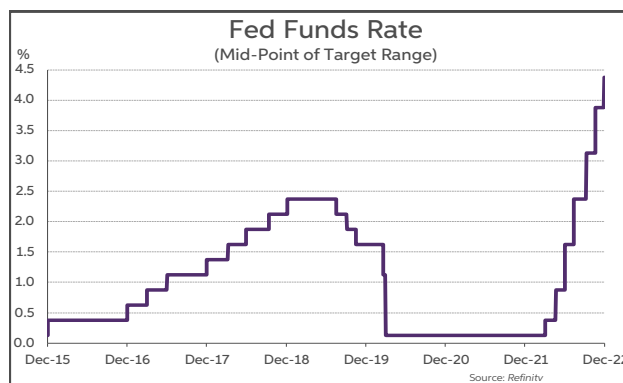


Fed slows rate hikes to 50bps, but more to come in 2023

After the US Federal Reserve had implemented four consecutive 75bps rate hikes since June, the December FOMC meeting saw it move back down to a 50bps rate increase. This brings the target range for the Fed funds rate to 4.25-4.50%. The decision to raise rates by 50bps was unanimous. The Fed has now enacted 425bps worth of rate increases since it commenced its tightening cycle in March of this year. It anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to its 2% target over time. In determining the pace of future increases, the Fed said it will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, as well as economic and financial developments.

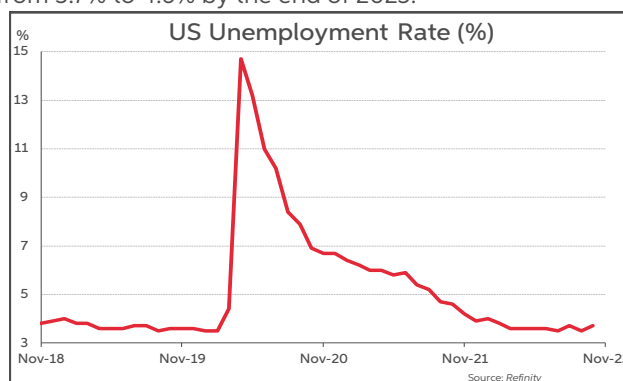


Given that the shift downwards to a 50bps increase was well sign-posted and had been priced in by markets, the main point of interest was on what signals the Fed would provide regarding the magnitude of rate hikes going forward and where they are likely to peak. In this regard, **the latest set of interest rate projections, or dot-plot, provided by the Fed showed that it now sees rates peaking at 5.125% next year, up from 4.625% from its previous forecasts made in September.** The Fed, though, had signalled in recent comments that it saw rates peaking at a higher level than projected in September. It sees rates ending 2023 at 5.125%, and then falling to 4.125% by end 2024 and 3.125% at end 2025. Thus, policy is projected to remain restrictive for the next three years.

Rate contracts firmed slightly after the meeting, but remain a good deal below the Fed projections. Markets are pricing in that rates will peak at 4.875% in the first half of next year, before being cut by 50bps to 4.375% by end 2023. Further out, the markets expect that the Fed will cut rates further to 3.125% by end 2024, which is 100bps below the Fed projection. We would highlight that only two of the eighteen FOMC members are in line with the market view that rates will peak at 4.875%, with seven seeing rates peaking at 5.125%, and seven more projecting rates above this level in 2023. This suggests that **there is a strong bias within the FOMC to take rates above 5% next year.**

A key reason for this hawkish view is revealed in the Fed's latest set of inflation forecasts. The projections for both the headline and core PCE inflation rates were raised to 3.1% and 3.5%, respectively, for Q4 2023 and are seen as still being above target at 2.5% by end 2024. The forecasts are also more downbeat for the economy next year, with the GDP growth rate for Q4 2023 being cut from 1.2% to 0.5% y/y. This points to an economy close to stagnation next year. As a result, the unemployment rate is projected to rise from 3.7% to 4.6% by the end of 2023.

There has been a marked improvement in inflation in recent months. The headline CPI rate is now in decline. It fell to 7.1% in November, down from 7.7% in October and 8.2% in September, well below its peak in June of 9.2%. This reflects falling energy prices, with oil prices well down since mid-year. Commodity food prices have also fallen sharply since the summer, but this has yet to be reflected in consumer prices. Meanwhile, the monthly rise in the core CPI slowed to 0.3% in October and to 0.2% in November.

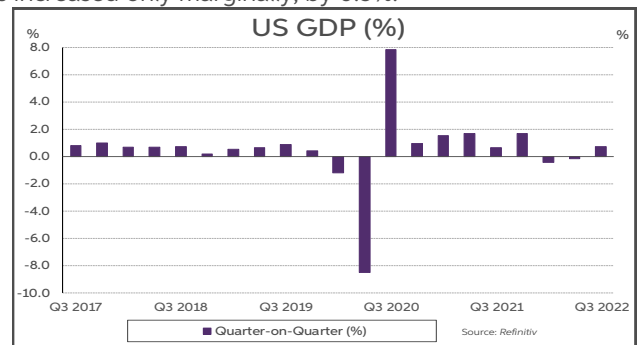


The Fed welcomed the reduction in the pace of price increases seen so far in October and November, but **Chair Powell cautioned that "it will take substantially more evidence to give confidence inflation is on a sustained downward path"**. This suggests the Fed will continue to tighten policy for some time yet and could deliver another 50bps hike at its next meeting on February 1st. It also suggests the Fed is not minded to start cutting rates before end 2023. There was a limited market reaction to the Fed meeting and the new forecasts as the market sticks to its more benign rate view. It suggests the market believes that inflation will fall more rapidly than the Fed anticipates over the course of next year. It will be encouraged by the recent omens in this regard. In particular, there would seem to be greater scope for headline inflation to fall more quickly than the Fed anticipates.

US economy is expected to largely stagnate in 2023

Having contracted by 1.6% in annualised terms in Q1, and by 0.6% in Q2, US GDP expanded by 2.6% in Q3. In the first half of the year, volatility in trade and inventories - a hangover from the supply chain issues caused by the pandemic - led to the fall in GDP. Real final domestic sales (which excludes external trade and inventories), though, increased in both quarters. In Q3, a sharp fall in imports as businesses had already rebuilt their stock levels, boosted the headline GDP figure. However, real final domestic sales increased only marginally, by 0.5%.

Regarding the breakdown of GDP for Q3, consumption grew by 1.4%, contributing 1.0 percentage points (p.p.) to growth. Investment fell sharply knocking 0.9 p.p. from the total, largely due a large 26% decline in residential investment. Government boosted output for the first time since Q1 2021, adding 0.4 p.p. to GDP, in part due to a pick-up in defence expenditure. Elsewhere, exports increased by 14% and imports fell by 7%, meaning net trade added a combined 2.8 p.p. to growth. Meanwhile, inventories, clipped 0.7 p.p. from GDP.

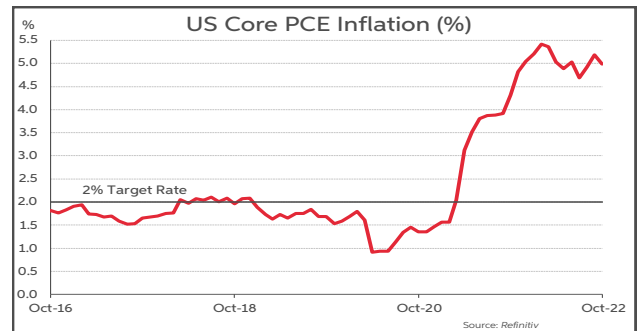


The hard data available for October have been somewhat mixed. Retail sales rose by a strong 1.3% in October, with core sales rising by a healthy 0.7% also. Auto-sales jumped sharply higher by 6.9% in the month. Meanwhile, solid income growth of 0.7% in October, as well as a further run-down in the large swell of savings accrued during the pandemic, saw personal consumption rise by 0.5% in real terms at the start of Q4. Elsewhere, industrial production which has been largely stagnant since August, fell by 0.1% in October. Housing data remain weak also.

Most survey data suggest the economy has lost momentum in October and November. The manufacturing PMI declined to 50.4 in October and to 47.7 in November, its lowest level since May 2020. The manufacturing ISM also moved lower, to 50.2 in October and 49.0 in November. Meanwhile, the services PMI slumped to 46.5 in October/November, though the services ISM has been much stronger at 54.4 in October and 56.5 in November. Consumer confidence remains very weak, with the Michigan measure of consumer sentiment staying moribund near its all-time lows. Overall, the expectation is that GDP will expand at a modest pace in Q4, despite the weak PMI data.

Meantime, labour market conditions remain very tight against the backdrop of continuing strong job growth. Payrolls have been increasing at a rapid pace, rising by circa 3.8m in the first three quarters of the year. They posted further strong gains of 284k in October and 263k in November. The unemployment rate fell to a 29-month low of 3.5% in September, before edging up to 3.7% in October/November. The tight conditions in the labour market have placed strong upward pressure on wages, with growth in average hourly earnings continuing to rise at circa 5.0% year-on-year in recent months.

Meanwhile, inflation has proved to be much stronger than expected this year, but the headline rate is now in marked decline. It fell to 7.1% in November, down from 7.7% in October and 8.2% in September, well below its peak in June of 9.2%. This reflects falling energy prices, with oil prices well down since mid-year. Food prices continue to rise strongly though, up 10.3% y/y in November. Meantime, core CPI has been sticky, largely running in a 6.0-6.5% range this year. However, the monthly rise slowed to 0.3% in October and 0.2% in November. Core-PCE inflation stood at 5% in October, the same rate as at end 2021. It is expected to move back slowly towards the 2% target level in the next couple of years. The latest Fed projections, published at this month's meeting, show core-PCE inflation easing to 3.5% by Q4 2023 and 2.5% in Q4 2024.



Having expanded by a robust 5.7% in 2021, the US economy has grown much more slowly this year. Very high inflation is weighing on real household incomes and consumer spending power. The Fed has raised rates by 425bps while financial conditions have also tightened significantly, since the start of the year. The housing market in particular has come under severe pressure from higher interest rates. Meantime, the global economy has weakened considerably. The strong jobs market remains the main bright spot in the economy. The risks of a recession in 2023 are rising, with the economy expected to be at best largely stagnant. The updated Fed forecasts are for the economy to grow by 0.5% y/y to Q4 2023. The OECD is forecasting GDP growth will average 0.5% in 2023, with growth at 0.2% y/y in Q4, pointing to a stagnant economy next year.

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