INVESTMENT STRATEGY WEEKLY VIEW

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THE FED TURNS LESS DOVISH THAN EXPECTED

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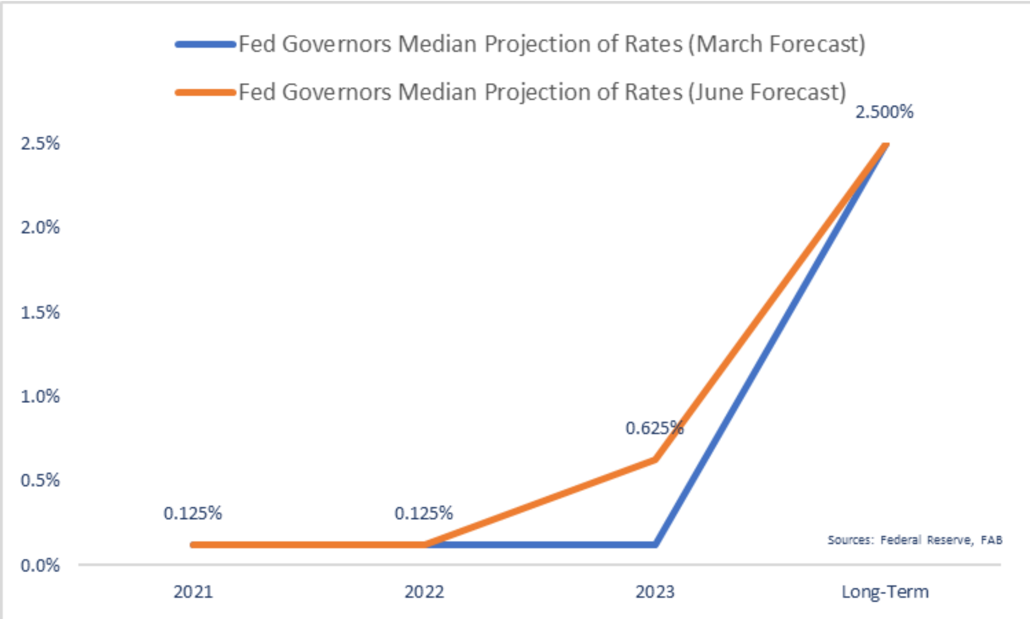
- The median forecast among Fed economists shifted to expect two rate hikes in 2023.
- All 18 Fed forecasters also expressed uncertainty about the path of inflation.
- The policy divergence between the US, Europe and Japan is pushing the dollar higher.
- The FAB AAC is overweight in equities, IG and EM bonds. It is also underweight cash and neutral in gold.



The median forecast of Fed economists now indicates two possible hikes in 2023

The words, models, forecasts and decisions of the Federal Reserve can be among the most powerful determinants of the short-term direction of markets. Last week, the Fed surprised global investors after the median forecast of its economists indicated the possibility of two rate hikes in 2023, a shift from the previous forecast, which showed no hikes that year.

For such a scenario to come to fruition, the Fed would have to start reducing its extraordinary monetary easing measures in the coming months. And, indeed, Fed Chairman Jerome Powell admitted that the central bank had started talking about talking about tapering asset purchases.

The shift was driven mostly by a change in the way Fed forecasters saw inflation. All the 18 economists that contribute their view to the summary of economic projections, from which investors glean the so-called dot-plot, said the path for inflation ahead was uncertain. Such high uncertainty is new.

They also indicated they saw potentially higher average inflation this year and next. In fact, the whole picture shifted higher. The median projection for GDP growth in the US this year moved to 7% from 6.5% in March and while the economists do not expect growth to shift next year, they are now projecting expansion of 2.4% in 2023 versus 2.2% in the previous set of forecasts. Furthermore, they changed their expectations for unemployment to 3.8% at the end of 2022 from 3.9% previously. The big change, however, was on the inflation front. The economists now project core PCE at 3.4% this year, compared to 2.4% in the March projections.

Given the latest inflation numbers, it is easy to see why the Fed is worried about consumer prices. The core PCE, the inflation measure the Fed watches, came in higher than expected in March and April, hitting multi-year highs. May numbers will be available this week and, while they are expected to show a deceleration from the 0.7% month-on-month figure of April, they are still expected to show a yearly pace of close to 3.4%.

This is far higher than the 2% target the Fed has set for itself. While the new framework of the Fed allows it to let inflation run hot for an undefined period of time, the central bankers are clearly getting concerned. The trouble, however, is that their concern can become an issue for broader markets.

Indeed, the Dow Jones Industrial Average had its worst week since October, falling five days in a row and dropping 3.45% in the period. The S&P 500 fared slightly better, down 1.91% for the week, thanks to the heavier weighting of some large cap technology stocks. The NASDAQ Composite outperformed and ended down only by 0.28%, as investors narrowed some of the gap that value stocks have opened in relation to growth companies since August of last year.

The bond market initially reacted as expected and the yield on the 10-year US Treasury jumped 8.3 basis points on Wednesday, following the Fed's statement and the publication of the summary of economic projections, showing the forecast of two rate hikes in 2023.

The move in bonds, however, reversed the next day in a sign that investors who have made bearish positions in long-term rates may have found a good reason to take profits. The yield on 10-year US Treasuries ended the week 1.4 basis points lower than where it was a week before the Fed meeting at 1.44% after falling 13.7 basis points on Thursday and Friday.

The move was not the same across the US Treasury curve, however. Yields on two-year notes jumped 10.7 basis points throughout the week. This left the Treasury curve a lot flatter than where it was a few weeks ago.

While it may be counterintuitive at first, the move makes sense. The Fed has most power over short-term rates and the one it determines in its Federal Open Market Committee meeting is the overnight rate. Hence, the possibility of higher short-term rates earlier than expected should entail higher two-year US Treasury yields.

The trouble is that between August and March, volatility in the short-end of the Treasury curve was very low because of expectations that the Fed would keep short-term rates anchored, while rising inflation was pushing volatility in the 10-year Treasuries higher. This had moved several hedge funds to sell volatility in the short end of Treasuries and buy it in the long end, in so-called 'steepener' trades. That trade, however, stopped working a few weeks ago and investors have since been reversing their curve-steepening trades, it seems.

While the bond market may not be behaving as it would initially be expected, the currency markets are. The US dollar index jumped 1.84% last week, its biggest move upwards since September. This may be explained in part by the Fed's hawkish position, but also is a result of the European Central Bank's dovish stance. The jump in the US dollar index had begun a week earlier after the euro dropped 0.53% on June 11th, following a pledge by the ECB to accelerate its plans for asset purchases, suggesting the opposite direction to the Fed's.

Such policy divergence is likely to attract more investments in US assets, which are likely to offer higher yields in the future. For now, though, the opposite is true, particularly for bonds.

The prospect of rising interest rates in the US means sooner or later investors should expect higher yields in bonds in the country, which means they would drop in price. Meanwhile, the opposite is true in Europe, where the prospect of more bond purchases should push prices higher, particularly for the bonds of peripheral countries such as Italy and Greece.

The move in the currency, however, could simply signal that investors are reversing some carry trades. One of the side effects of the Fed's asset purchase program has been a lot of dollar liquidity, which has made it ultra-cheap to hedge against moves in the US currency and made it worth even to borrow in higher dollar rates to invest in European bonds. The possibility of fewer asset purchases by the Fed should lead to less dollar liquidity and higher hedging costs. Meanwhile, the opposite is true for the euro.

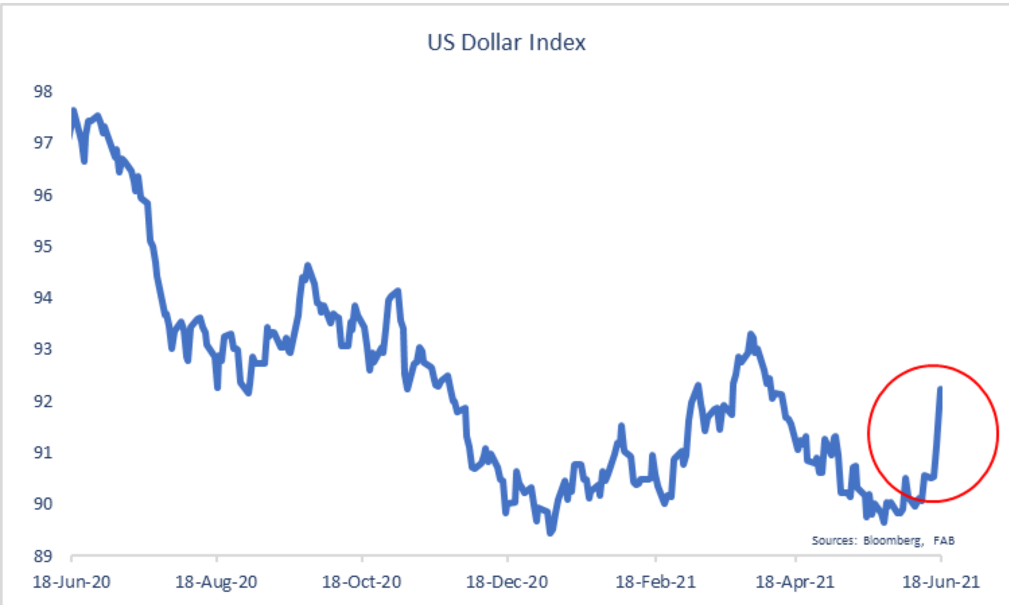
One issue with a higher dollar is the impact it can have on emerging markets and commodities. Both tend to have an inverse correlation with the US dollar and a rising dollar would normally bode ill for the asset class.

That correlation, however, does not always hold, particularly in periods of high growth. Emerging market growth tends to move in the same direction as that of developed nations, the US in particular, but just at a higher rate. Hence, the expectation expressed in the Fed projections that US growth will be above average this year and the next suggests that the backdrop continues to favour emerging market assets. Something similar can be said about commodities.

For the time being, however, commodities were hurt by the rising dollar and the forecast of higher rates in the US. The Bloomberg Commodity index fell 4.27% last week, pushed by raw materials such as copper and lumber. The MSCI Emerging Markets stock index, similarly, fell 1.5%.

The higher global growth ahead, however, suggests that both commodities and emerging market assets may just be starting their rally. Hence, a temporary retreat may provide a good opportunity to add exposure to them.

The US dollar index had its biggest weekly jump since September after the FOMC



Asset Class	Positioning	Detail
Cash	Underweight	Putting cash to work in risk assets.
Fixed Income	Overweight	Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds
Equities	Overweight	Slightly overweight in Asia ex-Japan and US markets.
Alternatives	Underweight	However, reducing the underweight in hedge funds