# Strategy Report

## FOMC signals Mar liftoff, runoff as soon as Jun

The U.S. FOMC kept the Fed funds rate at 0-0.25% at the Jan meeting, while "expects it will soon be appropriate to raise" the Fed funds rate. It decided to end its asset purchases in early Mar, as expected, and discussed balance sheet normalization. We expect the FOMC to start raising Fed funds rate in Mar, and may start shrinking its balance sheet as soon as Jun. U.S. growth stocks may underperform value stocks, but China growth stocks may outperform.

- **First rate hike probably in Mar.** At the post-meeting press conference, Fed Chair Jerome Powell mentioned raising the fed funds rate "at the March meeting, assuming that the conditions are appropriate for doing so". Answering a question on the pathway of interest rate hikes, Powell said that, compared to 2015, the economy is now much stronger and inflation is much higher. This implies a faster pace of rate hikes compared to the last cycle. Interest rate futures have priced in four hikes (100 bps in total) in 2022.
- **Balance sheet reduction may begin as soon as Jun 2022.** The FOMC issued "Principles for Reducing the Size of the Federal Reserve's Balance Sheet". Chair Powell said the FOMC will discuss the balance sheet reduction in more details in upcoming meetings. If the FOMC follows the footstep of the previous runoff in 2017, it is likely to announce in the May meeting to start shrinking the balance sheet in Jun 2022.
- **U.S. growth stocks underperformed during rate hike cycles.** We reviewed the relative performance of U.S. growth stocks and value stocks during the last three Fed funds rate upcycles, and concluded that U.S. value stocks tended to outperform growth stocks before or during the initial phase of interest rate hike cycles.
- **Chinese stocks may outperform thanks to monetary easing in China.** The U.S. is going to raise interest rates while China is cutting rates, having cut both the loan prime rates (LPR) and the medium-term lending facility (MLF) rate. From the experience of U.S.-China monetary policy divergence in 2014-2015, we expect Chinese stocks to react more positively than other major stock markets to changes in monetary policies in coming months.
- **China growth stocks outperformed when PBOC cut rates.** In China, the prospect of growth stocks and value stocks could be quite different to their U.S. counterparts, primarily due to the divergence in monetary policies. In all the previous three interest rate downcycles in China, growth stocks outperformed value stocks.
- **Prefer Internet, Healthcare & Construction Machinery sectors.** Among growth stocks, Internet sector may enjoy moderate re-rating as their significant sell-off in 2H 2021 has priced in much of regulatory risks. Healthcare sector may also outperform**.** Consumer sector may need to wait for the risks from COVID and housing market to ease before turning strong. Among value stocks, we prefer Construction Machinery which is set to benefit from increased infrastructure spending by China.

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**Market Data**

| | |
|---|---|
| Hang Seng Index | 24,290 |
| 52-week High / Low | 31,183/22,665 |
| 3-month avg. daily t/o | HK$126.6bn |

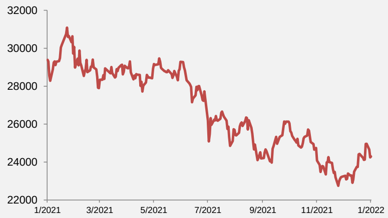
Source: Bloomberg

**Indices Performance**

| | HSI | HSCEI | HSTECH |
|---|---|---|---|
| 1-month | 4.6% | 3.8% | -0.4% |
| 3-month | -6.7% | -8.1% | -15.9% |
| 6-month | -7.3% | -9.0% | -17.6% |

Source: Bloomberg

**12-month HSI Performance**




Source: Bloomberg

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# FOMC signals raising Fed funds rate in March

The U.S. Federal Open Market Committee (FOMC) left the Fed funds rate target range unchanged at 0-0.25% at the Jan meeting, while "expects it will soon be appropriate to raise the target range for the federal funds rate".

- **Tapering – Asset Purchasing ending in Mar**

The FOMC decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early Mar, as expected.

- **Interest rate – First hike probably in Mar**

For the first time since the pandemic, the FOMC statement said the Committee "**expects it will soon be appropriate to raise the target range for the federal funds rate**". At the post-meeting press conference, Fed Chair Jerome Powell mentioned raising the fed funds rate "**at the March meeting**, assuming that the conditions are appropriate for doing so".

Answering a question on the pathway of interest rate hikes, Powell said in the press conference that, compared to 2015, the economy is now much stronger and inflation is much higher. This implies a **faster pace of rate hikes compared to the last cycle** (the first hike in Dec 2015, the second in Dec 2016).

**Figure 1: Key changes in FOMC statement – Jan 2022 vs. Dec 2021**

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent. With inflation ~~having exceeded~~ well above 2 percent ~~for some time~~ and a strong labor market, the Committee expects it will soon be appropriate to ~~maintain this~~ raise the target range for the federal funds rate. ~~until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment. In light of inflation developments and the further improvement in the labor market,~~ The Committee decided to continue to reduce the monthly pace of its net asset purchases ~~by $20 billion for Treasury securities and $10 billion for agency mortgage-backed securities.~~, bringing them to an end in early March. Beginning in ~~January~~ February, the Committee will increase its holdings of Treasury securities by at least $~~40~~20 billion per month and of agency mortgage-backed securities by at least $~~20~~10 billion per month. ~~The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook.~~ The Federal Reserve's ongoing purchases and holdings of securities will continue to foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

Source: Federal Reserve, CMBIS

■ **Balance sheet reduction – Start as soon as Jun 2022**

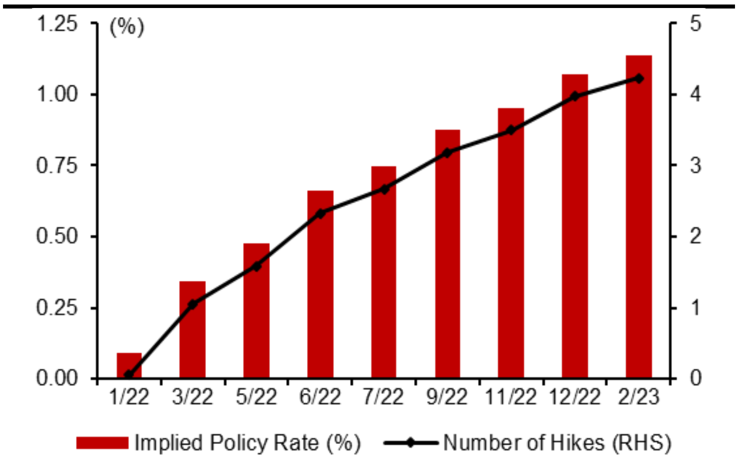
The FOMC issued "Principles for Reducing the Size of the Federal Reserve's Balance Sheet". Main points include 1) the Fed funds rate is the primary tool to adjust monetary policy; 2) will start shrinking the balance sheet after the process of increasing interest rates has begun; 3) in a predictable manner primarily by adjusting the amounts reinvested of principal payments.

Chair Powell said the FOMC will discuss the balance sheet reduction in more details in upcoming meetings (at least in the Mar and May meetings). Recall that in the previous balance sheet reduction process, the FOMC issued "Policy Normalization Principles and Plans" in Jun 2017, and then in Sep (the second meeting after the Jun meeting) announced to initiate the balance sheet normalization program in Oct. If the FOMC follows the footstep this time, it is likely to announce in the May meeting to **start shrinking the balance sheet in Jun 2022**.

■ **Market has priced in four rate hikes in 2022**

In recent weeks, following higher inflation numbers and more hawkish comments by some Fed officials, investors have raised their forecasts for the fed funds rate. Interest rate futures are now pricing in four hikes (100 bps in total) by the end of 2022.

**Figure 2: Interest rate futures priced in four hikes in 2022**



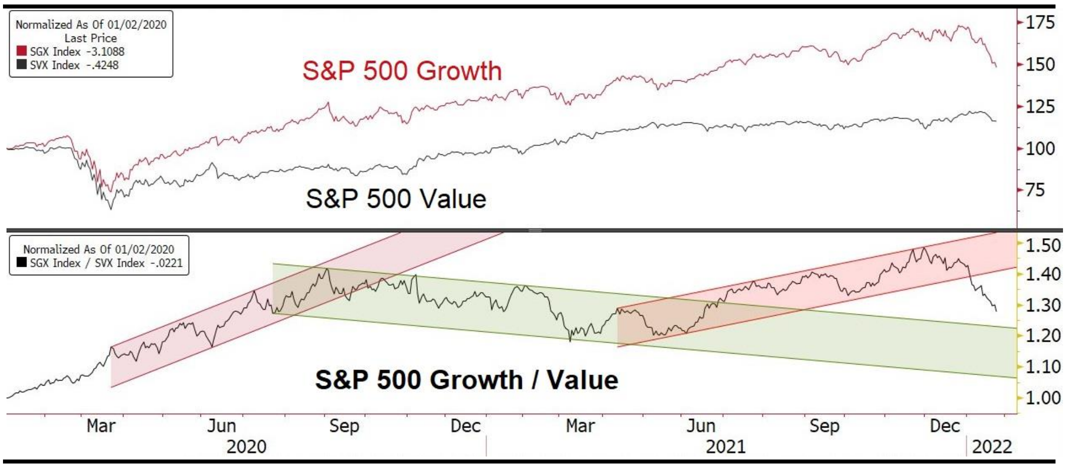

Source: Bloomberg, CMBIS; as of 26 Jan 2022

## U.S. Growth stocks underperformed during rate hike cycles

■ **U.S. Growth stocks weakened relative to Value**

U.S. growth stocks have weakened relative to value stocks since early Jan 2022 (Fig. 3), and may underperform further as 1) higher interest rates put more pressure on high-valuation stocks, and 2) Financials benefit from higher interest rates.

Figure 3: S&P 500 Growth vs. Value bucked uptrend



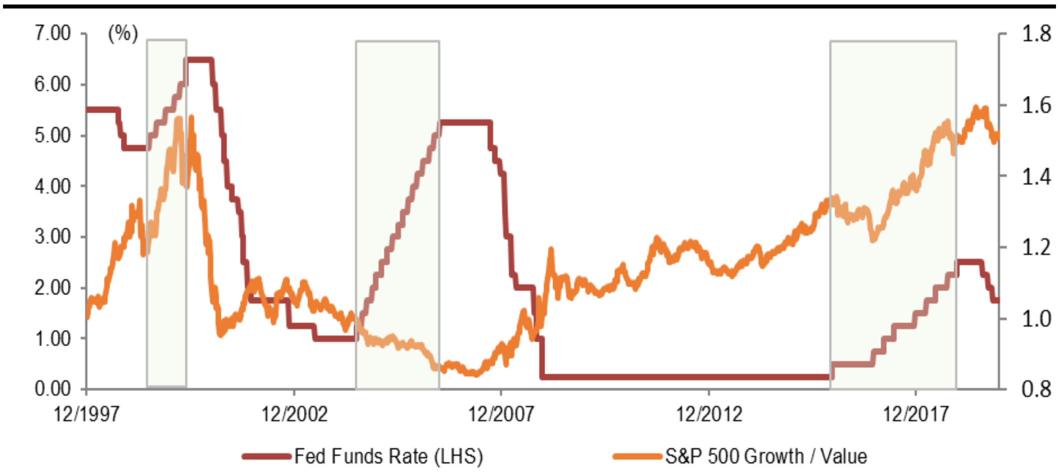

Source: Bloomberg, CMBIS; as of 26 Jan 2022

We reviewed the relative performance of U.S. growth stocks and value stocks during the last three Fed funds rate upcycles (shaded areas in Fig. 4):

- **2015 - 2018**: U.S. value stocks outperformed growth stocks during the early phase (first 12 months / first two hikes) of Fed funds rate upcycle.
- **2004 - 2006**: U.S. value stocks outperformed growth stocks for the majority of this Fed funds rate upcycle.
- **1999 - 2000**: U.S. growth stocks outperformed value stocks in this cycle, driven by the tech bubble which eventually burst when interest rates were near the peak. Value stocks did outperform growth stocks in the two months prior to the first rate hike, possibly pricing in rate hikes in advance.

In short, **U.S. value stocks tended to outperform growth stocks before or during the initial phase of interest rate hike cycles**.

Figure 4: U.S. Growth stocks vs. Value stocks & Fed funds rate



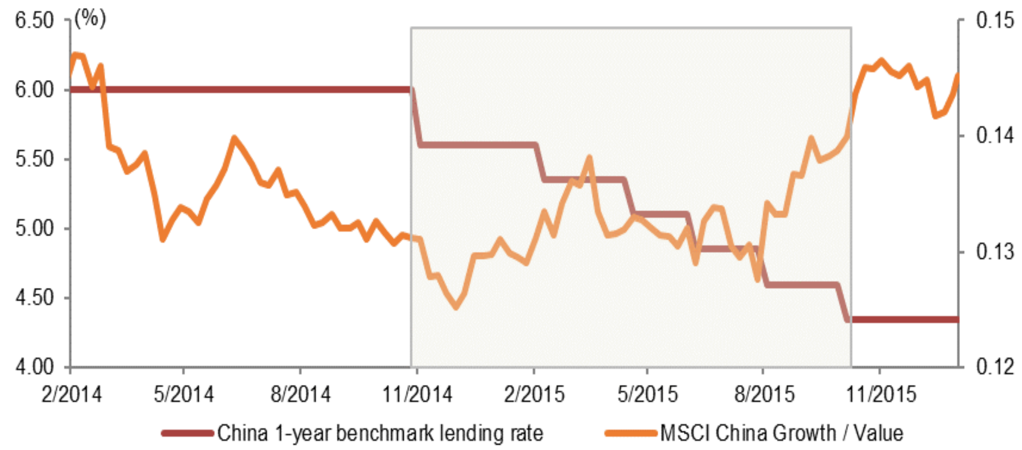

Source: Bloomberg, CMBIS

## China Growth stocks outperformed when PBOC cut rates

**In China, the prospect of growth stocks and value stocks could be quite different from their U.S. counterparts, primarily due to the divergence in monetary policies**, i.e. the U.S. is going to raise interest rates while China is cutting rates, having cut both the loan prime rates (LPR) and the medium-term lending facility (MLF) rate in Jan.

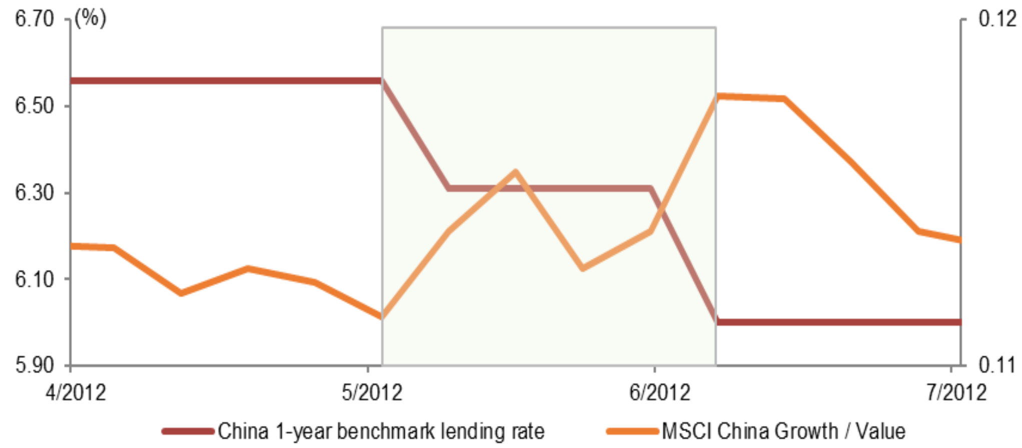
In all the previous three interest rate downcycles in China, growth stocks outperformed value stocks (Fig. 5-7).

**Figure 5: China Growth vs. Value stocks & China's lending rate (2014-2015)**



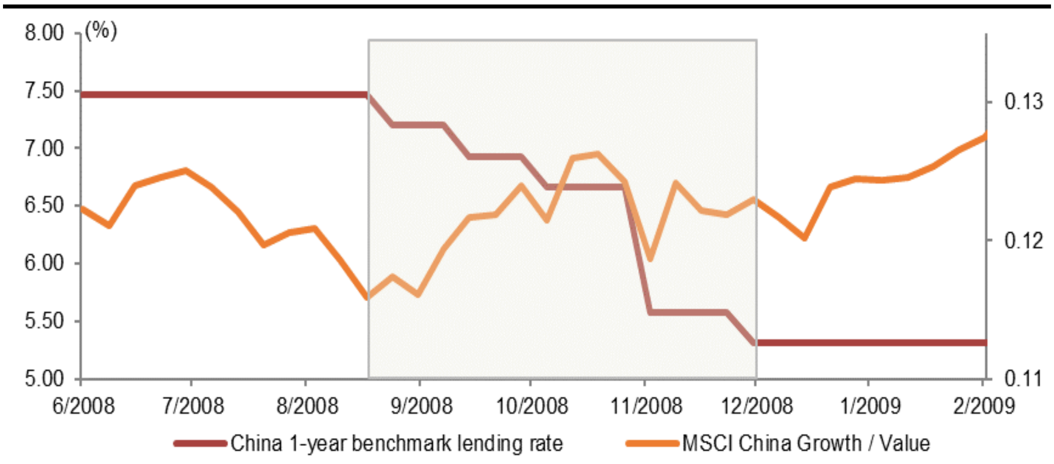

Source: Bloomberg, CMBIS

**Figure 6: China Growth vs. Value stocks & China's lending rate (2012)**




Source: Bloomberg, CMBIS

**Figure 7: China Growth vs. Value stocks & China's lending rate (2008)**

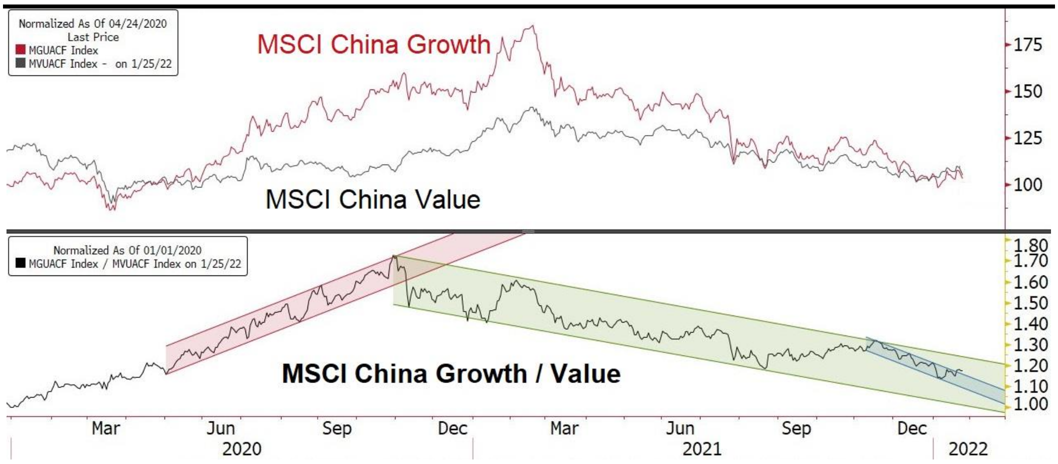



Source: Bloomberg, CMBIS

- **MSCI China Growth turning strong relative to Value**

Technically, China growth stocks are showing early signs of strengthening relative to value stocks, bucking a short-term downtrend, despite still being in a year-long downtrend.

**Figure 8: MSCI China Growth vs. Value breaking short-term downtrend**




Source: Bloomberg, CMBIS

- **Chinese stocks may outperform thanks to monetary easing in China**

From the experience of U.S.-China monetary policy divergence in 2014-2015, when the MSCI China Index surged despite the Fed tapering and thanks to the PBOC slashing interest rates and RRR, we **expect Chinese stocks to react more positively than other major stock markets to changes in monetary policies in coming months**.

**China growth stocks is likely to outperform value stocks as interest rates in China is going down**. Among growth stocks, Internet sector may enjoy moderate re-rating as their significant sell-off in 2H 2021 has priced in much of regulatory risks, in our view. Healthcare sector may also outperform.

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