05/05/2022

Special Coverage:

Nimble & Humble Fed lifts rates and risk sentiment

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Key takeaways

- As expected, the FOMC raised rates by 50bps lifting the Fed funds rate to the 0.75%-1.00% range. We believe there will be a further hike of 50bps in June, followed by four 25bps hikes in the second half of the year, and two in 2023.
- From June to August, reductions in Treasury and mortgage backed security holdings will be capped to $30 billion per month and $17.5 billion respectively. Thereafter, the caps move to $60 billion and $30 billion.
- The FOMC believes there is "a path" to achieve a soft landing. We stay invested with a focus on quality companies that produce cash flow and can protect margins. In fixed income, we keep duration short to medium, and look towards corporate credit in DMs and EMs for a yield pickup.

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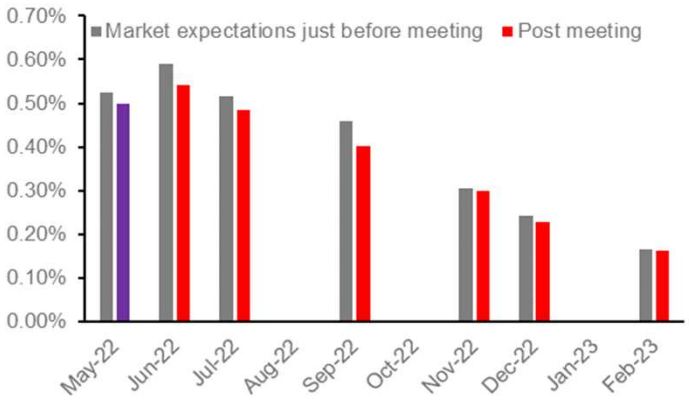
What happened?

- At its May meeting, the Federal Reserve raised policy rates by 50bps, which is the largest single hike in the Fed funds rate since 2000. The FOMC also outlined its plan to reduce the size of the Fed's balance sheet. This is all designed to slow the rate of inflation which is eroding real wages and real returns from financial markets.
- We believe the FOMC will raise Fed funds by 50bps at the June meeting followed by four 25 basis point hikes in the second half of the year. This would put the Fed funds rate in the 2.25-2.50% range by year-end 2022. We foresee two more rate hikes thereafter, in 2023. **Following the Fed's comments that it is not actively considering 75bp hikes, the markets slightly lowered their rate hike assumptions for future meetings.**
- From 1 June, the FOMC plans to reduce Treasury securities by $30 billion per month and mortgage backed securities by $17.5 billion per month. This will last for three months. After that the caps will be raised to reduce the balance sheet by $60 billion per month for Treasuries and $30 billion for mortgage backed securities per month.
- The FOMC believes **there is "a path" to achieve a soft landing, without triggering a US recession.** Fed Chairman Jerome Powell concluded that the Fed must slow demand and remove some of the excess liquidity to reduce inflation.

Markets slightly reduced the hikes they expect to see in future Fed meetings



Source: Bloomberg, HSBC Global Private Banking as at 5 May 2022

- US equity market investors had been concerned that the Fed might raise interest rates more aggressively in an effort to battle inflation. Some of these concerns may have been eased by the comments that 75bp were not actively considered, but some may linger.
- Historically, there have been six major Fed tightening cycles since 1982. In three of those cycles, the Fed pushed the economy into recession, but, on average, it took 36 months for recession to ensue. In the other three cycles, the Fed created a mid-cycle slowdown which led to slower growth but did not lead directly to recession. In fact, in those three mid-cycle slowdowns, a recession took more than six years to arrive.

The economy, demand destruction, and inflation

- The FOMC referred to the Covid-related lockdowns in China as a potential source of economic weakness but also a potential cause of further manufacturing slowdowns and supply chain constraints. This alone could help keep inflation higher than hoped. In addition, it also mentioned how the Russia-Ukraine war could be "creating additional upward pressure on inflation" and is "likely to weigh on economic conditions".
- On a positive note, US GDP was negative in the first quarter but should bounce back in the second quarter as inventories and exports rebound. Significantly, the US economy is expected to reopen after the latest wave of Covid this past winter which should keep demand steady. In China, the hope is that the re-opening of the economy and the manufacturing sector, combined with increased government stimulus should boost growth in the second half of the year. This confluence of events should prevent a global or US recession and keep demand healthy.
- US services consumption is accelerating and with the latest re-opening of the economy is expected to exceed goods consumption for the first time since the onset of the Covid recession. The pent-up demand for long sought-after services such as travel, entertainment, airlines, rental cars, cruises, and hotels is expected to lift consumer spending, economic growth, and profitability in certain long forgotten sectors of the US markets.
- Despite recent dis-savings, the US consumer is still sitting on more than $1.2 trillion of savings while job creation remains strong, the unemployment rate is drifting lower, wages keep rising, and the participation rate is finally rising. Balance sheets in both the household and corporate sectors look healthy and cash levels remain high. The labour markets remain strong with more than 1.2 million jobs created in the first quarter and the unemployment rate near a 50-year low of 3.6%.

Investment Summary

- The Fed sent a clear signal to financial market participants that it chose to move in a more measured fashion given all the uncertainty in the world today but remains firmly on course. Investors should remember that real monetary policy is still quite accommodative. Even if the Fed were to raise the Fed funds rate to 2.5% by year end, they would still be well below a "neutral" policy rate unless inflation were to slow dramatically back to its pre-Covid 2% symmetric goal.
- We suggest investors **focus on quality companies that produce cash, have low debt service, and can protect margins**. The re-opening of the US economy provides relative value opportunities as the services sector improves materially. Many long ignored companies, with attractive valuations, should begin to gain notice. In this inflationary environment, food, energy, and materials companies should benefit from the current global supply disruptions. Despite higher rates, the companies in those commodity producing sectors should benefit from improving demand and elevated prices.
- Fixed income investors **should keep duration short to medium term, and look towards the high yield and EM credit markets for better yields.** We find attractive income generation opportunities in short-dated high yield, EM hard currency bonds and dividend stocks and exploit high volatility levels to generate income. The more aggressive Fed policy relative to other major central banks suggests perhaps a modest further upward glide for the US dollar.

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