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Investment Event

Fed hiking cycle underway

At the March meeting, the Fed raised the federal funds target range by 25bp to 0.25-0.50%

Chair Powell also signalled the Fed could start reducing the size of its balance sheet as soon as the May meeting

The median expectation of FOMC members is now for seven hikes in 2022 and for the federal funds rate to reach close to 3.00% by end-2023

First step on policy normalisation path

At its March meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) raised the target range for the federal funds rate by 25bp to 0.25-0.50%, as widely expected. The FOMC also noted that it “anticipates that ongoing increases in the target range will be appropriate”.

In terms of its balance sheet policy, the Committee added that it “expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting”. In his press conference, Chair Powell went further and said the FOMC had made “excellent progress” in its discussions on this issue and the plan for the balance sheet could be announced as soon as May, although that decision had not yet been taken.

Slower growth, more persistent inflation, higher rates

The FOMC made material revisions to its economic projections at the March meeting, which now show slower growth, higher inflation and a quicker pace of policy normalisation in 2022. The Committee now judges it is likely it will need to raise the funds rate by a total of 175bp this year, well above the 75bp of rate hikes it had suggested would be appropriate in its last set of projections. The revised projections also point to a further 75-100bp of tightening during 2023, taking the funds rate to nearly 3.00%, around 75bp higher than the peak previously envisaged by the Committee.

The ’dot plot’ of individual FOMC member’s rate expectations show six of the 16 members believe it is likely the funds rate will need to rise at a faster pace in 2022 than indicated in the median forecast, while only four see a slower pace of tightening as likely.

Table 1: FOMC median economic projections

	2022	2023	2024	Longer run
GDP (% yoy) *Dec 2021 Fed projection*	**2.8** 4.0	**2.2** 2.2	**2.0** 2.0	**1.8** 1.8
Unemployment rate (%) *Dec 2021 Fed projection*	**3.5** 3.5	**3.5** 3.5	**3.6** 3.5	**4.0** 4.0
Core PCE inflation (%) *Dec 2021 Fed projection*	**4.1** 2.7	**2.6** 2.3	**2.3** 2.1	**2.0** 2.0*
Fed funds rate (%) *Dec 2021 Fed projection*	**1.9** 0.9	**2.8** 1.6	**2.8** 2.1	**2.4** 2.5

*Source: US Federal Reserve, figures refer to Q4 * Longer run figure is headline PCE inflation rather than core PCE*

The driving force for the change in the policy outlook is higher-for-longer inflation than the Fed had been expecting, rather than reflecting a stronger growth outlook. Indeed, Chair Powell noted the "committee is acutely aware of the need to return economy to price stability" given it now expects core PCE inflation to remain above 4% throughout 2022 and does not see it returning to the 2% target until beyond 2024.

The upward revision to inflation and downward revision to growth both reflect continued supply-chain difficulties and higher commodity prices.

Investment implications

Despite the market having been expecting the seven rate hikes in 2022 that the Fed has now signalled it will deliver, the 2-year US treasury yield rose by c.10bp immediately after the announcement while the 10-year yield rose by c.5bp. This flattening of the Treasury curve reflected some surprise in the market at the degree of further tightening the Fed expects to deliver in 2023.

The potential for a meaningful degree of policy tightening, combined with concerns regarding the situation in Ukraine, suggests 2022 is likely to be a year of ’hard yards‘ for markets. In our view, volatility is likely to remain elevated.

Against this backdrop, we think a defensive allocation is appropriate, which means a selective approach, rather than reducing equity exposures. This means taking exposure to the ’value‘ factor, which includes sectors that can perform well in the current environment (e.g. natural resources, financials). We also think the ’quality‘ factor has scope to perform well given exposure to companies with stronger corporate balance sheets and pricing power that protects margins from higher input costs.

Our views

We think a defensive allocation is appropriate against a backdrop of policy normalisation, which means a selective approach rather than reducing equity exposures

HSBC Asset Management

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