for a prolonged period of time. If not, market participants could take this as a sign of the Fed acquiescing, and the potential beginning of a Fed pivot. This obviously would be premature, and it's not a signal the Fed wants to send at this point. We believe the Fed will raise rates another 25 basis points at its March meeting and then pause. In an effort to continue to drive inflation lower, we believe the Fed will keep policy rates at this level for a sustained period of time. In analysing the risks of over-tightening, or not tightening enough, Powell indicated that the risk of doing too little is greater than going too far. "We have tools that would work if the Fed ended up over shooting" he says.

Investment Summary

- For fixed income, we maintain a short-to-medium duration, but given that the peak in rates seems near, locking in higher long rates might make sense very soon. In addition, given the weakness in economic activity this year, we focus on investment grade fixed income products, across both developed and emerging markets.
- For equities, the potential end of the Fed tightening cycle could be welcome news. US equity valuations are full, but peaking rates and any decline in real rates could help support valuations around current levels. Due to the economic slowdown and disinflation, we look for earnings downgrades to continue, but are somewhat comforted by the fall in earnings revisions to date (Bloomberg suggests consensus earnings growth for 2023 is now close to zero). Once earnings expectations better align with economic reality, we would increase our overweight position in US stocks in the future. For now, we continue to see better opportunities elsewhere, especially in mainland China, ASEAN and Hong Kong.
- For the US dollar, the possible Fed pause is a signal that the US dollar rally is behind us, leaving the currency to underperform other developed currencies. In Europe, tighter monetary policies and improved optimism on growth in the region should result in appreciating currencies.

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