March 17, /2022

Special Coverage:

Policy rate normalisation has begun

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Key takeaways

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- As expected from their March meeting, the Federal Open Market Committee (FOMC) raised the Federal funds rate by 0.25%, to the 0.25-0.5% range.
- The FOMC projects that the Fed funds rate could reach 2.75% by the end of 2023, well above market expectations of 2.0%. We have revised our previous expectations with total rate hikes now forecasted at +1.75% in 2022 and +0.75% in 2023.
- Markets have been fearful that inflation was potentially becoming a longer-term issue. The Fed's action suppressed this concern and good for risk appetite. Equities, and the financial sector in particular, should benefit.
- We advocate investors to remain invested in well-diversified and resilient portfolios, focused on quality assets and companies with strong margin power. We also prefer short-duration bonds as the yield curve is now even flatter.

What happened?

- At its March meeting, the Federal Reserve began the process of normalisation of policy rates. As expected, the FOMC raised the Fed funds rate by 0.25% to the 0.25-0.5% range. They have also made it clear that they would raise rates at a steady clip: most probably by 25 basis points during each of the remaining six meetings in 2022. Chairman Jerome Powell indicated that "if it is appropriate to move more quickly, we will do so". The Fed would be prepared to move on policy action for quantitative tightening (reduction of the Fed's balance sheet), yet gave no indication on timing or how the policy would be enacted.
- While the Fed cites that the economy continues to "strengthen and that job gains have been strong in recent months", they also indicated that "inflation remains elevated reflecting supply and demand imbalances related to the pandemic". The fact that the Fed acknowledged inflation as a longer-term issue has been a long time in coming. To illustrate this, the Fed raised its outlook on inflation to 4.3% in 2022 (up from its December forecast of 2.6%). In 2023, the Fed expects inflation to fall to 2.7% as an annual average.
- The FOMC believes it should normalise as higher rates and increased supply create a new supply/demand balance. They have clearly established that price stability remains a key objective, which can be achieved by getting inflation back towards a symmetric 2% target rate.

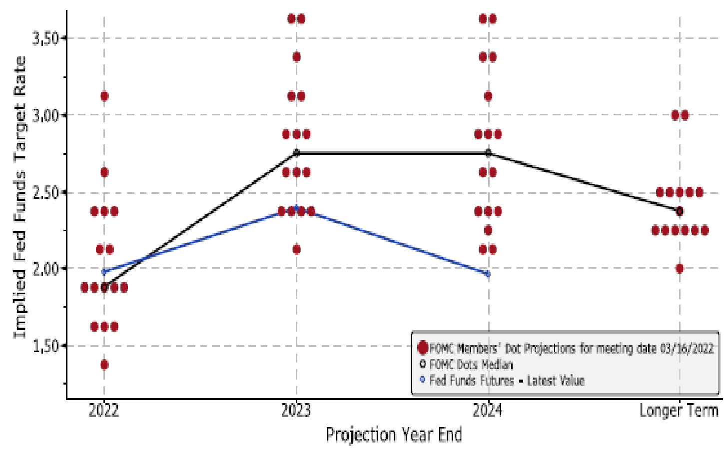
Median of the FOMC projections, March 2022

Variable (%)	Median			
	2022	2023	2024	Longer run
Change in real GDP	2.8	2.2	2.0	1.8
December projection	4.0	2.2	2.0	1.8
Unemployment rate	3.5	3.5	3.6	4.0
December projection	3.5	3.5	3.5	4.0
PCE inflation	4.3	2.7	2.3	2.0
December projection	2.6	2.3	2.1	2.0
Core PCE inflation	4.1	2.6	2.3	
December projection	2.7	2.3	2.1	
Memo: Projected appropriate policy path				
Federal funds rate	1.9	2.8	2.8	2.4
December projection	0.3	1.6	2.1	2.5

Source: Bloomberg, Federal Reserve, HSBC Global Private Banking as at 16 March 2022.

- The Fed maintains the economy is strong with more than one million jobs created in the last three months, coupled with a 3.8% unemployment rate (a post-pandemic low). However, the Fed reduced its growth rate of the economy in 2022 from 4.0% to 2.8%, reflecting on the European conflict and effects of higher global food and energy prices on growth. While Covid-19 did negatively affect growth in the US during the first quarter, the underlying demand seems healthy enough to ensure that this will rebound.
- In terms of the median expectations for the Fed funds rate, the FOMC's summary of economic projections gives an interesting perspective. In 2022, the FOMC board members project that the Fed funds rate could approach 2.0%. In 2023, the FOMC projects that Fed funds could reach 2.8% as a median value for the year. To quell fears that the Fed may continue to raise rates, the FOMC indicated that the longer-term Fed funds rate should be near what has long been considered the neutral rate of 2.5%.
- Many investors believed that the Fed was way "behind the curve" in terms of its tightening process. With the recent rate hike and projections for the next two years, the Fed took a major step forward to reclaim credibility as an inflation-fighting central bank. Powell and the FOMC have made it clear that this is not the Volcker Fed. In the early 1980s, Chairman Paul Volcker raised rates so aggressively that he was willing to push the US economy into two recessions to accomplish his goal of price stability. While price stability remains a central goal, the current Fed will not sacrifice labour market strength or push the US into recession to accomplish that.

Implied Fed fund target rate



Source: Bloomberg, Federal Reserve, HSBC Global Private Banking as at 16 March 2022.

Market consideration

- High inflation and geopolitical conflicts are hurting risk appetite, but fundamentals still remain broadly supportive for the medium term. We advocate investors to not overreact as historically, markets have often rebounded after a short sharp sell-off. However, stubbornly high inflation and increased uncertainty due to geopolitical strife have accelerated the pace of interest rate normalisation. As a result, we recommend to focus on quality companies that produce cash, have low debt service, and can protect margins.
- For US equity investors, the economic re-opening provides relative value opportunities as the services sector improves materially. In this environment, food and energy companies should benefit from the current global supply disruptions, while investment in renewable energy is also picking up globally. Despite higher rates, the energy and housing sectors should benefit from improving demand and perhaps higher prices. Financial companies may not see a steep yield curve, but the strength in the economy, housing, and M&A activity should benefit the sector. Value investors may also look to equity markets in ASEAN and Europe ex UK where value opportunities remain quite attractive.
- In fixed income, we keep duration short to medium term, as the yield curve is very flat, and we look towards the high yield and emerging market credit markets. 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.
- In terms of the US dollar, the more aggressive Fed policy relative to other major central banks suggests perhaps a modest upward glide for the currency.
- Volatility should remain elevated, which needs to be managed in portfolios. As for gold, the higher real yields are a potential headwind, but we think that the global risk environment, set by the growth and geopolitical outlook, will be the principal driver of gold's direction and keep some for diversification purposes.

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