HongLeong Bank

11 December 2023

Global Markets Research

Research Alert

Would looser financial conditions alter the Fed's path?

Tighter financial and credit conditions were being cited as the Fed paused in November

Persistent change in financial conditions can have implications for monetary policy path

We expect Fed to stay pat until mid-2024; vs market expectations for a cut in 1Q of 2024

Tighter financial conditions took centre stage for Fed's latest pause

In its latest monetary policy meeting on October 31-November 1, tighter financing conditions were the key to FOMC's decision to maintain the target range for the federal funds rate at 5.25-5.50%. According to the statement, policy makers agreed that "***tighter financial and credit conditions*** for households and businesses are likely to weigh on economic activity, hiring, and inflation but that the extent of these effects was uncertain."

This is in contrast with its previous two statements that "***tighter credit conditions*** for households and businesses which are likely to weigh on economic activity, hiring, and inflation." Largely being blamed for the tightened financial conditions were expectations of hawkish Fed pause and accompanying it, higher Treasury yields during that period of time. Using the Goldman Sach's US Financial Conditions Index (FCI) as a gauge, the index rose from 99.41 on July 25th (Fed last raised rates by 25bps during to July 25-26 meeting) to 99.96 (Fed stayed pat on September 19-20) to its peak of 100.74 on October 27th when the Fed added the tighter financial conditions in the statement.

Traders slashed chance of further rate hikes and brought forward expectations of the first rate cut to 1Q of 2024

Immediately after that, traders, using the Fed funds futures as a benchmark, effectively cut their expectations of the last rate hike in December to nil and expectations of a rate cut was brought forward to 1Q from May 2024. Fed Chair Jerome Powell has said that the FOMC is attentive to the increase in longer-term yields and a ***persistent change*** in tightening of broader financial conditions ***can have implications for the path of monetary policy*** in the press conference but since then, the index has fallen to 99.76 at the point of writing, signalling easing financial condition, largely driven by the pullback in yields and USD.

Financial conditions have eased; No change to our view that Fed will maintain status quo in 1H, first cut only in mid-2024

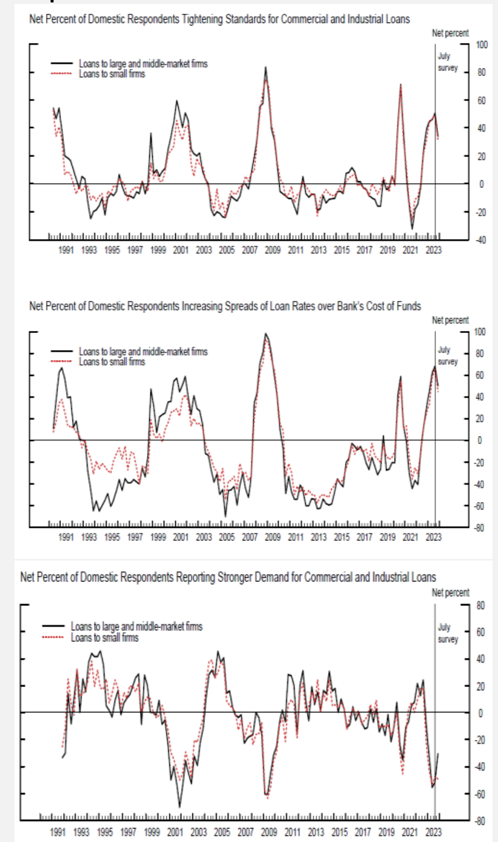
In line with consensus view, we expect the ***Federal Reserve to maintain its Fed funds target rate at 5.25-5.50% when they next meet on December 12-13*** but unlike consensus, ***we do not expect the first Fed funds rate cut to begin until mid-2024***. On top of the retreat in FCI close to its July levels, other factors supporting this includes:

1. **Upside risks to inflation and inflation expectations despite moderating trend.** The University of Michigan's inflation expectations (and oil prices) remained volatile despite moderating trend. Year-ahead inflation expectations plunged from 4.5% last month (highest since April 2023) to 3.1% this month, while long-run inflation expectations eased to 2.8% from November's 3.2% (highest since 2011). The latter remained elevated relative to the 2.2-2.6% range seen in the two years pre-pandemic. Fed is also expecting core inflation to remain above the 2.0% target at 2.6% in 2024 and 2.3% in 2025

Figure 1: US Financial Conditions Index has loosened again

Source: Bloomberg, Goldman Sachs

Figure 2: Supply & demand for commercial and industrial loans -Tightening of standards less reported by large banks, most widely reported for premiums on riskier loans



Source: Federal Reserve

2. IMF has pointed out that near-term expectations are critical to understanding inflation dynamics and explain a growing share of inflation since 2022. Secondly, historical episodes characterized by initial periods of persistently rising expectations suggests that inflationary expectations will come down only slowly. In these cases, **it took about three years for inflation and near-term expectations to return to their pre-episode levels.** Considering that the Fed only started hiking in March 2022, this suggests that the battle with inflation can only be won in early 2025. (The latest Fed dot plot indicated a 50bps rate cut in the median Fed funds rate from 5.625% in 2023 to 5.125% in 2024)

3. **Credit conditions may have eased but remain tight.** In the October 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), survey respondents reported tighter standards and weaker demand for commercial and industrial (C&I), commercial real estate, and on the household front, residential real estate (RRE) loans other than government residential mortgages as well as for home equity lines of credit (HELOCs), credit card, auto, and other consumer loans.

   The survey also revealed that banks were less likely to approve credit card and auto loans for borrowers with FICO scores of 620 and 680 in comparison with the beginning of the year, while they were more likely to approve credit card loan applications and about as likely to approve auto loan applications for borrowers with FICO scores of 720 over this same period. (*For information purposes, FICO scores of 670-739 are classified as "Good", 740-799 as "Very good" and 800-850 as "Excellent").* **Most commonly cited reasons for changing standards for all loan categories in 3Q were a less favorable or more uncertain economic outlook; reduced tolerance for risk; deterioration in the credit quality of loans & collateral values as well as concerns about funding costs.**

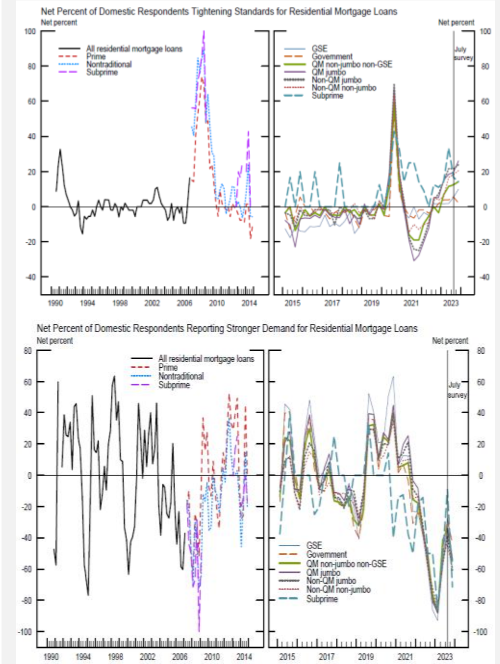
4. **Still resilient economic numbers despite some moderation.** Unemployment rate has stayed low at 3.7%, while noting that gains in non-farm payroll has slowed to 199k in November. The economy also expanded at a faster pace of 5.2% in 3Q, as compared to +2.0% in 2Q as the manufacturing sector has started to improve while the services sector moderated, albeit remained expansionary. On the demand side, the increase in real GDP reflected increases in consumer spending, exports and residential fixed investment.

Latest economic figures available just before FOMC meetings

	Jul 25-26	Sep 19-20	Oct 31-Nov 1	Dec 12-13 (Latest)
FOMC rate decision	+25bps	No change	No change	
GDP (Annualized q/q, %)	2.0	2.1	4.9	5.2
Retail sales (% m/m)	0.2	0.6	0.7	-0.1
ISM – Manufacturing	46.0	47.6	46.7	46.7
ISM – Services	53.9	54.5	53.6	52.7
Gains in non-farm payroll	209k	187k	336k	199k
Core-PCE prices (y/y%)	4.6	4.2	3.7	3.5
1Y inflation expectations (%)	3.4	3.1	4.2	3.1

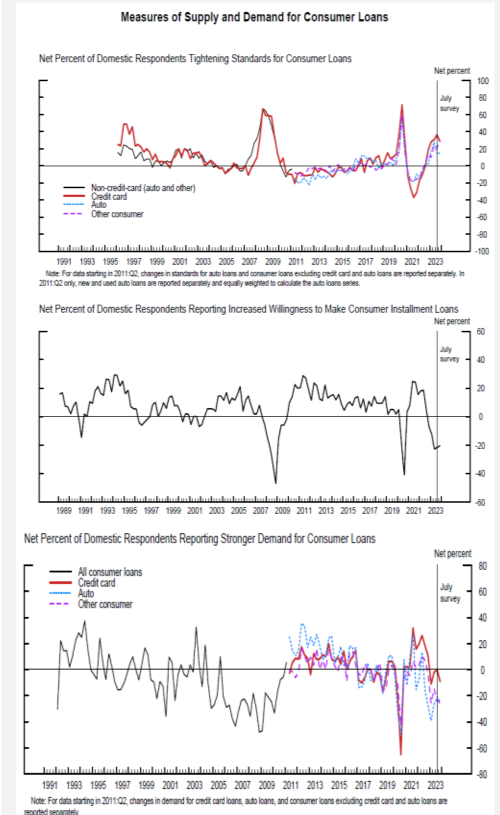
Source: Bloomberg

Figure 3: Supply & demand for residential mortgages – Major net shares of banks reported weaker demand, tightened lending standards across all categories



Source: Federal Reserve

Figure 5: Supply & demand for consumer loans - Significant net shares of banks reported weaker demand for auto and other consumer loans



Source: Federal Reserve

Hong Leong Bank Berhad
Fixed Income & Economic Research, Global Markets
Level 8, Hong Leong Tower
6, Jalan Damanlela
Bukit Damansara
50490 Kuala Lumpur
Tel: 603-2081 1221
Fax: 603-2081 8936
Email: HLMarkets@hlbb.hongleong.com.my

DISCLAIMER

This report is for information purposes only and does not take into account the investment objectives, financial situation or particular needs of any particular recipient. The information contained herein does not constitute the provision of investment advice and is not intended as an offer or solicitation with respect to the purchase or sale of any of the financial instruments mentioned in this report and will not form the basis or a part of any contract or commitment whatsoever.

The information contained in this publication is derived from data obtained from sources believed by Hong Leong Bank Berhad (“HLBB”) to be reliable and in good faith, but no warranties or guarantees, representations are made by HLBB with regard to the accuracy, completeness or suitability of the data. Any opinions expressed reflect the current judgment of the authors of the report and do not necessarily represent the opinion of HLBB or any of the companies within the Hong Leong Bank Group (“HLB Group”). The opinions reflected herein may change without notice and the opinions do not necessarily correspond to the opinions of HLBB. HLBB does not have an obligation to amend, modify or update this report or to otherwise notify a reader or recipient thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

HLB Group, their directors, employees and representatives do not have any responsibility or liability to any person or recipient (whether by reason of negligence, negligent misstatement or otherwise) arising from any statement, opinion or information, expressed or implied, arising out of, contained in or derived from or omission from the reports or matter.

Potential and actual conflict of interest may arise from the activities of HLB Group. HLB Group constitute a diversified financial services group. These entities engage in a wide range of commercial and investment banking, brokerage, funds management, hedging transactions and other activities for their own account or the account of others. In the ordinary course of their business, HLB Group may effect transactions for their own account or for the account of their customers and hold long or short positions in the financial instruments. HLB Group, in connection with its business activities, may possess or acquire material information about the financial instruments. Such activities and information may involve or have an effect on the financial instruments. HLB Group have no obligation to disclose such information about the financial instruments or their activities.

The past performance of financial instruments is not indicative of future results. Whilst every effort is made to ensure that statements of facts made in this report are accurate, all estimates, projections, forecasts, expressions of opinion and other subjective judgments contained in this report are based on assumptions considered to be reasonable as of the date of the document in which they are contained and must not be construed as a representation that the matters referred to therein will occur. Any projections or forecasts mentioned in this report may not be achieved due to multiple risk factors including without limitation market volatility, sector volatility, corporate actions, the unavailability of complete and accurate information. No assurance can be given that any opinion described herein would yield favorable investment results. Recipients who are not market professional or institutional investor customer of HLBB should seek the advice of their independent financial advisor prior to taking any investment decision based on the recommendations in this report.

HLBB may provide hyperlinks to websites of entities mentioned in this report, however the inclusion of a link does not imply that HLBB endorses, recommends or approves any material on the linked page or accessible from it. Such linked websites are accessed entirely at your own risk. HLBB does not accept responsibility whatsoever for any such material, nor for consequences of its use.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. This report is for the use of the addressees only and may not be redistributed, reproduced or passed on to any other person or published, in part or in whole, for any purpose, without the prior, written consent of HLBB. The manner of distributing this report may be restricted by law or regulation in certain countries. Persons into whose possession this report may come are required to inform themselves about and to observe such restrictions. By accepting this report, a recipient hereof agrees to be bound by the foregoing limitations.