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Asset Management

Fed at the peak?

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The Federal Reserve left the federal funds target range unchanged at 5.25-5.50%

The FOMC's projections indicate the possibility of one further hike this year and a relatively soft-landing for the economy expected next year, leading to modest rate cuts as inflation moderates further

Our view:

We continue to argue for a defensive positioning in portfolios given restrictive monetary policy, tightening credit conditions and too-optimistic Federal Reserve and consensus GDP forecasts

On hold but retaining a bias to hike

At its September meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) left the target range for the federal funds rate unchanged at 5.25-5.50%. The decision was in line with market expectations and comes after the Fed tightened policy by 525bp since February 2022, culminating in a 25p increase at its July meeting. Chair Powell referred to there being a "unanimous" support for the decision.

In its statement, the Fed upgraded its language on growth, referring to the economy as expanding at a "solid pace", rather than "moderate" pace, as it had previously. However, the Fed also acknowledged that "Job gains have slowed in recent months" but added they "remain strong". The language on inflation was unchanged with "Inflation remaining elevated" and the Fed "highly attentive to inflation risks".

In terms of the Summary of Economic Projections (SEP), the main changes were:

- Notable upward revisions to growth in 2023 and 2024, with a low point of 1.5% y/y in Q4 2024, up from 1.1% in the June projections.
- Downward revisions to unemployment, with the unemployment rate plateauing at only 4.1% in 2024 and 2025, only marginally above the Fed's estimate of the long run natural rate of 4.0%.
- A 50bp upward revision to the median Fed funds rate in 2024 and 2025, with only 50bp of cuts now seen in 2024 followed by just over 100bp of easing in 2025.

Changes to the inflation outlook were limited and Chair Powell confirmed the expectation for a higher-for-longer policy rate reflected the upgrade to the growth forecasts.

In terms of near-term policy, the median projection is for one further 25bp hike this year, although seven of the 19 committee members favour no change. Moreover, in his press conference, Chair Powell noted the FOMC is in a "position to proceed carefully", given how much policy tightening has already been delivered. Ultimately, at this stage in the cycle, the FOMC decisions are data dependent.

Table 1: FOMC median economic projections

	2023	2024	2025	Longer run
GDP (% yoy)	**2.1**	**1.5**	**1.8**	**1.8**
June 2023 Fed projection	*1.0*	*1.1*	*1.8*	*1.8*
Unemployment rate (%)	**3.8**	**4.1**	**4.1**	**4.0**
June 2023 Fed projection	*4.1*	*4.5*	*4.5*	*4.0*
Core PCE inflation (%)	**3.7**	**2.6**	**2.3**	**2.0**
June 2023 Fed projection	*3.9*	*2.6*	*2.2*	*2.0**
Fed funds rate (%)	**5.6**	**5.1**	**3.9**	**2.5**
June 2023 Fed projection	*5.6*	*4.6*	*3.4*	*2.5*

*Source: US Federal Reserve, figures refer to Q4 * Longer run figure is headline PCE inflation rather than core PCE*

Looking for a soft landing

Ultimately, the Summary of Economic Projections indicate a soft landing for the US economy, although in his press conference Chair Powell was loathe to call a soft landing a "baseline". He acknowledged that the Fed has tightened policy significantly since early 2022 and the full effects of its actions are yet to be felt, which creates uncertainty regarding the growth outlook.

While inflation is now coming down – Chair Powell referred to the last three core CPI readings as "good" – the Fed views the process of getting inflation sustainably down to 2.0% as "having a long way to go". On that front, Chair Powell noted policy would remain at a restrictive level until the Fed is confident that inflation is moving towards target on a sustained basis.

Significant downside risks

We see significant downside to the Fed's growth and policy rate expectations in 2024. While growth has been robust thus far in 2023, it has been supported by an inadvertent easing of fiscal policy, which is unlikely to repeat, and consumers' willingness to run down the savings accumulated during the pandemic. However, on the current trajectory, these savings will be exhausted by early 2024.

Moreover, as the Fed acknowledges, monetary policy is restrictive, and its full impact is still feeding through to the economy. Credit conditions have tightened markedly while employment growth is slowing, and a range of indicators suggest this trend will continue heading into 2024 (Figure 1), ultimately leading to a rise in unemployment. The backbone of the US economy – the consumer – is therefore likely to become notably more cautious in H1 2024, triggering a wider US recession.

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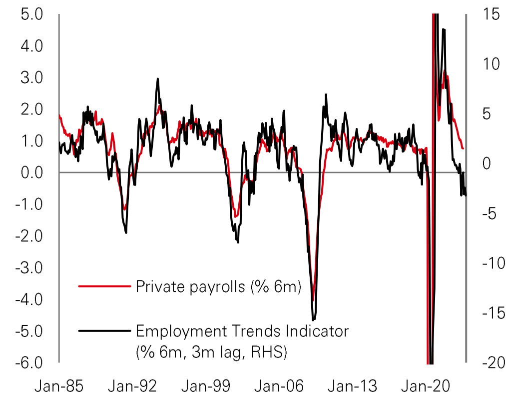
Investment implications

At the time of writing, the shift up in the FOMC's 2024 and 2025 policy rate expectations pushed the 2y Treasury yield 8-9bp higher; this is a relatively tame reaction given the Fed suggested rates at end-2025 would be 50bp higher than previously expected. The 10y yield moved by less (4-5bp), meaning the yield curve inverted further; an inverted yield curve is typically seen as an indicator of a future recession. US equities weakened with the S&P 500 down by around 1%.

Looking ahead, we continue to argue for a defensive positioning in portfolios. Specifically:

- Our central scenario is for a US and Western advanced economy recessions to emerge during H1 2024, which we believe is consistent with "choppy waters" for global risk assets over the next 12 months. We do not see a large margin of safety in developed market equities against disappointing growth outcomes.
- Our house view is consistent with a preference for high-quality fixed income assets, especially US Treasuries, given our view of a US recession. We also want to take advantage of the additional carry that high quality credits offer and believe solid corporate balance sheets offer protection against default risk.
- Within EM, we see several decent propositions in Asia, which continues to benefit from low inflation and relatively strong growth. Broadly speaking, EM risk premiums look generous, while EM equities typically perform well after peak Fed rates. In particular, India looks attractive from an earnings perspective amid positive macro trends, including economic diversification into advanced manufacturing, but the market also looks relatively expensive.

Figure 1: Employment growth slowing



Source: Macrobond, Conference Board and Bureau of Labour Statistics as of 20 September 2023

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