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December FOMC Meeting

Rate cuts unlikely in 2023 as US labor market remains tight & inflation risk is unabated

Key message

As expected, the Fed announced a rate hike of 50bps at the December FOMC meeting. In order to tame inflation, we expect the Fed to maintain rate hikes, albeit at a slower pace in light of current economic and financial conditions. Risks of recession will be the primary swing factor for the financial market in 2023F. Notably, markets now anticipate a Fed rate cut of 50bps in 4Q23F in response to economic recession, while in our view, given limited financial leverage in the private sector, US households still enjoy excess savings, boosted by COVID-19 relief and aid. Meanwhile, the labor market has remained overheated in the wake of labor shortages. All considered, we expect the US economy to head into moderate recession, and in order to lower inflation, the Fed will likely raise the terminal rate to 5.25% in 2023F before rate cuts are announced in 2024F.

Fed to maintain rate hikes, albeit at a slower pace, in light of current economic & financial conditions, in order to tame inflation

As expected, the US Federal Reserve (Fed) announced a moderate rate hike of 50bps at the December FOMC meeting, pushing up the range of the policy rate to 4.25-4.5%.

In the post-meeting statement, the Fed mentioned: (1) optimal growth in production and expenditure; (2) robust payroll growth and a low unemployment rate; and (3) persistently high inflation facing the US economy. These are consistent with the November postmeeting statement. The two key points announced in regard to monetary policy are also in line with the November statement: (1) it is adequate of the Fed to raise the target range of the policy rate in order to bring inflation back to 2%; and (2) the committee will fine-tune the pace of future rate hikes in consideration of the cumulative effects of monetary tightening and the lags between monetary policy and economic activity, as well as inflation.

Economy-wise, the Fed has: (1) lowered 2023F projected GDP growth; and (2) raised 2023F core CPI and unemployment rate, indicating its expectation for decelerating inflation declines in 2023F, which is why a higher terminal rate is needed to cool down the labor market. We expect a more significant economic slowdown ahead, as a result (Figure 1).

The interest rate dot plot also provides an outline for future rate hikes (Figure 2): (1) the Fed may raise the benchmark interest rate by 75bps in 2023F (up 50bps from September guidance), sending the terminal rate rising to 5-5.25% with potential upside ahead; (2) the Fed is likely to maintain the terminal rate until a rate cut cycle begins in 2024F. We expect rate cuts of 100bps in 2024F, with the policy rate down to 4-4.25%; (3) another cut of 100bps will ensue in 2025F for the policy rate to decline further to 3-3.25%; and (4) the dot plot beyond 2024 is rather dispersed, meaning it is subject to major changes depending on economic (and inflation) conditions.

Fed governors see upside risks in inflation & note the labor market remains unbalanced & overheated; thus rate cuts are not an option for 2023; the policy rate will remain restrictive for an extended period Fed Chair Powell highlighted the below at the post-meeting press conference.

Inflation (Figure 3): (1) Fed governors recognize upside risks in inflation; (2) the Fed won't be complacent about inflation declines in the past two months as it appears to be rather rigid; (3) shelter inflation should start to retreat in 2023; (4) service inflation (ex shelter) will take some time to go down, and even when it does, the pace will be slow (the recent declines in ex-shelter service inflation are unsustainable, according to the Fed, mainly as wages remain high).

Labor market: (1) structural issues facing the US labor market remain unresolved, leading to continued labor shortages; (2) despite some improvements in job vacancies, the labor market overall is still unbalanced and overheated (Figure 4); (3) given numerous job vacancies, massive lay-offs won't help to cool down the labor market; (4) wage growth remains undesirably strong, and efforts to control the average hourly wage haven't been effective. It is essential that wage growth stays in line with the 2% inflation target, and this is why the Fed is particularly concerned about service inflation (Figure 5).

Policy rate & economic growth: (1) the policy rate is approaching the restrictive level; (2) following aggressive rate hikes in previous months, a timely slowdown can mitigate the risk of excessive rate hikes; (3) rate cuts seem unlikely in 2023 as inflation is nowhere near the 2% target. As such, we expect the policy rate to remain at the restrictive level for quite a long time; (4) the US should deliver moderate economic growth in 4Q22F, and the Fed anticipates slow growth ahead rather than a recession, although it cannot tell for sure that a recession won't happen.

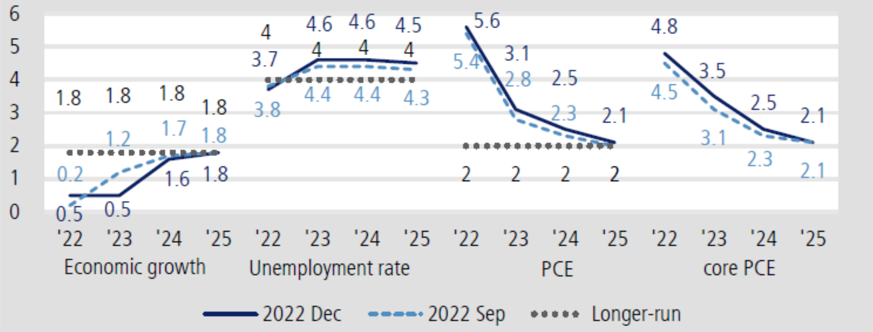
We expect the US to undergo moderate economic recession, while the Fed is likely to raise & maintain the terminal rate at 5.25% in 2023F to rein in inflation before rate cuts are put in place in 2024F

The dot plot and comments on economic outlook after the December FOMC meeting imply a rather hawkish stance of the Fed, triggering a stock market correction while the dollar and US Treasury yields picked up. However, at the press conference, Chairman Powell only said that the Fed is determined to bring inflation down, and that was as hawkish as it got. Markets now expect the Fed to raise the interest rate by 25bps each in February and March (Figure 6) amid likely waning inflation and slower economic growth in 1Q23F. As a result, stock markets rebounded slightly, while the dollar and Treasury yields both pulled back.

Risks of recession will be the primary swing factor for the financial market in 2023. Notably, markets now anticipate a Fed rate cut of 50bps in 4Q23F in response to economic recession. In our view, given limited financial leverage in the private sector (Figure 7), US households still enjoy excess savings (Figure 8), boosted by COVID-19 relief and aid. Meanwhile, the labor market has remained overheated (Figure 9) in the wake of labor shortages. All considered, we expect the US economy to head into moderate recession; and in order to lower inflation, the Fed will likely raise the terminal rate to 5.25% in 2023F before rate cuts are announced in 2024F.

Figure 1: Fed tweaked up core CPI growth & unemployment rate, while cutting GDP growth markedly for 2023F

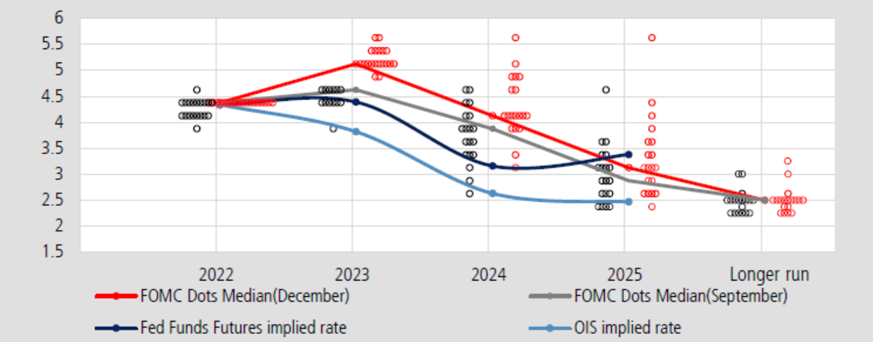
Full-year FOMC estimates of various economic indicators, percent



Source: Bloomberg; KGI Research

Figure 2: Fed will raise the terminal policy rate to 5-5.25%

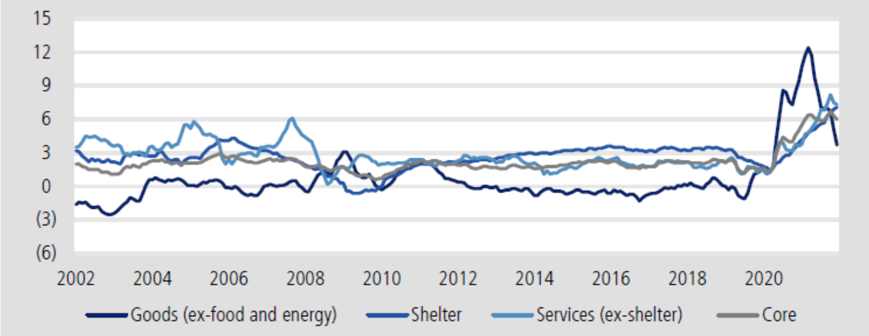
Fed dot plot and market expectations for interest rate, percent



Source: US Fed; Bloomberg; KGI Research

Figure 3: Recent declines in ex-shelter service inflation are unsustainable, according to the Fed, mainly as wages remain high

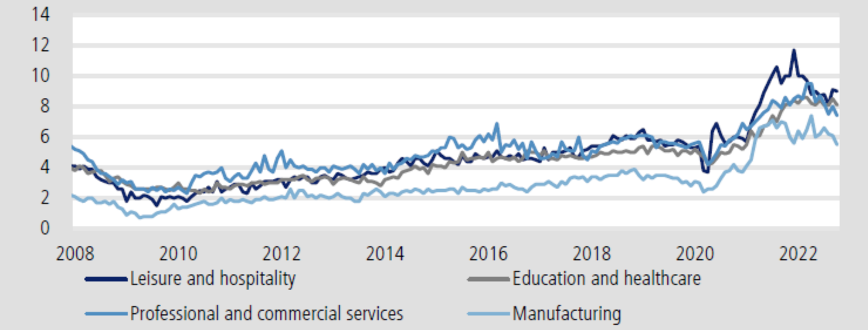
US goods, services & core CPI (goods does not include food & energy; services does not include shelter), percent



Source: Bloomberg; KGI Research

Figure 4: Industries with higher job vacancy rates are seeing higher wage growth; most such industries belong to low-end service sector where wages are lower

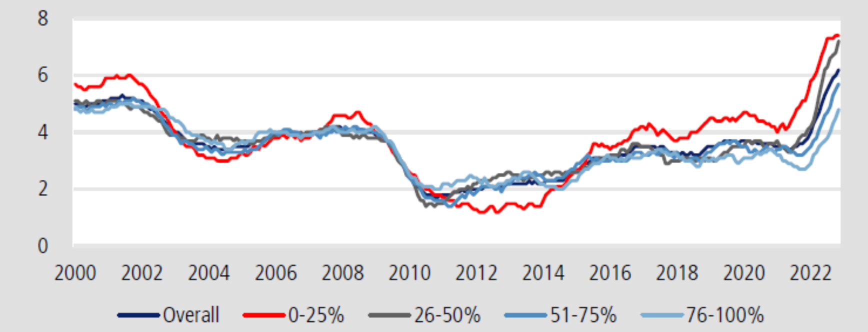
Job vacancy rate - Leisure & hospitality, education & healthcare, professional & commercial services, manufacturing, percent



Source: Bloomberg; KGI Research

Figure 5: Accelerating wage growth in low-income sectors has led to unbalanced labor supply & demand, prompting companies to pass through additional costs to service prices

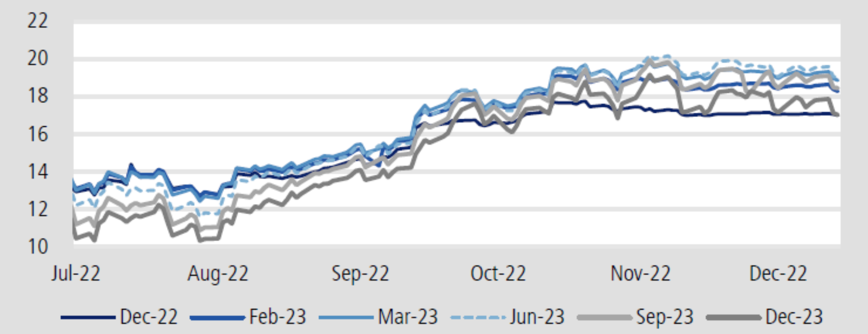
Wage growth by income bracket - Overall, 0-25%, 26-50%, 51-75% and 76-100%, percent



Source: Bloomberg; KGI Research

Figure 6: Markets now expect the Fed to raise the benchmark interest rate by 25bps each in February & March

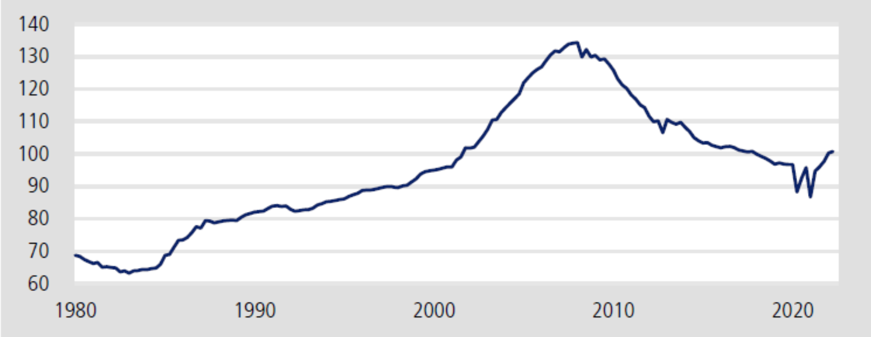
Cumulative rate hikes implied in Fed funds rate futures for December 2022 and February, March, June, September & December 2024, quarter point



Source: Bloomberg; KGI Research

Figure 7: Financial leverage in US private sector has been limited

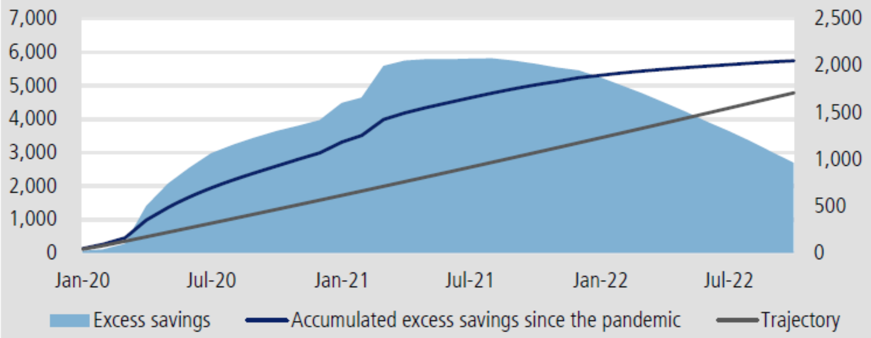
Household debt to disposal income rate, percent



Source: Bloomberg; KGI Research

Figure 8: US households still enjoy excess savings thanks to COVID-19 relief & aid

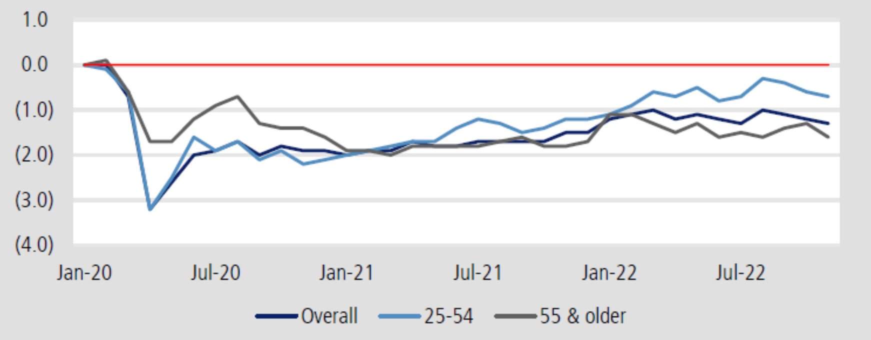
Trend & value of excess savings since the pandemic, US$bn (LHS); excess savings, US$bn (RHS)



Source: Bloomberg; KGI Research

Figure 9: Labor market remains overheated given labor shortages

Labor participation rate (present-pre-pandemic) by age group - Overall, 25-54 years & over 55 years, percent



Source: Bloomberg; KGI Research

Figure 10: Key US economic data

Indicators		Units	2019	2020	2021	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22
GDP	GDP QoQ SAAR	QoQ %, SAAR						(1.6)			(0.6)			2.9		
	GDP YoY	YoY %	2.3	(2.8)	5.9			3.7			1.8			1.9		
Consumer prices	CPI	YoY %	1.8	1.2	4.7	7.5	7.9	8.5	8.3	8.6	9.1	8.5	8.3	8.2	7.7	7.1
	Core CPI	YoY %	2.2	1.7	3.6	6.0	6.4	6.5	6.2	6.0	5.9	5.9	6.3	6.6	6.3	6.0
	PCE price index	YoY %	1.5	1.1	4.0	6.1	6.4	6.8	6.4	6.5	7.0	6.4	6.2	6.3	6.0	
	Core PCE index	YoY %	1.7	1.3	3.5	5.2	5.4	5.4	5.0	4.9	5.0	4.7	4.9	5.2	5.0	
Labor market	Labor force participation rate	%	63.3	61.5	61.9	62.2	62.3	62.4	62.2	62.3	62.2	62.1	62.4	62.3	62.2	62.1
	Unemployment rate	%	3.7	8.1	5.4	4.0	3.8	3.6	3.6	3.6	3.6	3.5	3.7	3.5	3.7	3.7
	Non farm payrolls	'000	1,968	(9,292)	6,743	504	714	398	368	386	293	537	292	269	284	263
	Avg. hourly earnings	YoY %	2.9	5.5	4.9	5.4	5.2	5.6	5.5	5.3	5.2	5.2	5.2	5.1	4.9	5.1
Economic activity	Industrial production	YoY %	(0.7)	(7.0)	4.9	2.9	6.9	4.8	5.3	4.4	3.9	3.9	3.8	5.0	3.3	
	Durable goods orders	YoY %	(6.6)	(4.5)	15.6	12.5	10.3	9.8	10.1	12.2	11.9	9.1	11.3	11.5	10.7	
	Core capital goods orders	YoY %	(0.6)	(7.8)	12.4	12.0	11.5	10.6	6.4	11.2	9.4	7.3	9.8	7.9	6.4	
	ISM manufacturing index	Point	51.2	52.5	60.6	57.6	58.6	57.1	55.4	56.1	53.0	52.8	52.8	50.9	50.2	49.0
	ISM non-manufacturing index	Point	55.5	54.3	62.5	59.9	56.5	58.3	57.1	55.9	55.3	56.7	56.9	56.7	54.4	56.5
	ISM manufacturing index: new orders	Point	51.2	54.0	64.3	57.9	61.7	53.8	53.5	55.1	49.2	48.0	51.3	47.1	49.2	47.2
	Conference board leading index	YoY %	1.5	(4.1)	7.1	6.3	7.2	6.0	4.3	2.7	1.4	(0.1)	(0.9)	(1.5)	(2.7)	
Housing market	Building Permits	'000, SAAR	1,386	1,476	1,737	1,841	1,857	1,879	1,823	1,695	1,696	1,685	1,542	1,564	1,512	
	Housing starts	'000, SAAR	1291	1,395	1,605	1,666	1,777	1,716	1,805	1,562	1,575	1,377	1,508	1,488	1,425	
	New home sales	'000, SAAR	683	831	769	831	790	707	619	636	571	543	661	588	632	
	Existing home sales	mn, SAAR	5.3	5.6	6.1	6.5	5.9	5.8	5.6	5.4	5.1	4.8	4.8	4.7	4.4	
	NAHB housing market index	Point, SA	66	70	81	83	81	79	77	69	67	55	49	46	38	33
	S&P/Case-Shiller 20-city composite home price index	YoY %	2.8	10.2	18.5	19.0	20.3	21.2	21.3	20.5	18.7	16.0	13.1	10.5		
Consumption	Personal expenditures	YoY %, SA	2.0	(3.0)	8.3	5.6	6.7	2.3	2.4	2.6	2.1	2.1	2.1	2.0	1.8	
	Retail sales	YoY %	3.1	0.6	19.7	13.7	17.7	7.1	7.8	8.7	8.8	10.0	9.7	8.6	8.3	
	Retail sales ex-autos	YoY %	3.2	1.3	19.0	14.0	17.7	9.5	10.5	12.0	11.0	12.1	10.3	9.3	9.0	
	Domestic vehicles sales	mn, SA	203.0	173.0	179.2	15.0	14.1	13.3	14.3	12.7	13.0	13.4	13.2	13.5	14.9	14.1
	Michigan Consumer Sentiment Index	Point	96.0	81.5	77.6	67.2	62.8	59.4	65.2	58.4	50.0	51.5	58.2	58.6	59.9	56.8
Fiscal	Budget balance	As % of GDP	(4.7)	(15.6)	(10.8)	(9.6)	(9.2)	(7.2)	(4.9)	(4.7)	(4.3)	(3.2)	(3.7)	(5.4)	(4.3)	(5.3)
Int'l balance	Current account balance	As % of GDP	(2.1)	(2.9)	(3.6)			(3.8)			(3.9)					
Monetary & financial	Federal funds rate	%	1.75	0.25	0.25	0.25	0.25	0.50	0.50	1.00	1.75	2.50	2.50	3.25	3.25	4.00
	10-Year treasury yield	%	1.92	0.91	1.51	1.78	1.83	2.34	2.93	2.84	3.01	2.65	3.19	3.83	4.05	3.61
	Dollar index	Point	96.4	89.9	95.7	96.5	96.7	98.3	103.0	101.8	104.7	105.9	108.7	112.1	111.5	106.0

Source: Bloomberg; KGI Research

Figure 11: Key Taiwan economic data

Indicators		Units	2019	2020	2021	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22
GDP	GDP YoY	YoY %	3.1	3.4	6.5			3.9			3.0			4.0		
Consumer prices	CPI	YoY %	0.6	(0.2)	2.0	2.8	2.3	3.3	3.4	3.4	3.6	3.4	2.7	2.8	2.7	2.4
	Core CPI	YoY %	0.6	0.7	1.8	2.4	1.6	2.5	2.5	2.6	2.8	2.7	2.7	2.8	3.0	2.9
Labor market	Unemployment rate	%	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.6	3.6	
Economic activity	Industrial production	YoY %	(0.3)	7.1	13.4	8.4	9.5	2.4	6.4	4.1	0.5	1.6	3.3	(4.5)	(3.6)	
	Markit Taiwan manufacturing PMI	Point		51.0	58.5	55.1	54.3	54.1	51.7	50.0	49.8	44.6	42.7	42.2	41.5	41.6
	NDC monitoring light signal					Yellow-red	Yellow-red	Green	Green	Green	Green	Green	Green	Yellow-blue	Yellow-blue	
	NDC monitoring indicators	Point	20.7	24.3	39.0	36.0	34.0	31.0	28.0	28.0	27.0	24.0	23.0	17.0	18.0	
	NDC composite leading index	YoY %	(0.7)	(0.5)	3.8	6.3	5.9	5.6	5.2	4.5	3.4	2.0	0.5	(0.9)	(2.2)	
	NDC composite coincident index	YoY %	(2.7)	(1.1)	4.7	8.5	7.7	7.0	6.3	5.7	5.0	4.0	2.5	0.7	(1.2)	
Consumption	Retail sales	YoY %	3.1	0.2	3.3	6.3	0.2	5.5	4.7	3.6	22.5	18.1	12.0	7.8	2.1	
Trade	Exports	US$bn	329.2	345.2	446.6	40.0	37.5	43.5	41.5	42.1	42.2	43.3	40.3	37.5	39.9	36.1
	Imports	US$bn	285.6	285.8	381.3	35.1	31.6	38.9	36.6	39.7	37.6	38.3	37.4	32.5	37.0	32.7
	Trade balance	US$bn	43.5	59.4	65.3	4.9	5.8	4.7	4.9	2.4	4.6	5.0	3.0	5.0	3.0	3.4
	Export growth	YoY %	(1.5)	4.9	29.4	16.7	34.8	21.3	18.8	12.4	15.2	13.9	1.9	(5.3)	(0.5)	(13.1)
	Import growth	YoY %	0.3	0.1	33.4	24.1	35.2	19.4	26.7	26.6	19.1	19.1	3.4	(2.6)	8.2	(8.6)
	Export orders	US$bn	484.6	533.7	674.1	58.9	51.6	62.7	51.9	55.4	58.8	54.3	54.6	60.9	55.4	
	Export order growth	YoY %	(5.3)	10.1	26.3	11.7	21.1	16.8	(5.5)	6.0	9.5	(1.9)	2.0	(3.1)	(6.3)	
Monetary & financial	M1B	YoY %	7.4	16.2	12.8	11.5	11.1	10.9	9.8	8.5	8.1	6.7	7.6	6.6	5.2	
	M2	YoY %	4.1	8.5	8.0	7.9	7.7	8.1	8.1	7.9	7.7	7.0	6.9	6.8	7.3	
	Foreign reserves	US$bn	529.9	548.4	548.4	548.9	550.0	548.8	545.1	548.9	549.0	547.8	545.5	541.1	542.8	552.2
	Rediscount rate	%	1.1	1.1	1.1	1.1	1.1	1.4	1.4	1.4	1.5	1.5	1.5	1.6	1.6	1.6
	Exchange rate	USD/TWD	28.1	27.7	27.7	27.8	28.0	28.6	29.4	29.0	29.7	29.9	30.4	31.8	32.3	30.8

Source: Bloomberg; KGI Research

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