# Special Coverage:

# Dovish Fed comments boost markets despite recent inflation concerns

## Key takeaways

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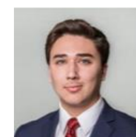

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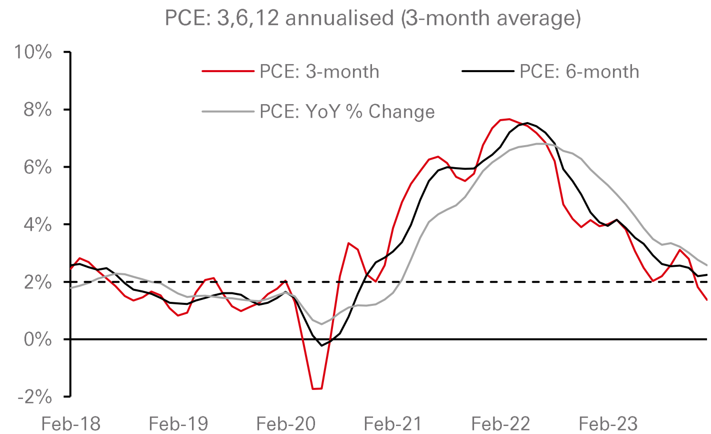
- As widely expected, the Federal Reserve voted unanimously to leave the target benchmark Fed funds rate unchanged at 5.25%-5.5% for the fifth straight meeting. We continue to expect a first Fed cut of 0.25% in June and a cumulative 0.75% of cuts in 2024, taking the Fed funds target range down to 4.5-4.75%.
- The March statement repeats prior language saying the FOMC doesn't expect to cut rates "until it has gained greater confidence that inflation is moving sustainably toward its 2% symmetric target". The median forecast for PCE inflation was unchanged at 2.4% for 2024, while core PCE projection rose to 2.6% from 2.4%. We think this path shows sufficient progress to allow a June rate cut.
- 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. Also, slower inflation should help maintain corporate margins. We expect the dovish comments to lead to some mild weaking of the US dollar, but within its current trading range.

## What happened?

- As widely expected, the Federal Reserve voted unanimously to leave the target benchmark Fed funds rate unchanged at 5.25%-5.5% for the fifth straight meeting. The Fed has been on hold since its meeting in July 2023.
- We expect the first Fed cut to be a 0.25% reduction in June and a cumulative 0.75% in rate cuts in 2024, taking the federal funds target range down to 4.5-4.75%. We forecast an additional 0.75% of policy rate cuts in 2025, taking the Fed funds target range down to 3.75-4.0% at the end of that year.
- Lower policy and market interest rates aren't necessary preconditions for US equity markets to continue to rally. Indeed, US equities have done well in recent weeks, even with some bond market volatility. However, lower interest rates have historically been accretive to earnings and should help maintain margins growth and are therefore welcome news for US and global stocks.
- It's important to remember that overall monetary policy remains restrictive. With inflation (PCE deflator) running at 2.4% y-o-y, real Fed funds are now 3.1% which historically has been viewed as restrictive. In addition, quantitative tightening remains in place. As the Fed continues to reduce the size of its balance sheet, liquidity is becoming less abundant than before. These measures should lead to sufficient progress in the inflation fight to allow the Fed to cut rates by June.
- The March statement repeats prior language saying the FOMC doesn't expect to cut rates "until it has gained greater confidence that inflation is moving sustainably toward its 2% symmetric target". The PCE deflator is rising at an average annualised rate of 1.4% rate over the last three months and 2.2% over the last six months.

- In the summary of economic projections (SEP), the median view is that the Fed will cut rates three times in 2024, and another three times in 2025.
- Given the reduced expectations for rate cuts, the median projection for Fed funds in 2025 and 2026 were increased by 0.25% each year, while the long-term rate forecast also rose slightly.
- The median forecast for PCE inflation was unchanged at 2.4% for 2024 while the core PCE projection rose to 2.6% from 2.4%.
- The real GDP estimate for 2024 jumped to 2.1% from 1.4%, illustrating the US economic resilience. The Fed's GDP forecast for 2024 is now above the long-term growth target for US economic growth.

**Inflation is slowing**




Source: Bloomberg, HSBC Global Private Banking and Wealth as at 20 March 2024.

- Fed Chair Powell stated, "participants generally revised up their growth projections since December reflecting the strength of incoming data including data on labour supply. The labour market remains relatively tight, but supply and demand conditions have continued to come into better balance."
- The Fed maintained its pace of quantitative tightening, with a maximum of USD60 billion of Treasuries and USD35 billion of mortgage-backed securities rolling off the balance sheet each month and did not give any immediate hint of change to the program.

## Investment implications

- The US equities have surpassed all-time highs while the economy and inflation are broadly expected to slow. As a counterweight, the Fed is anticipated 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. Also, slower inflation should help maintain corporate margins. It's, therefore, very typical for markets to rally ahead of the first rate cut, as we have seen in recent months.
- While many cyclical drivers of economic growth are showing limited signs of strain, US growth remains more resilient and higher than in much of the rest of the world. In addition, the tailwinds provided by secular themes like the technology revolution, innovation in healthcare and other sectors, near/onshoring, and the re-industrialisation of North America should boost economic activity, maintain margins, increase productivity, and most significantly, increase the return on invested capital. We maintain broad-based exposure to the US stock markets across several sectors.
- For the US dollar, we expect the dovish comments to lead to some mild weakening, but within its current trading range.

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