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Special Coverage:
Fed begins to pivot to discuss rate cuts

Key takeaways

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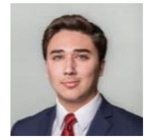

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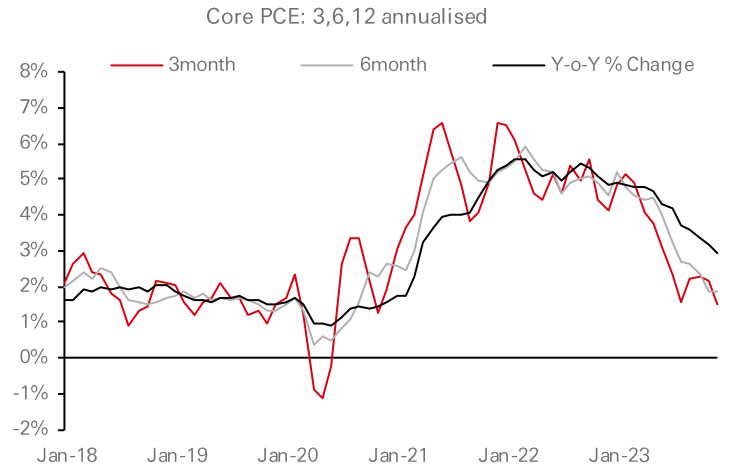
- As expected, the Fed left rates unchanged at 5.25-5.5% for a fourth straight meeting.The press statement from the FOMC reined in expectations for a March rate cut and Powell further explained that he thinks a cut at the next meeting is unlikely, as Fed officials really want to see a continuation of the good inflation data they've seen lately.
- We still believe that the FOMC will begin to cut policy rates in the second quarter of this year, starting June, and will do so three times, lowering the Fed funds rate by 0.75% before year-end.
- We remain bullish on Treasuries and maintain medium-to-long duration. In the credit markets, we prefer investment grade with a focus on quality. For equity investors, the recent rally may face a few short-term headwinds, but the long-term fundamentals remain quite supportive. We continue to believe that the prospects of lower market and policy rates this year, a much-improved earnings outlook through 2025, and the tailwinds of several secular themes should support better US equity market valuations in 2024. We believe USD will be supported during a Fed easing cycle, amid a slowing global economy.

What happened?

- As expected, the Fed left rates unchanged at 5.25-5.5% for a fourth straight meeting. We still believe that the FOMC will begin to cut policy rates in the second quarter of this year, starting June, and will do so three times, lowering the Fed funds rate by 0.75% before year end. Next year, our outlook is for another 0.75% of policy rate cuts, leaving the Fed funds rate in the 3.75-4% range by year-end 2025.
- The FOMC removed a line from their statement that referenced "additional policy firming" but included a new sentence saying it won't be appropriate to cut rates until the committee has "gained greater confidence that inflation is moving sustainably toward 2%." It's important to note that the US Core PCE has slowed to a 1.5% annualised rate over the last three months and 1.9% annualised over the last six months.
- The press statement from the FOMC reined in expectations for a March rate cut. Powell further explained in the press conference that he thinks a cut at the next meeting is unlikely, as Fed officials really want to see a continuation of the good inflation data they've seen lately. He did say that good news on that front could move up the time frame, keeping the door to a March cut slightly ajar. Powell sounded a cautious tone on the pace of rate cuts. He noted that the decision to start cutting rates would be highly consequential and pointed to past surprising turns in economic data.
- Policymakers signalled they're not yet ready to cut interest rates as soon as the next meeting in March, saying that a move likely won't be appropriate until they gain more confidence that "inflation is moving sustainably toward 2%." No proposal to cut rates at this meeting, but the Fed did signal that they would look at all options going forward. The FOMC Chair said policymakers began discussing when to start slowing the pace of their balance sheet runoff, or quantitative tightening, at this meeting but plan to have a more robust conversation about it in March.

- In the wake of fourth-quarter GDP rising more than forecast, the Fed characterised economic growth as "solid" and said job gains "remain strong". In terms of inflation, the Fed stated that inflation has eased over the past year but remained elevated (still above the 2% symmetric target).
- The Fed omitted language that had been included in statement in some form since March 2023, calling the banking system "sound and resilient," and warning that tighter credit conditions were likely to weigh on the economy.
- Powell reiterated that they want to see more data. In the base case, the economy is performing well, and the labour market remains strong. If they see a weakening in the labour market, that would affect their decision to cut rates sooner, he added.
- The Fed Chairman also noted that the disparity in views on the FOMC is clear from public remarks made by numerous policymakers. "There's a wide disparity, a healthy disparity of views," Powell says of the committee.

Three-month and six-month annualised pace of core inflation is below the Fed's 2% inflation target



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 31 January 2024.

- Markets reacted to the meeting by further reducing the chances of a March rate cut, which supported the USD but weighed somewhat on equities overnight. The impact on bond markets was muted thanks to the quarterly funding announcement by the US Treasury, which said it does not see the need to increase bond auction sizes, thereby reducing supply concerns.

Investment implications

- The Fed has been on hold since July and made it fairly clear that it is done tightening, unless inflation reignites. This seems unlikely as the US economy is slowing and disinflation continues. The FOMC yet again made its intentions clear by announcing it is beginning to discuss lowering policy rates. Given the progress the Fed has seen in core inflation and the continued disinflation still underway, it should provide ample room to ease.
- For fixed income investors, we remain bullish on Treasuries and maintain medium-to-long duration. In the credit markets, we continue to like investment grade with a focus on quality. For equity investors, the recent rally may face a few short-term headwinds, but the long-term fundamentals remain quite supportive. We continue to believe that the prospects of lower market and policy rates this year, a much-improved earnings outlook through 2025, and the tailwinds of several secular themes should provide the impetus for better US equity market valuations in 2024.
- Financial markets are expecting interest rate cuts in 2024, with investors pricing in the probability that rates should be lower than their current level. Historically, lower market and policy rates have been accretive to earnings. As a result, that development should be bullish for stocks, especially considering that rate hikes weighed the S&P 500 down heavily in 2022. In the US, a pause from the Fed, combined with continued disinflation and an improving earnings outlook, could be a real positive boost to equity fundamentals.
- As regards to the US dollar, we believe USD will be supported during a Fed easing cycle, amid a slowing global economy. Recession risks still loom, while other central banks may also be easing, and where the safe-haven USD will continue to offer a relatively high yield.

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