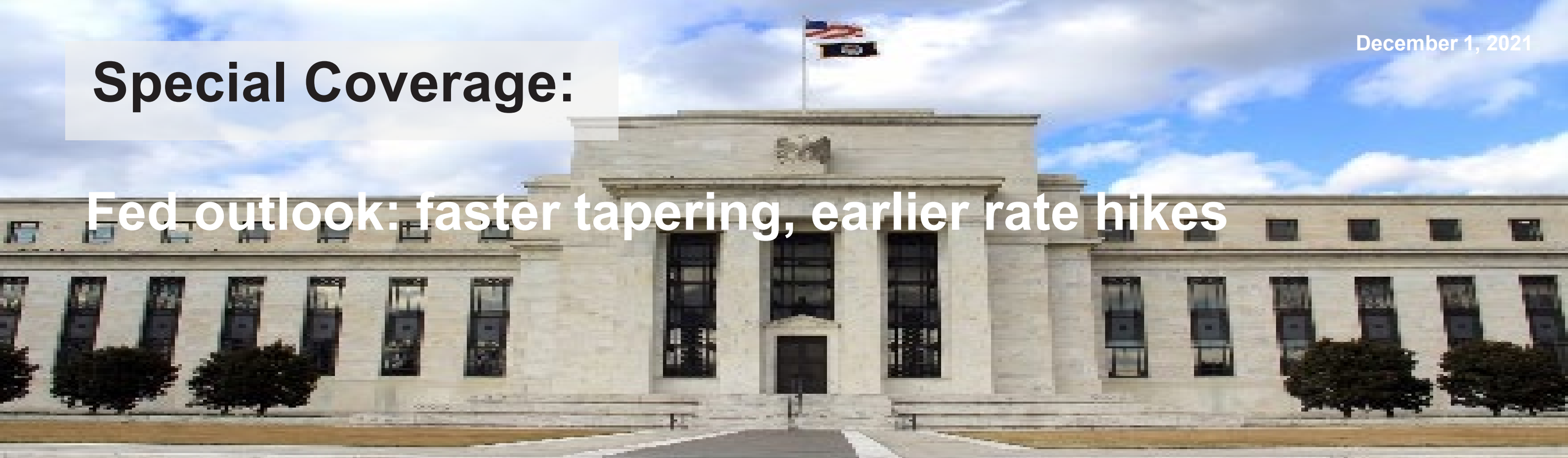

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December 1, 2021

Special Coverage:

Fed outlook: faster tapering, earlier rate hikes

Key takeaways

- We have changed our view on the Fed's likely policy path. More Fed members have been taking a hawkish tone on recent higher-than-expected inflation readings. Improved labour market means that the Fed is getting closer to the second aspect of its mandate – full employment.
- We expect the tapering of bond purchases to go faster, which also allows earlier rate hikes. We believe the Fed will hike policy rates by 0.25% in June 2022, September 2022, March 2023 and September 2023.
- Even with the interest rates we expect, policy rates will still be well below the rate of inflation. Cash remains unattractive, and in the mid-cycle stage, we think there are many reasons to remain invested.

Willem Sels
Global Chief Investment Officer, Global Private Banking and Wealth, HSBC

What are the key things to note?

- The Fed has a dual mandate of price stability and maximum sustainable employment, and in their recent policy discussions, they stated that they would keep Fed funds unchanged until 1) inflation has risen to 2% and is on track to exceed 2% for some time, and 2) labour market conditions have reached levels consistent with its assessment of maximum employment.
- The first condition for rate hikes has clearly been fulfilled (and exceeded) for some time. But unemployment has so far remained too high to satisfy the second condition. This may soon change and allow the Fed to take a more hawkish tone, as we have already seen from several Fed members' speeches. The strong labour market figures last month, and the strong expectations for non-farm payrolls later this week (550k) suggest a change in policy could be imminent. In September, the committee was evenly split on the whether rate hikes are appropriate before December 2022, and given recent labour and CPI data, we think the balance will now be tilted in favour of rate hikes starting in 2022.
- As a first step, we think the Fed will start to double the pace of its tapering from December (from 15bn to 30bn per month), which would mean bond purchases would end in March 22. That should allow them to start hiking interest rates in June 2022. In the course of H1, they may also start to discuss shrinking the balance sheet and they could start actively selling bonds by the end of 2022.
- We note that the market has already priced in 2 hikes in 2022, and our 2023 assumptions are also close to the market's expectations. Hence, we do not change our investment strategy, but think volatility will help quality stocks, the US dollar and hedge funds.
- Markets continue to focus on the outlook for inflation and central banks' interest rate policy. We already knew that the Fed had started a policy transition by initiating its tapering programme, but the speed of it, and the timing of interest rate hikes remain uncertain. The recent data however point to faster tapering, which allows for earlier rate hikes as well.

- The uncertainty around the Omicron variant presents a risk around the Fed's growth forecast, and there is a possibility that central banks take a wait-and-see attitude until more data are available. This clarity should come in a few weeks, however, and hence should not impact the June date for the first expected rate hike.

What does it mean for investors?

Fed funds futures have already priced in two rate hikes in 2022, and our 2023 expectations are close to the market's, so we do not think there would be a big market impact if the Fed indeed follows our view. Markets have been flip-flopping recently between growth and inflation concerns, and we think this will remain the environment to deal with. It implies more market volatility, which we manage by building resilient portfolios:

- For bonds, we maintain our 'low but volatile' yield outlook. As the rate hikes are priced in, we do not expect material upward pressure on the US Treasury yield. But we keep duration manageable to weather the volatility. We **overweight high yield and EM hard currency bonds**, but of course are selective as higher interest costs could impact corporate cash flows (though the rate hikes are still mild).

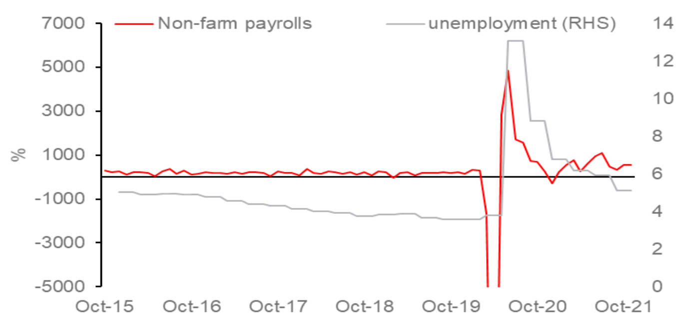
- For equities, we think **the rate hikes support our quality strategy**, as companies will need to stomach high inflation, somewhat slower growth, higher taxes and higher rates. Companies with strong market positions should be able to weather them, and we do not think the rate hikes will change the equity market direction.

- We continue to **balance growth and value stocks**. Rate hikes can sometimes favour value, but as we do not expect any drift in the US Treasury yield, we remain comfortable with growth stocks. Financials should benefit from the rate hikes, although they tend to be more correlated to the steepness of the curve and longer dated bond yields, which we do not expect to move much (we do see them as a good natural hedge against higher bond yields, though). As for consumer stocks, we think the positive evolution in the labour market which is the cause of the Fed's optimism, is more important than the gradual increase in the cost of consumer loans.

- **The US dollar should continue to see mild upside**. Even though the rate hikes are already expected, we think the dollar will benefit from the rate differential vs most other major currencies. Within EM FX, CNY should remain relatively resilient.

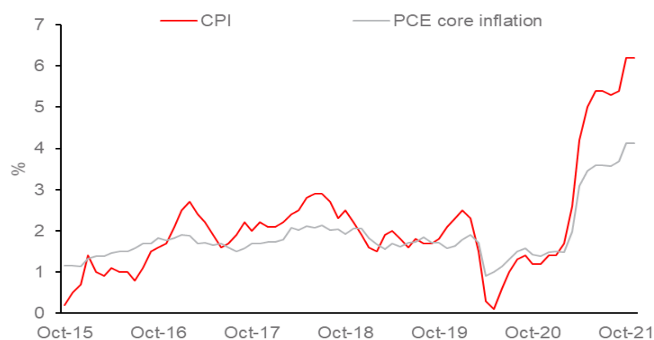
- **Hedge funds should continue to benefit from volatility** and changing views on rate hikes in different countries, the impact on currency movements and sector rotation. We think hedge funds have a rich opportunity set and are important diversifiers in this volatile market environment.

Chart 1:Although unemployment remains high, the Fed seems to be comforted by the better than expected recent labour market figures



Source: Bloomberg, HSBC Global Private Banking as at 30 November 2021. Note: in April 2020, non-farm payrolls fell to -20.7 million. We have cut off the Y-axis at -5 million to make the graph for legible.

Chart 2: We expect core PCE to peak at 4.5% in Q1 before gradually easing



Source: Bloomberg, HSBC Global Private Banking as at 30 November 2021.

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