CIO Office

Market Update

Fed outlook: faster tapering, earlier rate hikes

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Contributor

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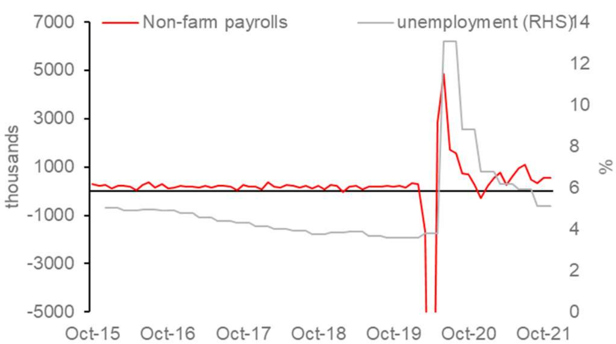
We have changed our view on the Fed's likely policy path. As recent inflation readings have been higher than expected, more Fed members have been taking a hawkish tone. And improvement in the labour market means that the Fed is getting closer to the second aspect of its mandate – full employment. So 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. We discuss the market implications, but note that the market already prices in at least as many rate hikes.

- 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 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 already prices 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 be extremely focused on the outlook for inflation and central banks' interest rate policy, with the Fed obviously being the main point of interest. 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. We think the recent data however point to faster tapering, which allows for earlier rate hikes as well. Chairman Powell's testimony to the Senate Banking Committee on 30 November could give us more insight.

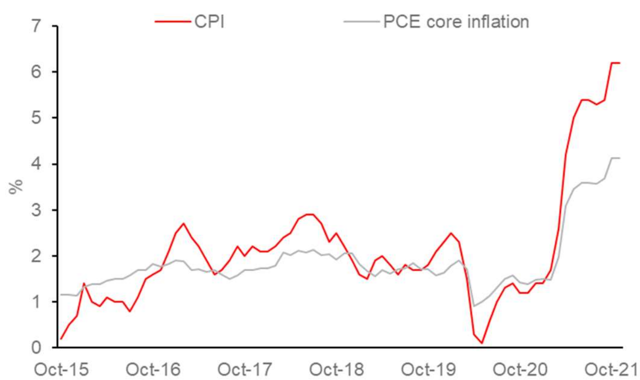
The uncertainty around the Omicron variant, of course, presents a risk around the Fed's growth forecast, and there is a possibility that central banks take a wait-and-see attitude until more data are available. This clarity should probably come in a few weeks, however, and hence should not impact the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

Although unemployment still 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 more legible.

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.

What does it mean for investors?

Because Fed funds futures already price in two rate hikes in 2022, and our 2023 expectations are also close to the market's, 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 we will need to deal with. It implies more market volatility, which we manage by building resilient portfolios:

- 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.
- 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 add support for 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, though, 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 also 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.
- We note that even with the interest rates we expect, policy rates will still be well below the rate of inflation. Cash thus remains unattractive, and in the mid-cycle stage, we think there are many reasons to remain invested.

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:
• Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
• Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
• Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
• Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
• Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
• Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalization risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate.
Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Risk disclosure on Dim Sum Bonds
Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.
Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond. There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.
Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets
Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin
The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies
When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks
There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY

products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.
There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products
In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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