

Market Update

Fed meeting: Hawkish humility

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- ◆ At its January 25-26 meeting the FOMC kept rates unchanged at 0-0.25%, as expected, and announced that its quantitative easing program will come to a conclusion in early March. That said, the press conference had a hawkish tone, with the market pricing in a higher risk of more rate hikes as a result.
- ◆ One of the key themes of the press conference was the topic of quantitative tightening, or balance sheet reduction. The FOMC released a set of guiding principles they will follow to announce the size, pace, and the composition of the monthly reductions but many observers remain concerned about the amplitude of the reduction in the balance sheet. We now believe that quantitative tightening will start in Q3, compared to our earlier forecast of it starting in Q4.
- ◆ During the press conference, real yields rose, hurting bonds, gold and stocks. But much is now priced into Fed futures, and we think the bond market will stabilise, with the 10-year Treasury yield remaining in the 1.5-2% range. We maintain our risk-on bias and an overweight to equities as our preferred asset class as US and global growth are supportive of earnings. Indeed, the Fed chair painted a very positive picture of the US economy, especially its labour market.
- ◆ However, he also said the Fed would be humble and nimble, given the uncertainty around inflation. As this can lead to volatility in markets, we suggest investors consider non-correlated asset classes such as hedge funds and focus on building resilient and diversified portfolios.
- ◆ For fixed income investors, we continue to focus on carry opportunities as we believe Treasury yields will continue to trade in a range. We continue to look to high-yield and emerging market credits as an opportunity to improve potential returns. As for the US dollar, the tighter Fed policy and attractive relative interest rates suggest a continued upward glide for the currency.

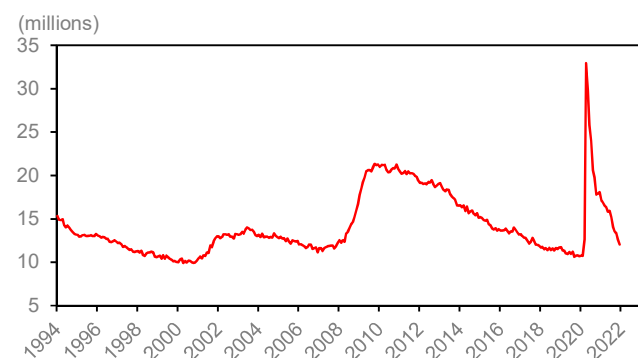
Financial markets have been struggling of late with Omicron and the new outlook for higher interest rates. At its January meeting the Federal Reserve delivered as expected for the most part. The Fed did not raise interest rates but Fed Chairman Jerome Powell said the FOMC is “of a mind to raise rates in March”. The Fed also announced they would continue to taper the quantitative easing program and wrap it up by early March. In addition, the Fed gave some indications that they would begin to unwind the balance sheet at some point after the initiation of rate hikes. The Fed Chairman pointed out that the committee feels that the shift in policy is appropriate to achieve the Fed’s dual mandates and to “promote a long expansion”.

The FOMC

Given the Fed’s dual mandate of achieving maximum employment and stable inflation, the Fed feels the time for normalization has arrived. In terms of the Fed funds rate, while the FOMC kept rates unchanged at this meeting it did suggest that with inflation well above 2% and the labor market still tight “the committee expects it will soon be appropriate to raise the target range for the federal funds rate”. As stated above, Fed Chair Powell suggested at the press conference that March would probably be the first meeting at which rates could be raised. In considering the tapering of its quantitative easing program, “the committee decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March”.

In its January press release the FOMC acknowledged that the Omicron variant has affected the economy in numerous sectors in recent months. Despite the delay in demand this may have created the Fed noted that the economy remains strong, and labor markets remain tight. In terms of inflation, the FOMC pointed to “supply and demand imbalances related to the pandemic and the re-opening of the economy. This has contributed to elevated levels of inflation”.

The available labor force continues to decline



*Available labor force: Unemployed + Not in labor force but looking for a job

Source: Bureau of Labor Statistics and Bloomberg, HSBC Global Private Banking, 26 January 2022. Past performance is not a reliable indicator of future performance.

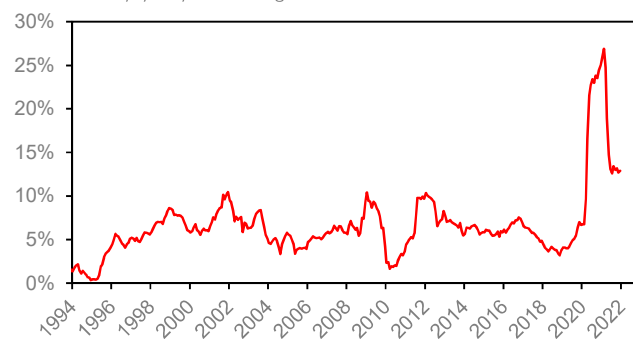
Throughout his press conference Fed Chair Powell continually pointed to the strength in demand and in the labor markets. He noted that the unemployment rate is down to 3.9%, which is very close to the 3.5% trough achieved before the Covid pandemic. He suggested that labor markets were at or near full employment. Moreover, he pointed out that the number of job openings is above the number of unemployed people in the economy suggesting the potential for further labor market tightness and higher wages. On the inflation front, he continued to point to the supply/demand imbalance and how that would be corrected throughout the remainder of the next year. In addition, he pointed to the recent rise in retail inventories suggesting that the inventory rebuild will correct itself in due course.

A balancing act

One of the key themes of the press conference was the topic of quantitative tightening, or balance sheet reduction. The FOMC released a set of guiding principles they will follow to announce the size, pace, and the composition of the monthly reductions in the Fed’s balance sheet. Many observers remain concerned about the size of the reduction in the balance sheet, and the pace at which it could take place. If the pace is too rapid and credit conditions tighten, credit markets could tighten excessively, causing the economy to slow. In addition, the composition of the reduction is of tremendous importance. Given that a high percentage of the Fed’s balance sheet is in shorter duration instruments, market participants will monitor the composition of the reduction and the potential implications for fixed income markets. The Fed Chair suggested that the process would be passive, allowing instruments to roll off the balance sheet, rather than active which would include the outright selling of securities.

The fed is reducing the historic growth in the expansion of the money supply

M2 monthly y-o-y % change

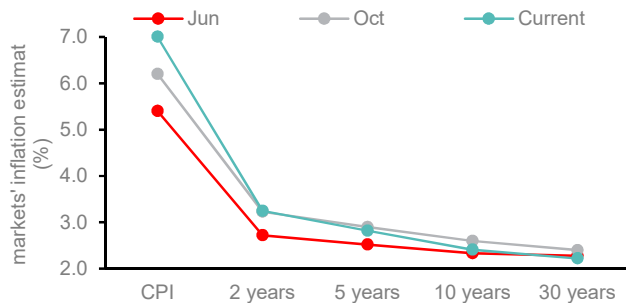


Source: Federal Reserve Bank of St. Louis, HSBC Global Private Banking as at 26 January 2022.

Given the anticipated passive nature of the program it seems like shorter duration instruments might be more heavily skewed in the initial reduction of the balance sheet. This suggests to us

that short term interest rates may rise as the buyer of last resort disappears. In terms of longer-dated maturities, the combination of slowing inflation, strong global demand, and the Fed not liquidating those instruments at the same pace, could keep longer-dated treasuries well bid, long-term interest rates lower, and the yield curve flatter than investors believe. The fact that breakeven expectations remain well anchored suggests that the market is confident that the Fed's actions will ensure that inflation does not spiral out of control or becomes a long term problem. This in turn should help keep the 10-year Treasury yield in a range of 1.5-2%.

Inflation expectations have been rising, but mostly for the short term, helping keep longer dated treasury yields in check



Source: Bloomberg, HSBC Global Private Banking, 26 January 2022. Past performance is not a reliable indicator of future performance.

(Too) many rate hikes are now already priced in, reducing the scope for further upward pressure on Treasury yields



Source: Bloomberg, HSBC Global Private Banking, 26 January 2022. Past performance is not a reliable indicator of future performance.

Investment Summary

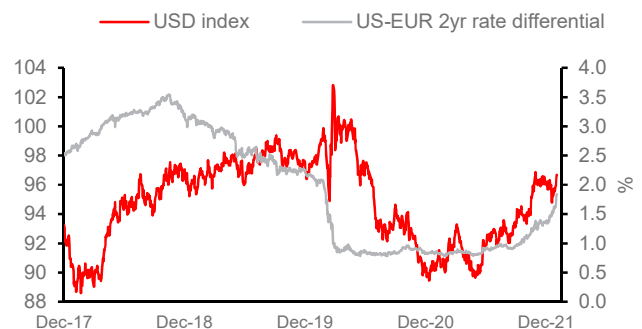
This Fed, under the stewardship of Chair Powell, will remain 'humble and nimble', looking at the data to constantly adjust policy. This more active policy with a clear growth agenda, suggests to us that markets may flip-flop between rewarding growth and relative value opportunities as Omicron fades and the services sector reopens. We maintain our risk-on bias and an overweight to equities as our preferred asset class. However, given the increased volatility in markets and potentially in Fed policy, we suggest investors consider non-correlated asset

classes such as hedge funds at this point in the business cycle. For equity investors, technology shares may remain volatile as bond yields are a key driver of valuations, especially for those companies whose earnings may take longer to deliver than investors may be willing to wait. That said, demand remains strong and as the technology revolution continues to expand we look for earnings to improve and the prospects to remain strong in the sector. In the consumer sector, tight labor markets and strong wage gains suggest good returns for consumer discretionary companies. In addition, the aforementioned reopening of the services sector should help provide jobs for workers and value opportunities for investors. Financials should benefit from an economy that is growing at more than double its historic average, continued strength in M&A, and a housing market that should remain vibrant as the unemployment rate continues to decline and wages remain strong. Finally, the energy sector should provide solid above-market returns. Energy demand remains strong and as the economy reopens should improve markedly. Whether crude oil prices rise or not, continued solid demand, combined with tight refining capacity could keep earnings expanding throughout the sector.

The recent selloff in equity markets has lowered valuations and many investors are now asking if the growth selloff has been more fully priced in. Moreover, many technical equity indicators suggest that negative sentiment has reached levels that suggest that perhaps a rebound may be in the offing. We remain focused on quality companies with high cash levels and low debt service. In addition, companies may lift dividend policies to increase returns to shareholders which could provide relief for income investors.

For fixed income investors, we continue to focus on carry opportunities. With the yield curve remaining flatter we continue to look to high-yield and emerging market credits as an opportunity to improve potential returns. For the US dollar, the tighter Fed policy and attractive relative interest rates suggest a continued upward glide for the currency.

The US dollar benefits from rising interest rate differentials



Source: Bloomberg, HSBC Global Private Banking, 26 January 2022. Past performance is not a reliable indicator of future performance.

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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