

# Market Update

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## Fed lifts economic outlook but no policy change in sight

18 March 2021



The Fed did not change its policy rate or bond purchase plan at its March FOMC meeting. Its economic growth forecast was much improved for 2021 and its unemployment forecast lowered. It also lifted its inflation forecast for 2021, but importantly sees little change in 2022 and 2023 inflation. The temporary nature of the higher inflation also means that Fed members foresee unchanged rates through 2023. Fed Chair Jerome Powell suggested the first rate hike is “far into the future”. Although bond yields are up slightly, the Fed’s message should provide comfort to equities and our ‘Reopening America’ theme.

- ◆ At its March meeting the Federal Open Market Committee (FOMC) made no change in policy, but did alter its outlook on growth and inflation. The Fed funds rate remains in the 0.0% to 0.25% range and should stay there through 2023.
- ◆ Significantly, the Fed increased its growth forecast for 2021 by more than 2% to properly incorporate the stimulus packages from the both the Trump and Biden administrations.
- ◆ The Fed’s accommodative policies stand in sharp contrast to some market fears that the economy is growing excessively fast and the risk of inflation has become so elevated in both the short and long term as to continue to foster a reflation trade. From the Fed’s perspective, the risks of inflation are temporary due to base effects and supply constraints, both of which should be resolved in the next few months.
- ◆ Based on the Fed’s outlook, its accommodative monetary policy stance, and the generous fiscal stimulus put in place in the past few months, we remain overweight on US and global equities as growth and profitability should be better than most suspect.
- ◆ From a sector perspective we focus on cyclical sectors such as financials, housing, autos, and even technology. Let’s not lose sight of the fact that we are at the beginning of a multi-year secular technology revolution that should create jobs, lift productivity and profitability and keep a lid on inflation.
- ◆ For Fixed Income investors we continue to expect rate volatility in the next few months as inflation readings may continue to rise in the short term. However, given the move we have already seen in the market’s inflation expectations, we still think there is limited upside to bond yields. We focus on carry opportunities in Fixed Income and look to selective opportunities in the Investment Grade and High-Yield credit markets.
- ◆ Overnight, equities rebounded, with cyclicals such as industrials and materials outperforming. Gold also welcomed the Fed meeting outcome.

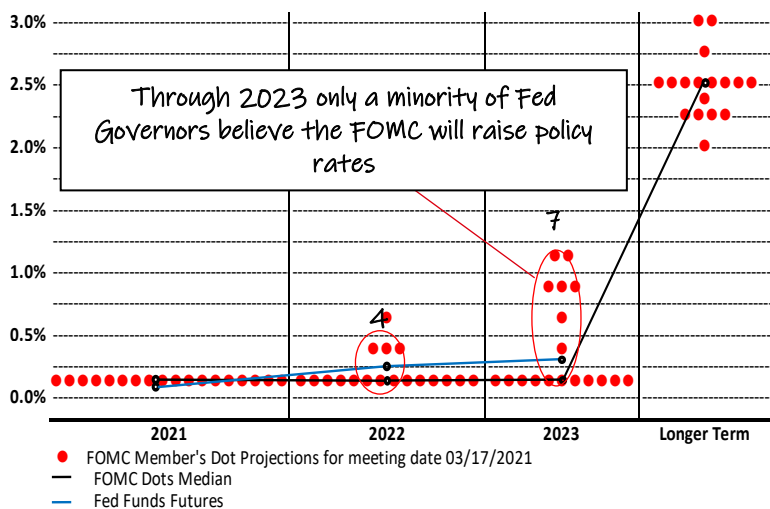
## What did the FOMC do?

It was no surprise to see that the Federal Reserve did nothing to change policy rates at its March meeting. The Fed maintained its very accommodative monetary policy stance by keeping interest rates low and maintaining its quantitative easing program at the same pace, suggesting support for a flatter yield curve.

One notable change was in the dot plots, or the projections by the Fed governors of where policy rates could go in the future. For 2022 there was one dissenting vote that suggested that policy rates could rise next year. In 2023 there were seven Fed governors who indicated that policy rates could rise in that year. While the shift in the dots is interesting it is important to note it is still below the threshold needed to indicate any possible change in monetary policy. Fed members are thus saying that they expect rates to be unchanged through the end of 2023.

Another change at the FOMC meeting was the meaningful upgrade in the economic projections for the US economy. It seems the FOMC has finally incorporated the COVID-19 stimulus plans put in place by both the Trump and Biden administrations in the past few months. Since December the US government has announced plans to inject an incremental \$2.8 trillion in fiscal stimulus (approximately 12.7% of US nominal GDP) into the US economy in 2021. That stimulus, combined with the accommodative monetary policy from the Fed, should provide the impetus needed to lift growth rates this year and in the future. As a result, the Fed governors increased their forecast for economic growth in 2021 to 6.5% which is significantly higher than the 4.2% they were anticipating in December. They did not increase their economic projections for economic growth in either of the next two years, or the longer run average which remained at 1.8%. That reflects continued uncertainty around the long term effects of current measures, and should ease fears of long term overheating or long term inflation.

## The Fed's New Dot Plot after its March policy meeting



Source: Federal Reserve, Bloomberg, HSBC Private Banking as of 3/17/2021

The Fed Governors, in an effort to account for the incremental stimulus, now expect the unemployment rate to fall much more rapidly in 2021 than in prior forecasts. As seen in the accompanying table, the Fed now expects the unemployment rate in the US to reach 4.5% this year. Moreover, they now expect the unemployment rate to return to pre-pandemic levels at some point in the next two years.

On the inflation front, the Fed remains firm in its view that any pickup in inflation should be temporary and not structural in nature. As we have pointed out before, the Fed is aware that there will be base effects resulting in a short-term pickup in inflation and that the COVID-19 lockdowns have left many suppliers either closed or functioning at much lower levels of capacity. The unintended consequence is that the supply of goods in many sectors will take time to rebuild. Moreover, with the incremental buying power provided by the recent stimulus packages, any pent-up demand or any attempt to rebuild inventories will face short-term shortages and thus higher prices until supplies are rebuilt and delivery times return to historically more normal levels. It is at that point that we can expect to see price normalization and stability, with inflation falling back later in the year. The Fed indicated in its new economic projections that inflation could rise more rapidly in 2021 by putting its forecast for the PCE deflator at 2.4%, up from its outlook of 1.8% at its December meeting. For the core PCE deflator the Fed also acknowledged higher inflation in 2021 by lifting its forecast to 2.2% from 1.8% at its December meeting. This is the indicator most followed by the Fed, and it is expected to move only marginally above 2%.

The most telling statistic on the Fed's inflationary outlook is that the forecast for both total and core inflation remain virtually unchanged in 2023 and remain at 2.0% in the longer run. This suggests the Fed – like us - continues to believe that any pickup in inflation is temporary and the effects of both globalization and technology disruption and diffusion will continue to put downward pressure on prices in the markets for labour as well as goods and services.

In an effort to combat the potentially corrosive effects of higher bond yields on the US economy, the Fed maintained its quantitative easing program firmly in place. The Fed's QE program continues at the current pace of purchasing \$80 billion in treasuries and \$40 billion in mortgage backed securities. There is talk in the markets that the Fed could shift some of its bond buying program toward purchasing more Treasuries, especially at the longer end of the curve, to try to alleviate any further upward pressure on interest rates. To be clear, that was not discussed in the communication but based on prior history it seems clear the Fed could be open to this if inflation is more persistent, if the market selloff in Treasury bonds becomes more pervasive, and if the Fed believes such an action would be required.

## Investment Summary

Fed Chairman Jerome Powell said “the state of the economy in two or three years is highly uncertain and I wouldn’t want to focus too much on the exact timing of a potential rate increase that far into the future”. The Fed’s mandate to keep unemployment rates low and to maintain stable inflation seem to be well on track. In 2021, it seems clear to us that both monetary and fiscal policy will remain accommodative for the foreseeable future. This suggests, as outlined above, that growth and profitability should be better than many people expect. As vaccination rates continue to climb and the economy continues to reopen, normalization of delivery times and the supply chain should help keep inflation rates stable as well.

In the fixed income markets, we expect bond yields to remain volatile, and momentum as well as short term inflation readings could even lead to a further backup in yields. But they are already overshooting fair value in our view, so the upside to yields should get more and more limited. We continue to look for volatility in Fixed Income markets but believe there is a limit to the upside for treasury yields. We focus on carry opportunities in fixed income and look to select opportunities in investment grade, high-yield credit markets and emerging market bonds.

For equity investors we maintain our overweight position in global equities, with the US being one of our principal overweight positions. We continue to focus on the pro-cyclical sectors such as financials, housing, autos, and technology. It is important to keep in mind that many companies and households refinanced very aggressively in 2020 which has lowered debt service. The strength of the housing market has also allowed some households to take some equity out. Moreover, many companies extended the duration of their debt suggesting the need for access to capital markets may not be as great as the market anticipates. Therefore the risk of higher interest rates to equity market valuations may be lower than people think. Moreover, the inventory build already underway, combined with the prospects for infrastructure spending should continue to lift performance in the materials and industrial sectors as well. Finally, the technology revolution, which is just beginning, should be a multi-year expansion of the US digital infrastructure which should provide positive momentum for economic growth and corporate profitability.

## Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, March 2021

Variable	Median			Longer run
	2021	2022	2023	
Change in real GDP	6.5	3.3	2.2	1.8
December projection	4.2	3.2	2.4	1.8
Unemployment rate	4.5	3.9	3.5	4.0
December projection	5.0	4.2	3.7	4.1
PCE inflation	2.4	2.0	2.1	2.0
December projection	1.8	1.9	2.0	2.0
Core PCE inflation (4)	2.2	2.0	2.1	
December projection	1.8	1.9	2.0	
<b>Memo: Projected appropriate policy path</b>				
Federal funds rate	0.1	0.1	0.1	2.5
December projection	0.1	0.1	0.1	2.5

Source: Federal Reserve Summary of Economic Projections, HSBC Private Banking as of 3/17/2021.



## Risk Disclosures

### Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

#### Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

#### Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

#### Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

### Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

### Nationalization risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

### Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

### Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

### Alternative Investments

Investors in Hedge Funds and Private Equity should bear in mind that these products can be highly speculative and may not be suitable for all clients. Investors should ensure they understand the features of the products and fund strategies and the risks involved before deciding whether or not to invest in such products. Such investments are generally intended for experienced and financially sophisticated investors who are willing to bear the risks associated with such investments, which can include: loss of all or a substantial portion of the investment, increased risk of loss due to leveraging, short-selling, or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; prohibitions and/ or material restrictions on transferring interests in the fund; absence of information regarding valuations and pricing; delays in tax reporting; - key man and adviser risk; limited or no transparency to underlying investments; limited or no regulatory oversight and less regulation and higher fees than mutual funds.

### Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (e) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

### **Risk disclosure on FX Margin**

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

### **Currency risk – where product relates to other currencies**

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

### **Chinese Yuan (“CNY”) risks**

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

### **Illiquid markets/products**

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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