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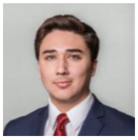
Key takeaways

- As expected, the FOMC voted to keep the Federal funds target range at 5.25-5.5% at its December meeting. In 2024, the Fed is forecasting a series of three quarter-point rate cuts. That is followed by further declines in the Fed funds rate, putting the average Fed funds rate at 3.6% in 2025.
- Our view has also shifted. We now expect a cumulative 0.75% in cuts in 2024 and an additional 0.75% in cuts in 2025, which is 0.25% more than the previous forecast. Our revised projection is for rate cuts to start in Q2 (vs. Q3 previously) and for federal funds target range of 3.75-4% at the end of 2025, down from our prior forecast of a 4-4.25% range.

Jose Rasco
Chief Investment Officer, Americas, HSBC Global Private Banking and Wealth



Michael Zervos
Investment Strategy Analyst, HSBC Global Private Banking and Wealth

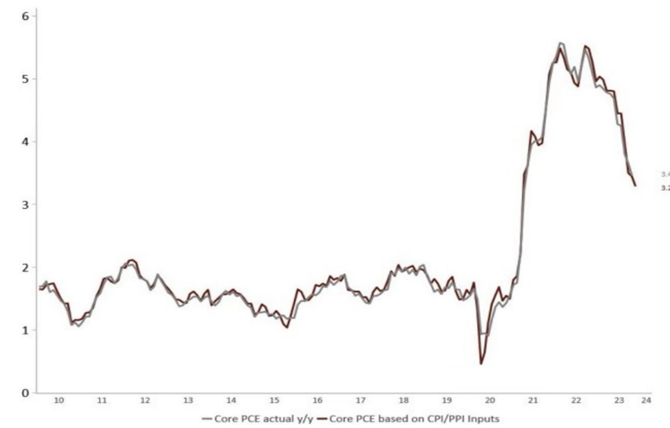
- For equity investors, the recent rally may face a few short-term headwinds in early 2024, but the fundamentals remain quite supportive. We continue to believe that the prospects of lower market and policy rates next year, a much-improved earnings outlook through 2025, and the tailwinds of several secular themes should provide the impetus for better US equity market valuations in 2024. For fixed income investors, we remain bullish on Treasuries with a medium-to-long duration stance. We also favor investment grade with a focus on quality. We believe the US dollar will be supported during a Fed easing cycle amid a slowing global economy.

What happened?

- As expected, at its December meeting, the FOMC voted to keep the Federal funds target range at 5.25-5.5%. Significantly, the FOMC gave its clearest signal that its most aggressive rate hiking campaign ever is finished by taking out the December rate hike planned in September. From there, the FOMC forecasts continued lower policy rates.
- In 2024, the Fed is forecasting a series of three quarter-point rate cuts. That is followed by further declines in the Fed funds rate, putting the average Fed funds rate at 3.6% in 2025. This would result in almost 2% of rate cuts over the next two years.
- Accordingly, our view has also shifted. We now see the first Fed cut in June 2024. Also, we now expect a cumulative 0.75% in cuts in 2024 and an additional 0.75% in cuts in 2025, which is 0.25% more than the previous forecast. Our revised forecast is for rate cuts to start in Q2 (vs. Q3 previously) and for a federal funds target range of 3.75-4% at the end of 2025, down from our prior projection of a 4-4.25% range.
- Markets embraced the more dovish tone by the FOMC and Powell, and are now pricing in the likelihood of the first rate cut in March of next year and 1.5% of Fed rate cuts by the end of 2024.
- The FOMC said it would "consider a range of factors in determining the extent of any additional policy firming that may be appropriate to return inflation to 2% over time." Fed Chairman Powell stated that while FOMC participants "do not view it as likely to be appropriate to raise interest rates further, neither do they want to take the possibility off the table."
- Regarding potential rate cuts, Powell described the discussion with the Committee as "preliminary" but also said that this would likely remain a topic for consideration "looking ahead". In Q&A, the Fed Chairman explained that one key reason for the Committee's evolving views is that the FOMC had "seen real progress in core inflation".

- For 2023, the FOMC updated its forecast for 2023 economic growth to 2.6% from the 2.1% projection made at its September meeting. The Fed's new forecast has PCE inflation below 3%, reaching 2.8% by year-end 2023.
- In recognizing an important inflation driver, Powell noted that "nominal wage growth appears to be easing" and that the FOMC members "expect the rebalancing in the labor market to continue, easing upward pressures on inflation". The committee members estimate real GDP growth will hit 1.4% by the end of 2024, down slightly from the prior forecast of 1.5%, before rebounding to 1.8% in 2025. The Committee does not forecast the US economy to enter a recession.
- Wholesale inflation in November was somewhat softer than expected, and the year-over-year metrics still suggest that inflation is nonthreatening. The key to continued disinflation at the consumer level is that input costs remain quite subdued.

Core PCE falling more rapidly than expected



Source: Renaissance Macro Research, HSBC Global Private Banking and Wealth as at 14 December 2023.

- Headline PPI was unchanged in November, which translates into a +0.9% y-o-y gain from +1.2% y-o-y in October. The core PPI (ex. food, energy, and trade) edged up just +0.1% or +2.5% y-o-y. Energy goods prices fell -1.2% m-o-m and food prices grew +0.6% m-o-m. Airline fares, which closely track the PCE deflator component, fell in November.
- At the consumer level, the CPI rose +0.1% m-o-m, modestly higher than the consensus estimate of 0% vs. a prior 0% in October. The y-o-y rate fell to +3.1%, down from +3.2% in October. The core CPI rose +0.3% m-o-m vs. +0.2% m-o-m in October. The y-o-y rate of core CPI inflation was unchanged at +4.0%. Core CPI, ex. shelter and used vehicles just rose +0.1% m-o-m in November while core goods excluding used vehicles declined -0.6% m-o-m and as supply chains loosen, goods costs outside of used vehicles could fall further.

Investment implications

- The Fed has been on hold since July and made it fairly clear that it's 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 discussing 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 our medium-to-long duration stance. In the credit markets, we continue to favor investment grade with a focus on quality.
- For equity investors, the recent rally may face a few short-term headwinds in early 2024, but the fundamentals remain quite supportive. We continue to believe that the prospects of lower market and policy rates next 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 next year, 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.
- We believe the 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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