FLASH

Brief updates on portfolios, markets & more 15 December 2022

DECEMBER 2022 FED MEETING

The US Federal reserve has raised interest rates by 50 basis points yesterday evening, as expected. We also note some hawkish revisions to the inflation forecast.

A hawkish Fed points to a last thing restrictive policy

Read more on p2

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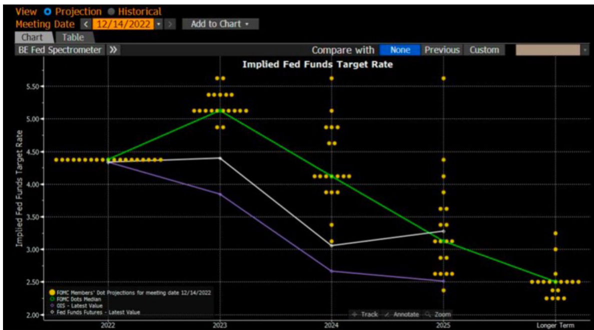
THE FACTS

The US Federal reserve hikes rates by 50 basis points yesterday evening, as it was widely expected. They increased key rate to 4.5%, the highest since 2007. Projected rates would end next year at 5.1% (+50bps beyond prior median of 4.6%), according to Fed median forecast, before being cut to 4.1% in 2024 - higher level than previously indicated (see FOMC dots below). Prior to decision, markets were expecting rates would reach ~4.8% in May.

Fed dots



Source: Bloomberg

During the conference call, Fed Chairman highlighted the following key points:

- The labor market remains extremely tight. Powell spent at least 7-8 minutes of the press conference endlessly repeating how hot the labor market is.
- A restrictive policy stance is likely needed for some time;
- The fed needs to see substantially more evidence of lower inflation before shifting policy;
- The Fed still has some ways to go on rate hikes,
- The stance isn't yet restrictive enough even with today's move;
- No rate cuts will take place until they are confident inflation is moving toward 2%;
- They will have to hold restrictive rates for sustained time.

We also note some hawkish revisions to the inflation forecast with a majority of FOMC participants seeing core PCE decelerating to 3.5% at the end of 2023, versus a projection of 3.1% in September.

The Fed also released its economic projections: real GDP to grow by a mere 0.5% in 2023, and by just 1.6% in 2024. It sees the unemployment rate rising to 4.6% by the end of 2023 (vs. 3.7% now), i.e the Fed sees more economic pain ahead as this is the price to pay to fight inflation.

OPINION

So overall a hawkish message which wasn't fully bought by investors as:

- The dollar reversed some of its initial spike;
- Treasury yields mostly ended the day lower in yields. The short-end notably underperformed however (2Y +2bps, rest of curve down 1-2bps) which flattened the yield curve;
- The market is now pricing in rates being lower than current rates by January 2024;
- Rate markets lean toward a further slowdown in the pace of rate hikes for the first half of 2023, with likely incremental movements of 25bp. Indeed, the odds of a 50bps hike in Feb is now at just 25% while the odds of a March 25bps hike rose to 60%. There's a 76% chance that The Fed will not hike in May.

In other words, the bond market isn't buying Fed hawkishness. The Fed can change the Dot Plot all they want, but at this point in the cycle the market believes there is no chance they'll be able to keep rates above 5% for the entire 2023.

So why the Fed message wasn't taken too hawkishly? Investors think the Fed is bluffing. And that current tightness will lead to lower inflation quicker than the Fed said.

Bottom-line: The Fed remains hawkish and the statement takes back some of Powell's perceived dovishness at his recent speech.

The clustering of dots for 2023 above 5%, with only two below that level, shows an FOMC on the same page to get the job done (at the risk of triggering a recession).

Bulls believe that falling inflation could allow the Fed to deviate from its aggressive path before it's too late - and this should trump the negative effects of downward revisions to earnings.

They might be right but there are many downside risks attached to this scenario.

In the short-term, the Fed might have to keep a hawkish communication as the easing of financial conditions (due to a less hawkish interpretation by the market) is counterproductive to what the fed intends to achieve.

In the medium-term, there are two additional issues. First, the assumption that a Fed which would turn less hawkish would help increase equity valuations doesn't take into account the fact that equity valuations are not cheap (equity risk premium currently stands at 2.5%). Second, the fact that the Fed is still pursuing quantitative tightening and not cutting rates at a time the economy might enters recession and earnings revision are being downgraded is something which hasn't happened in the past (see table below). The key turning point in terms of monetary policy will not be a pause but rather a clear pivot (i.e rate cut). This will only take place if something breaks (the economy or the market). This means that equity volatility could stay elevated for some time.

Bear Market	Fed Chair	Fed Response
1987	Greenspan	Rate cuts from 7.3% to 6.5%
1990	Greenspan	Rate cuts from 8.0% to 3.0%
1998	Greenspan	Rate cuts from 5.25% to 4.75%
2000-02	Greenspan	Rate cuts from 6.5% to 1.0%
2007-09	Bernanke	Rate cuts from 5.25% to 0.0%
2011	Bernanke	Hold rates at 0% until 2015, Starts "operation twist", QE3 starts in 2012
2018	Powell	Ends rate hikes, Rate cuts in 2019 from 2.25% to 1.50% and starts QE4
2020	Powell	Rate cuts from 1.50% to 0%, Record balance sheet expansion with QE5
2022	Powell	Rate hikes from 0% to 4.25%, Additional hikes to 5% expected, Balance Sheet Reduction
COMPOUND		@CharlieBilello

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

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