Investment Event

20 December 2018
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The Fed signals slower pace of hikes

At the December meeting, the Federal Reserve (Fed) raised the fed funds target range by 25bp to 2.25-2.50%

The Fed made minor adjustments to its macro projections, slightly reducing its forecasts for 2019 growth and inflation

Given its economic and inflation outlook, the Fed expects to continue normalising monetary policy, but at a slower pace

We do not change our asset class view as a result of this Fed meeting. There remains scope for US rates to move higher in 2019

HSBC

The Federal Reserve raised rates by 25bp to 2.25-2.50%

As widely expected, the Fed raised the target range for the funds rate by 25bp to 2.25 2.50% at its December meeting, despite the recent volatility in markets. Its balance sheet policy was left unchanged. Since October, the Fed has been reducing its holdings of Treasuries by USD 30bn per month and agency securities by USD 20bn per month, in line with their respective caps.

More dovish projections

While currently the economy continues to grow well above its trend pace, the latest Summary of Economic Projections show a modest downward revision to the 2019 GDP growth forecast. The Fed now expects a figure of 2.3% vs. 2.5% in September. The 2019-21 core PCE inflation forecasts have also been trimmed; the Fed expects a 2.0% reading in each of these years, down from 2.1% in its previous projections. The unemployment rate forecast was left at 3.5% in 2019, but nudged up by 0.1pp in 2020 and 2021 to 3.6 and 3.8% respectively.

Table 1: FOMC median economic projections

	2018	2019	2020	2021	Longer run
GDP (% yoy)	3.0	2.3	2.0	1.8	1.9
September	*3.1*	*2.5*	*2.0*	*1.8*	*1.8*
Unemployment rate (%)	3.7	3.5	3.6	3.8	4.4
September	*3.7*	*3.5*	*3.5*	*3.7*	*4.5*
Core PCE (% yoy)	1.9	2.0	2.0	2.0	-
September	2.0	2.1	2.1	2.1	-
Fed funds rate (%)	2.4	2.9	3.1	3.1	2.8
September	*2.4*	*3.1*	*3.4*	*3.4*	*3.0*

Consistent with the modest changes to the 2019 growth and inflation forecasts, the median projection of interest rates (or “dot plot”) was also adjusted marginally lower. In its previous set of forecasts, the FOMC had expected the funds rate to end 2019 at 3.1%. This was revised down in the December projections to 2.9% - this means the Fed’s central case is for only two 25bp rate hikes in 2019, indicating a slower pace of rate rises than seen in 2017 and 2018. The median funds rate for 2020 and 2021 was also revised down to 3.1% from 3.4% previously.

Fed is data dependent and alert to the risks

The Fed made two important changes to its statement in December. First, the Committee now “judges that some further gradual increases” in the funds rate will be needed. This seems less committal than its line from the September statement, namely that it “expects that further gradual increases” will be needed. Second, the Committee now “judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook”. Previously, the statement had simply said “Risks to the economic outlook appear roughly balanced”. The change suggests the Fed is now more alert to the potential for headwinds emanating from the global economy and markets.

In the press conference, Fed Chair Jerome Powell also emphasised the data dependence of the path for policy and that there is a high degree of uncertainty about the end point for policy.

Market considerations

We do not alter our asset class view as a result of this monetary policy decision. Ahead of the Fed’s meeting, the market was pricing in only one 25bp rate hike in 2019 and some probability of a rate cut in 2020. Hence, if the Fed is correct in its analysis of the economic outlook, there is scope for market rate expectations to retrace higher.

Such a scenario would likely weigh on US fixed income assets, albeit more so at longer maturities. The potential for higher rates represents a headwind to US equities, offsetting the positive effect of continued strong profitability. We therefore remain neutral on this asset class.

While many in the market are focused currently on downside growth risks, stronger-than-expected medium-term US inflation remains an important risk to monitor. Even as growth slows in 2019, inflation pressures are likely to build gradually later in the year and into 2020, given the tight labour market.

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