Special Coverage:

FOMC stands still but dovish comments from Powell lift markets

HSBC

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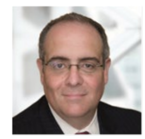
Key takeaways

- For the sixth consecutive meeting (since July 2023), the FOMC voted unanimously to leave the benchmark rate unchanged. We had been noting that the risk of delayed cuts was rising, and given the bumpy inflation path, we have revised our forecasts to only one 0.25% rate cut in September 2024, which is still earlier than what markets price in.
- The Fed announced it will slow its pace of quantitative tightening beginning 1 June 2024, lowering the cap on the amount of Treasury securities rolling off the balance sheet to USD25 billion each month from USD60 billion. This was earlier than some commentators thought and therefore seen as a mildly dovish measure.


Jose Rasco
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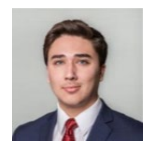
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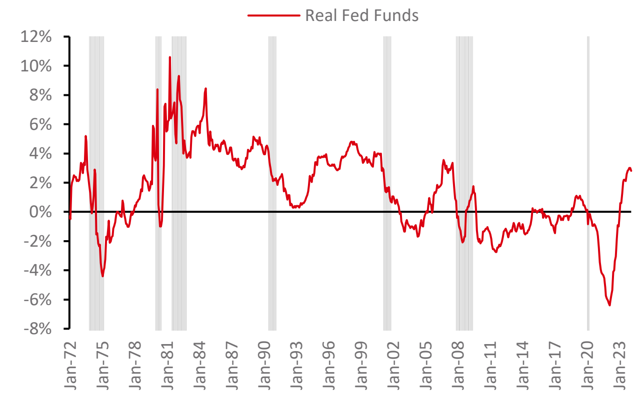
- Bonds rallied especially as Mr. Powell much reduced any remaining concerns of a rate hike by stating the next move in his mind would be a cut. We believe the 10-year yield is now at the top of its range. For equities, they remain supported by better-than-expected earnings, while more stability in the bond markets should also help. The USD weakened slightly on the Mr. Powell's dovish comments. But looking ahead, we continue to look for USD support if other central banks, most notably in Europe, cut rates ahead of September.

What happened?

- As widely expected at its May meeting, the FOMC voted unanimously to leave the benchmark rate unchanged in the target range of 5.25%-5.5%. This is the sixth straight meeting that the Fed left rates unchanged.
- The most notable addition to the FOMC statement being "In recent months, there has been a lack of further progress toward the Committee's 2% inflation objective.". The Fed also tweaked the language to say that the risks to achieving employment and inflation goals "have moved toward better balance over the past year;" with the statement previously stating risks were "moving into better balance" (so a change from present to past tense). The May statement repeated prior language saying the FOMC doesn't expect to cut rates "until it has gained greater confidence that inflation is moving sustainably toward 2%."
- At the May meeting, the Fed also announced it will slow its pace of quantitative tightening beginning 1 June 2024, lowering the cap on the amount of Treasury securities rolling off the balance sheet by more than half, to USD25 billion each month from USD60 billion. Officials maintained the pace of runoff for mortgage-backed securities at a maximum of USD35 billion per month, and the Fed will reinvest any principal payments above the cap into Treasuries instead of MBS.
- Powell noted in his opening statement that "Inflation is still too high" and further progress in bringing it down isn't assured and the path forward is uncertain. Powell also stated that inflation has eased notably over the past year but remains above the longer-run goal of 2%. He said "Inflation data received so far this year have been higher than expected. Some measures of short-term inflation expectations have increased in recent months. Longer-term inflation expectations appear to be more anchored, as reflected in a broad range of surveys of households, businesses and forecasters.".

- Powell stated, “I do think that the evidence shows pretty clearly that policy is restrictive and is weighing on demand.”. We believe over time it will be sufficiently restrictive.”.
- Inflation has remained stubborn as the headline PCE inflation remained at 0.3% m-o-m while y-o-y headline PCE inflation rose to 2.7% vs. 2.5% in prior month.
- Core PCE inflation rose 0.3% m-o-m, while February’s and January’s prints were revised higher by 0.01% and 0.05% to 0.27% and 0.5%, respectively. Supercore PCE inflation rose 0.4% m-o-m vs. 0.2% m-o-m prior, driven by transportation services and other services prices. Nevertheless, Powell was confident that inflation will return to 2%.

Real rates remain restrictive



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 1 May 2024.

- Regarding the economy, Powell stated that recent indicators suggest economic activity has continued to expand at a solid pace and consumer spending has been robust over the past several quarters. For those worrying that 1Q GDP was on the weak side, he pointed to the domestic demand component of GDP, which stands at a quite resilient 3.1% level. The labor market remains relatively tight, but supply and demand conditions have come into better balance.
- Payroll job gains averaged 276k jobs per month in the first quarter, while the unemployment rate remains low at 3.8%. Powell said that “Strong job creation over the past year has been accompanied by an increase in the supply of workers, reflecting increases in participation among individuals aged 25 to 54 years and the continued strong pace of immigration.”

Investment implications

- Given stronger-than-anticipated economic growth and somewhat higher-than-anticipated core inflation over recent months, we have revised our forecast to only one 0.25% rate cut in September 2024 and retained our view for a potential 0.75% rate cut in 2025. The timing remains highly uncertain but is still before the market expectation (December) and broadly consistent with the view that y-o-y core PCE inflation may fall modestly this summer but then increase somewhat into year-end.
- US equities have surpassed all-time highs while the economy and inflation are broadly expected to slow. As a counterweight, the Fed is expected to begin to become less restrictive in its monetary policy by reducing nominal policy rates, and lower interest rates have historically been quite accretive to earnings. Slower inflation should help maintain corporate margins. While many cyclical drivers of economic growth are showing limited signs of strain, the tailwinds provided by secular themes like the technology revolution, innovation in healthcare and other sectors, near/onshoring, and the re-industrialization of the US should boost economic activity, maintain margins, increase productivity, and most significantly, increase the return on invested capital.
- For fixed income, the peak in policy rates should help bonds stabilize and, with time, lead bond yields lower from here. We believe that the 10-year yield is at the top of its recent range and continue to lock in attractive yield levels on both Treasuries and investment grade bonds.
- The Fed’s decision and comments suggest that the USD is likely to be on the back foot in the very near term. Looking ahead, relative rates should offer some support to the USD if other central banks, most notably in Europe, show more dovish momentum in the weeks and months ahead.

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