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Underestimating the risks?

Investment event | 15 December 2023

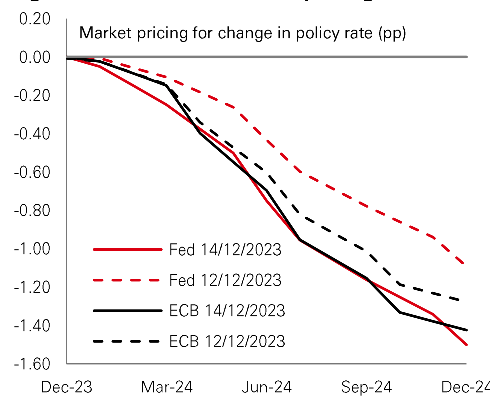
Fed furthers the rally in everything

Many risk assets and bonds have had a great run since late October and this trend accelerated in the aftermath of the Federal Reserve's December policy meeting. While policy was left unchanged, the Fed adjusted its economic projections in a market-friendly way. It revised up near-term growth, revised down inflation in the coming years and continued to predict a limited rise in unemployment. Most importantly, the Fed removed its prior expectation for one further 25bp rate hike this cycle and lowered its end-2024 Fed funds figure by 50bp to 4.60%, implying 75bp of policy easing next year.

Ahead of the meeting, the market was pricing about 110bp of Fed rate cuts in 2024. But, despite the Fed projections pointing to only 75bp of easing, the market has subsequently moved to price in c.150bp of rate reductions next year.

Ultimately, the market appears to have focused on the simple message from the projections – namely that policy rates are likely at their peak and the next move is most probably a cut. It seems willing to overlook some of Chair Powell's more nuanced comments that the FOMC still needed to see further evidence that inflation would move durably down to 2.0% before easing policy.

Figure 1: Fed & ECB market pricing



Source: Bloomberg, HSBC AM as of 14 December 2023

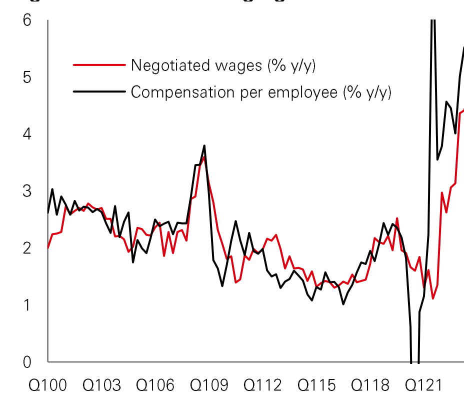
The signal that the next move in Fed funds is more likely to be a cut than a hike, combined with sanguine macro projections for solid growth, a resilient labour market and inflation gliding back to target furthered the recent "rally in everything". Treasury yields fell sharply with the 2-yr down c.40p and 10-yr down c.30bp. US equities also performed strongly with the S&P500 rising to its highest for nearly two years.

ECB and BoE lean against the market

The ECB delivered a more mixed message. It revised down its forecasts for growth and inflation in 2023 and 2024 but noted that "domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs". In the press conference, President Lagarde noted the Governing Council needs to see more evidence that wage growth is slowing and profit margins are moderating for it to become confident that inflation is on a sustainable path towards its 2% target. President Lagarde also emphasised that the ECB did not discuss future rate cuts (unlike the FOMC) and that its forecasts are based on higher interest rates than prevail in the market today.

The ECB also announced a change to its balance sheet policy. Specifically, it will start reducing its holdings of bonds under the Pandemic Emergency Purchase Programme (PEPP) by EUR 7.5bn per month in the second half of 2024 and cease PEPP reinvestments completely at the end of 2024. Previously, it had stated full reinvestment of maturing bonds would continue until at least the end of 2024. President Lagarde sought to separate this announcement from expectations for interest rate policy, referring to iterations to the PEPP as being "standalone" and happening on the "backburner". It seems, therefore, that the ECB is willing to continue gradually normalising the size of its balance sheet while also, at some point, cutting interest rates.

Figure 2: Eurozone wage growth



Source: Macrobond, Eurostat, HSBC AM as of 14 December 2023

The Fed abandoned its bias to hike and pivoted towards rate cuts in 2024 on the back of a likely further improvement in inflation. Bonds and equities rallied

Markets appear to be pricing in a soft-landing for the global economy, but may be under-estimating the risks to growth given the full impact of policy tightening has yet to be felt

Our view:

Our 'house view' is for defensive positioning in investment portfolios at present. A weaker economy and disinflation should be a supportive environment for government bonds and challenging for stocks

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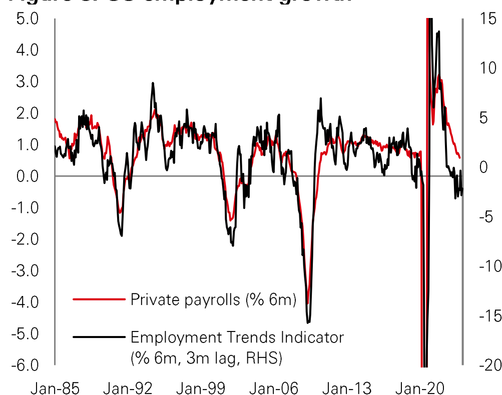
The Bank of England was the most hawkish of the three central banks, consistent with the slower progress it has seen on inflation and wage growth. Three of the nine Monetary Policy Committee members continued to vote for a 25bp rate hike and most of the six who voted for unchanged policy noted "it was too early to conclude that services price inflation and pay growth were on a firmly downward path". Consistent with this, the market is pricing in less easing by the BoE (around 100bp) than by the Fed or ECB (around 150bp) next year.

Priced for perfection

Among these three central banks, the Fed has clearly pivoted, and the ECB is heading in that direction while the BoE is lagging. The improving inflation outlook and change of tone, particularly by the Fed, means markets are becoming ever more excited about the prospect of a soft landing. However, it is still tricky to stay on this "golden path" of largely painless disinflation.

Figure 3: US employment growth



Source: Macrobond, Conference Board and Bureau of Labour Statistics, HSBC AM as of 14 December 2023

Getting inflation from 3% to 2% could prove more difficult than the move from over 5% towards 3% has been, as the trade-offs with the labour market potentially come into play. Wage growth on both sides of the Atlantic is not yet down to rates consistent with underlying inflation settling durably around 2.0%; some further rebalancing of labour demand supply is likely to be needed. In the US, this is unlikely to come entirely via supply, given the participation rate is now above trend, while several labour market leading indicators point to a further softening in employment growth next year. More widely, the US yield curve remains heavily inverted and credit conditions are tight.

In Europe, economies are already stagnating or contracting and while the market appears to be pinning its hopes on lower inflation leading to a revival of consumer spending and overall growth, money and credit data point in the opposite direction. Moreover, monetary policy acts with a lag and we have not yet felt the full impact of the rapid policy tightening delivered in this cycle.

The risk of a recession, therefore, seems higher than discounted by markets, which increasingly look like they are priced for perfection.

Investment implications

Economies are seemingly making progress down the "golden path", especially the US. But the risks are very high. As the "long and variable lags" of monetary policy kick in, data points consistent with a "soft landing" macro-outcome can morph into an economic "hard landing" further down the path.

And the big danger at the current juncture is that that a soft-landing outcome is fully priced, implying little room for disappointment on the macroeconomic and corporate profits scenario.

Our central market scenario remains centred on a "defensive growth" stance with a bias on quality and selectivity in stocks and credits. We also suggest 'intelligent diversification' strategies. This can include a systematic approach to thematic allocations, or EM exposure. We think EM assets also benefit from decent valuations, relatively robust growth, and central banks which are ahead of the Fed in reducing rates.

Overall, the experience of 2023 has been a noisy narrative, and schizophrenic market action. We think this is likely to continue heading into 2024 as investors continue to grapple with what the "new normal" for the macroeconomy and investment markets will look like. Being nimble and active in this environment makes sense.

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