Special Coverage:

Fed reigns in rate cut expectations but still expects one cut this year

Key takeaways

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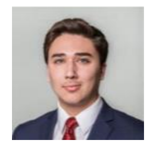

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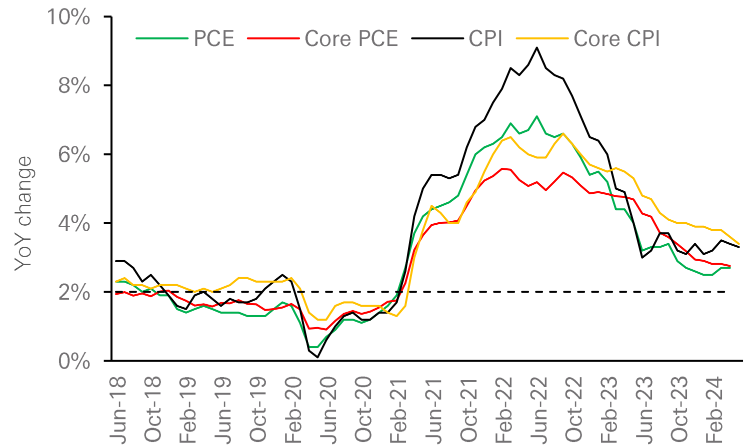
- For its seventh consecutive meeting, the FOMC voted unanimously to leave the benchmark rate unchanged in the target range of 5.25%-5.5%. In the Summary of Economic Projections (SEP), the Committee left growth rates unchanged but raised its inflation outlook modestly.
- The dot plot of Federal Open Market Committee rate projections shows the median official expects one quarter-point cut in 2024 but the median forecast for 2025 rises to 4.1% from 3.9%. The Fed officials also lifted forecasts for where they see rates settling over the long term, boosting their median estimate to 2.8% from 2.6% in March.
- With Fed rate cuts anticipated, we expect short rates to drop, which would create reinvestment risk, and the yield curve to normalise. We remain overweight on Treasuries and investment grade credit and lock in higher long-term market rates. While the median assumption for the funds rate is for only one rate cut in 2024, the Fed has maintained its view on the Fed funds rate at 3.1% by 2026. This has historically been quite accretive to earnings, which are currently forecast to rise 11% and 14% in 2024 and 2025, respectively. We maintain our overweight on US equities.

What happened?

- The FOMC voted unanimously to leave benchmark rate unchanged in the target range of 5.25%-5.5%, a two-decade high, for a seventh straight meeting. The press release repeats prior language saying the FOMC doesn't expect to cut rates "until it has gained greater confidence that inflation is moving sustainably towards 2%" symmetric target but has also acknowledged "modest further progress" towards the inflation goal in recent months.
- In the Summary of Economic Projections (SEP), the Committee left growth rates unchanged from prior meetings but raised its inflation outlook modestly, reflecting the recent difficulties with continued disinflation.
- Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has remained low. Economic growth estimate for 2024 is unchanged at 2.1%.
- Median forecast for inflation has risen to 2.6% for 2024 while core PCE projection is up 0.2 percentage point to 2.8%. The May CPI report showed a slowdown in consumer inflation, as the CPI was unchanged from the prior month, with the annual inflation rate slowing to 3.3% from 3.4% in April. The core CPI in May slowed, rising only 0.2% from the previous month and slowing to 3.4% y-o-y. This is the slowest core inflation rate since April 2021.

- The dot plot of Federal Open Market Committee rate projections shows the median official expects one quarter-point cut in 2024, two fewer than the previous round of quarterly forecasts in March. However, the median forecast for 2025 rises to 4.1% from 3.9%, implying four cuts compared with three projected in March.
- The Fed officials lifted forecasts for where they see rates settling over the long term, boosting their median estimate to 2.8% from 2.6% in March. However, the SEP still has the terminal rate reaching 3.1% by year-end 2026, which implies 2.25% of policy rate cuts in the next two and a half years.
- "If the economy remains solid and inflation persists, we're prepared to maintain" the current target rate, Powell says.

Inflation is slowing and is heading towards the Fed's 2% target rate



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 12 June 2024.

Investment implications

- For fixed income investors, the fundamentals remain largely unchanged. The Fed paused last summer and still seems likely to begin monetary policy normalisation at some point this year. The direction for market rates still looks lower, albeit perhaps at somewhat higher rates than previously expected.
- The lumpy Treasury issuance calendar could result in further volatility in market rates, affecting returns in the short term.
- With Fed rate cuts anticipated, we expect short rates to drop, which would create reinvestment risk, and the yield curve to normalise. As a result, we maintain our overweight on Treasuries and investment grade credit and lock in higher long-term market rates. The latest FOMC guidance reinforces our base case of only one 0.25% Fed rate cut in September this year.
- For US equity investors, the Fed's growth assumptions remain unchanged - around 2.0% through 2026, with longer-term growth still at 1.8%. Even with the slight uptick in the view on inflation this year and next, and a minor increase in the unemployment rate, the inflation outlook remains benign. As a result, expectations for corporate profit margins and corporate profits should remain quite healthy.
- While the median assumption for the funds rate is for only one rate cut in 2024, the Fed has maintained its view on the Fed funds rate at 3.1% by 2026. This has historically been quite accretive to earnings, which are currently forecast to rise 11% and 14% in 2024 and 2025, respectively according to FactSet as of 31 May 2024. Moreover, the total forecast of 2.25% of rate cuts is far in excess of what we've seen historically and much more than we experienced in 1994-1995.
- These rate cut forecasts remain quite attractive and are supportive of our US equity overweight. The more restrictive policy, relative to prior expectations, should be supportive of US dollar denominated assets and USD in general.

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