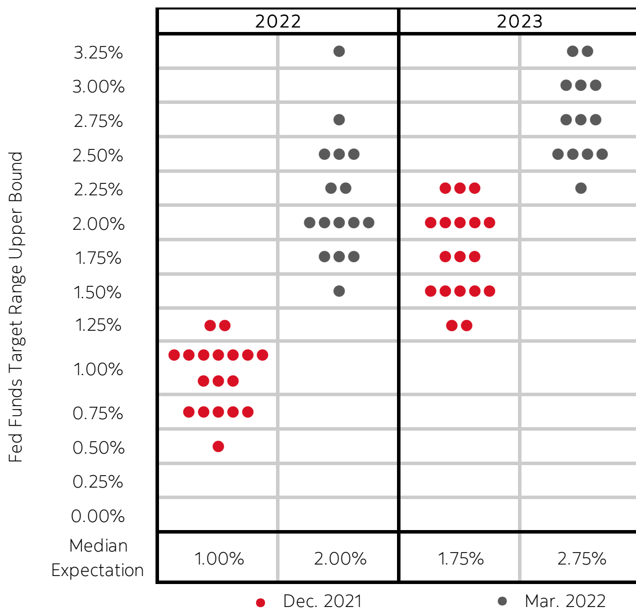
Here's What We're Thinking

Investment Strategy

Despite tighter policy and geopolitical risks, the Fed forecasts a "soft-landing" with little effect on growth or employment. The U.S. Federal Reserve raised the target range for the federal funds rate by 25 bps in a widely expected move this week and set out a more aggressive path for policy normalization than we and consensus had predicted. The median projection in the updated "dot plot", which shows each member's interest rate forecast, signaled six more hikes this year, and the Federal Open Market Committee's (FOMC's) policy statement indicated that ongoing increases in the target range will be appropriate. That said, the FOMC intends to remain data-dependent and to consider a wide range of information when making decisions, including readings on public health, labour market conditions, inflation pressures and expectations, and financial and international developments. The two personal consumption expenditures (PCE) and one consumer price index (CPI) inflation readings expected between now and the Fed's next decision, on May 4th, will likely determine the size of the central bank's next move. Speeches by FOMC leadership (Jerome Powell, Lael Brainard, and John Williams) may also provide a window into the committee's thinking. Investors may also pay attention to Mary Daly, President of the San Francisco Fed, who has emerged as an FOMC bellwether.

Figure 1: FOMC participants expect policy to tighten more quickly as inflation continues to run well above target



Sources: Scotia Wealth Management, Bloomberg, U.S. Federal Reserve

The FOMC's updated summary economic projections showed a significant cut to 2022 growth expectations (2.8% vs. 4.0% previously) but no change to 2023 (2.2%) or 2024 (2.0%) forecasts. The unemployment rate outlook was unchanged at 3.5% across the forecast horizon. Unsurprisingly, the committee marked up all of inflation estimates, most notably this year's. From our perspective, the new forecasts are confusing insofar as they call for higher inflation and tighter policy than the Fed's prior forecasts did, but no change to unemployment or longer-term growth estimates. The current estimates predict the oft-discussed "soft-landing" wherein policy is normalized rapidly but has only a limited effect on the real economy. In his press conference, Fed Chair Jerome Powell made numerous references to the strength of the U.S. economy and labour market. While we agree with this characterization, we believe the inflation and monetary policy tightening anticipated by the Fed would crimp growth and employment. We continue to believe the Fed will raise rates fewer than the seven times the market is pricing in this year, announce the terms of its balance sheet reduction (quantitative tightening, or QT) in May, and start QT in June.

Equities

A new phase of government support provides some relief to Chinese equities. Chinese stocks have been hard hit this year on the back of economic growth risks and tougher regulations for real estate and internet companies. However, the Chinese government is taking action to stabilize domestic financial markets and foreign-listed Chinese equities by promising to ease regulatory crackdowns, support property and technology companies, and stimulate the Chinese economy. The Financial Stability and Development Committee (FSDC), China's most powerful financial policy body, concluded earlier this week that there is a need to "boost the economy" in 1Q22. It promised investors relief on several regulatory fronts and said monetary policy will be proactive this quarter and that new loans will grow appropriately.

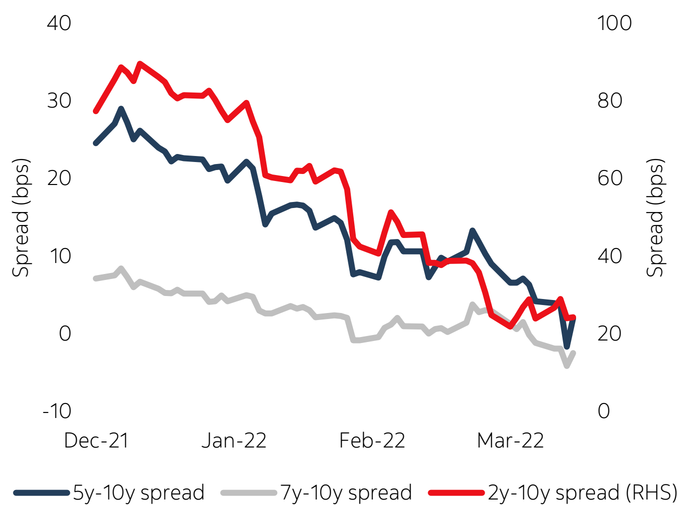
Moreover, at China's annual parliamentary meeting earlier this month, Beijing decided to put some long-term reforms on hold to focus on economic growth. Policymakers said this year's ambitious economic growth target of around 5.5% would be achieved mainly through looser fiscal policy, with officials remaining hawkish on the property market and debt growth. Reports of progress on an agreement with the U.S. on audit supervision under the *Holding Foreign Companies Accountable Act* (HFCAA) boosted sentiment related to the American Depositary Receipts (ADRs) of Chinese companies. Still, the volatility in Chinese ADRs may persist due to China's ties to Russia and the delisting uncertainty created by the HFCAA.

Fixed Income

Treasury yield curves flattened following Wednesday's FOMC decision, meaning the difference between long and short-term

bond yields narrowed. This suggests bond traders expect the Fed's policy tightening to slow the economy. This is a concern because the economy was showing signs of rolling over even before the Fed tapped the brakes. If data keep weakening, expect curves to flatten further or even invert (short yields exceed long ones). Then the Fed will need to decide if it is willing to risk recession to curb inflation. The shape of a yield curve is frequently measured as the difference between a government's 10 and 2-year bond yields. This spread is also a widely accepted recession indicator. Over the last five decades, 20 months, on average, have elapsed between initial yield curve inversion and the beginning of a recession in the United States.

Figure 2: Segments of the U.S. yield curve have inverted, but the bellwether 2-10 spread remains positive



Sources: Scotia Wealth Management, Bloomberg

Segments of the yield curve have already inverted, with the 7-year–10-year (7-10) spread trading in negative territory for the past week and the 5-10 spread dropping below zero briefly after the Fed decision. For now, we think the risk of a recession in the U.S. is low, but overly aggressive monetary policy tightening throughout the year, spillover risks from the war in Ukraine, and multi-decade high inflation could cause the economy to contract. The first of these factors would lead to higher yields at the short end of the curve as investors priced in policy rate hikes, while the latter two could prompt investors to seek the relative safety of U.S. Treasury securities, leading to lower long-end yields.

Economics

A dovish hike from the BoE weighs on the British pound, as policymakers tie the policy rate outlook to the balance of inflation and growth risks. The Bank of England (BoE) raised its policy rate 25 bps this week but softened its commitment to continue tightening in the coming months. The Monetary Policy Committee (MPC) voted 8-1 to raise the BoE's benchmark interest rate to 0.75% from 0.50%, as was widely expected. One dissenting vote favoured no change. The MPC tempered its forward interest rate guidance, saying that tighter monetary policy "may be appropriate" rather than "is likely", as it had said in past. This suggests policymakers now have less appetite than they did previously to push ahead with higher rates. The MPC added, "there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve". If the war in Ukraine escalates and energy and food costs spiral higher, we would expect the MPC to stand still in May, given the corrosive effect higher policy rates would have on economic growth. Conversely, if the situation deescalates, we believe the MPC would be comfortable raising rates in the second half of the year. The BoE sees inflation peaking at "around 8%" in 2Q, up from 7% in its February forecast. A further spike is possible in October, when the U.K.'s energy regulator, the Office of Gas and Electricity Markets, resets the energy price cap.

Geopolitics

The U.S. dollar is likely not in danger, but reserve diversification may be attractive for some countries. Western countries have responded to the invasion of Ukraine with sweeping economic sanctions against Russia and its most powerful individuals. A large chunk of Russia's US$630 billion in foreign reserves are frozen, major credit card and payment firms have suspended service in the country, and many other companies have ceased operations. Cutting Russia off from the global financial system has sparked debate about the future of the U.S. dollar. The greenback, backed by the United States' growing and productive economy and military might, has served as the world's reserve currency since the 1944 Bretton Woods agreement, and nearly 60% of the world's US$12.8 trillion in foreign currency reserves are denominated in U.S. dollars. China's GDP per capita stands at about one-sixth that of the United States', and the Chinese yuan's value is based on China's economic growth, which is expected to slow to just 5.5% in 2022. While China needs its manufacturing engine humming to maintain baseline economic growth, the country has struggled to foster more productive service industries to enhance its growth profile.

We do not believe the U.S. dollar is in danger of being supplanted as the global reserve currency in the near term, but a move away is conceivable. For example, the yuan has been boosted by reports that Saudi Arabia is in talks with Beijing to price some oil sales in the Chinese currency. A deal between the world's biggest producer and importer of oil could undermine the dominance of the U.S. dollar and the Euro in global energy markets. However, discussions between China and Saudi Arabia about pricing oil contracts in yuan have been on and off over the past few years, and there is still little to suggest that there has been any concrete progress toward an agreement. However, the most significant headwind to the yuan's internationalization is its inconvertibility in most places in the world, and Chinese policymakers are unlikely to give up control of the country's currency and expose it to outside forces.

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