Special Coverage: Hawkish Fed cut leads to market repricing of rate path ahead

Key takeaways

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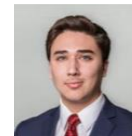

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- As expected, the Federal Reserve cut the Fed funds rate by 0.25% to a range of 4.25 - 4.50%. However, its economic and rate projections, the meeting statement and Mr. Powell's press conference were all more hawkish than expected. The Fed surprised markets as it now projects to cut rates only two times next year, as opposed to the four times it had forecasted in September. We now forecast a 0.25% rate cut at its March, June and September policy meetings in 2025.
- Fixed income returns could remain more muted and volatile given the reduction in rate cuts we expect, and the likely volatility in rate assumptions as we get more economic data and clarity about the policies of the next administration. When the dust settles, our view is that yields will be lower.
- The fundamentals remain constructive for US equities. Given the strong economy and secular drivers of profit growth, volatility could create an opportunity. However, with a less aggressive Fed easing cycle, the upside clearly has to come from earnings, not valuation multiples. The good news is that earnings expectations – especially outside of the Magnificent 7 – are low, providing a low bar to exceed.

What happened?

- As expected, the Federal Reserve cut the Fed funds rate by 0.25%, taking the Fed funds rate range to 4.25 - 4.50%.
- However, for 2025, the Fed now projects to cut rates only two times, as opposed to the four times it had earlier forecasted in September. The FOMC has made it clear that they will ease more slowly, extending the Fed easing cycle into 2027.
- As per Summary of Economic Projections (SEP), inflation is expected to accelerate in 2025 to 2.5% from 2.4% in 2024.
- Moreover, the FOMC believes inflation risks are now more skewed to the upside. It now believes to achieve its 2% target in 2026, as opposed to 2025 that it forecasted at its September meeting.

Median of the FOMC economic projections, December 2024

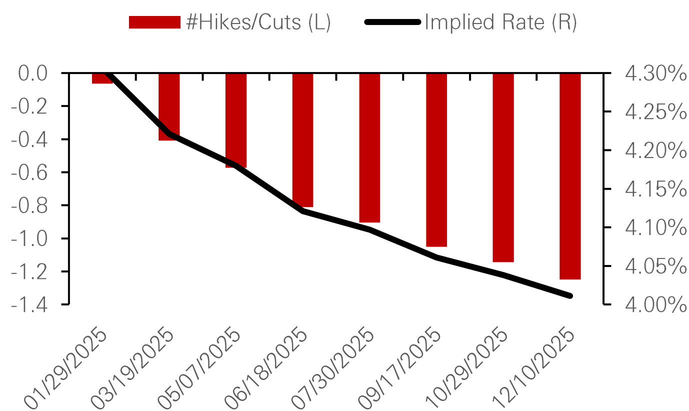
Variable %	Median				
	2024	2025	2026	2027	Longer run
Change in real GDP	2.5	2.1	2.0	1.9	1.8
September projection	2.0	2.0	2.0	2.0	1.8
Unemployment rate	4.2	4.3	4.3	4.3	4.2
September projection	4.4	4.4	4.3	4.2	4.2
PCE inflation	2.4	2.5	2.1	2.0	2.0
September projection	2.3	2.1	2.0	2.0	2.0
Core PCE inflation	2.8	2.5	2.2	2.0	
September projection	2.6	2.2	2.0	2.0	
Memo: Projected appropriate policy path					
Federal funds rate	4.4	3.9	3.4	3.1	3.0
September projection	4.4	3.4	2.9	2.9	2.9

Source: Bloomberg, HSBC Global Private Banking and Wealth as at 18 December 2024.

- The Committee judges that the risks to achieving its employment and inflation goals are roughly in balance. Balance sheet reduction should continue as the FOMC will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities.

- The FOMC reported, "Recent indicators suggest that economic activity has continued to expand at a solid pace. Labour market conditions have generally eased, and the unemployment rate has moved up but remains low." The SEP points to even faster, and above-trend economic growth.
- "Inflation has made progress towards the Committee's 2 percent objective but remains somewhat elevated". The SEP points to elevated inflation, which can take longer to achieve its target inflation range.
- Changes were made to the FOMC forecasts, mostly reflecting the reality of faster economic growth and stickier inflation.

Market-implied Fed policy expectations for 2025



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 18 December 2024.

- Significantly, the FOMC changed its outlook for 2025 for the Fed funds rate. It now forecasts only 0.5% of further easing in 2025 as opposed to the 1% of easing it expected in September. For 2026, they kept a similar profile of rate cuts, reducing the Fed funds rate by 0.5%. Then in 2027, they have now included another 0.25% rate cut, taking the longer-term Fed funds rate to 3%, which is similar to their September forecast. We forecast 0.75% of rate cuts from the Fed in 2025, delivered in 0.25% steps at the March, June and September policy meetings.
- The FOMC forecast for 2024 real economic growth was revised up to 2.5% from 2.0% at the September meeting. Longer-term growth forecasts remain unchanged.

Investment implications

- Dollar strength should continue as other central banks could ease more aggressively, causing USD to benefit from an attractive rate differential. The fundamentals remain supportive for US dollar-denominated investors. Economic growth remains healthy and well above the long-term trend.
- The technology revolution is just beginning and the productivity enhancing technologies that will diffuse throughout the economy should lift growth, reduce costs and expand profitability.
- The re-industrialisation of the US continues, and construction of new manufacturing facilities remains quite strong. Near/onshoring of jobs and the securing of supply chain remain a major theme for US corporations. This will continue to be a factor in stabilising the labour markets and creating wealth.
- Fixed income returns could remain more muted as rates should now fall more slowly with the extension of the monetary policy easing cycle.
- The fundamentals for US equities remain quite constructive. The recent fall can be a good opportunity to increase exposure. However, with a less aggressive Fed easing cycle, the slightly more hawkish tone on the monetary policy will have to be offset by increased fiscal stimulus (lower income tax rates) and better economic growth, which the Fed is forecasting. This would allow the earnings-led bull market to broaden out.
- From a sector perspective, interest rate relief will probably be less dramatic, and the growth imperative remains. Interest rate-sensitive sectors should see a less emphatic stimulus from lower market rates. The growth emanating from a technology revolution should be positive for the Technology, Communications Services, and Healthcare sectors. The increased demand for energy should be positive for Industrials.
- Lower interest rates, a positive slope to the yield curve, and less regulation should culminate in better economic growth, increased M&A and possibly more IPOs, all of which would be positive for the Financial sector.

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