Fed Watch

AIB Treasury Economic Research Unit

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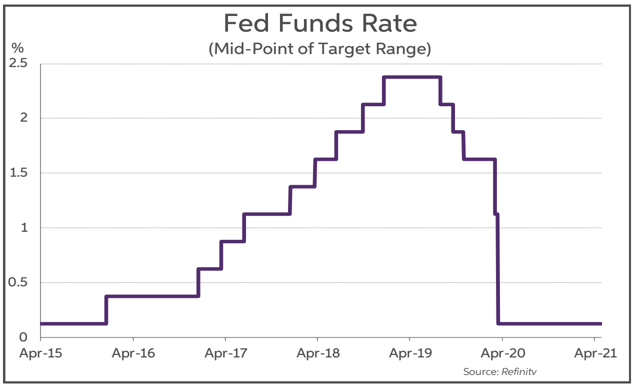
Uneventful meeting, as Fed remains dovish for now

As expected, the April meeting of the US Federal Reserve concluded with no changes to monetary policy. The central bank kept the funds rate in its target range of 0.00-0.25% as well as continuing to implement an open-ended asset purchase programme. There was unanimity within the FOMC on its decision to leave policy unchanged.

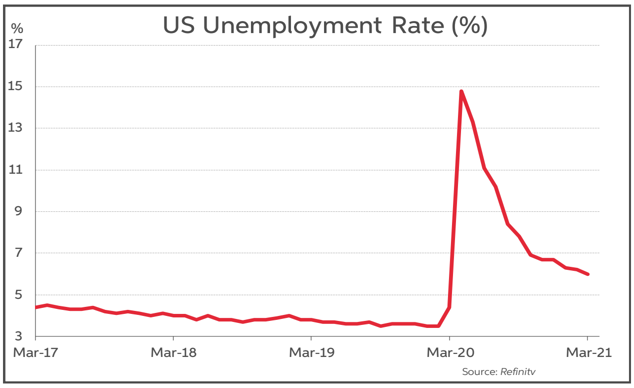


Meanwhile, the changes that were contained in the meeting statement were confined to the description of the economy and its outlook, with no amendments made to its policy guidance section. The statement noted that progress on vaccinations and strong policy support had coincided with a strengthening in indicators of economic activity and employment. It also acknowledged that while those sectors of the economy most impacted by the pandemic remain weak, they have shown "some improvement".

Meantime, it stated that although inflation had risen, this was largely due to "transitory" factors. In light of the progress in the ramping up of the vaccination programmes, the Fed downgraded its assessment of the risks posed by Covid by removing the word "considerable" in its characterization of the difficulties that the pandemic still poses to the economic outlook.

The most recent detailed update on the Fed's view of the economic outlook was provided at last month's FOMC. At the March meeting, the Fed revised its 2021 GDP growth forecast significantly higher to 6.5% y/y by the end of the year (versus previous forecast of 4.2% y/y). Its growth forecasts for end 2022 and end 2023 showed only minor changes at 3.3% y/y and 2.2% y/y respectively. In terms of its outlook for the labour market, the median projection of FOMC participants was for the unemployment rate to fall to 4.5% (was 5.0%) by the end of this year and to move down to 3.5% by the end of 2023. Meanwhile, it expects inflation to rise to 2.4% (was 1.8%) by the end of this year, declining back to 2% by the end of 2022 and edging back above 2% by end-2023.

The March meeting also saw the Fed release its latest view on the likely path of future interest rates (i.e. the dot plot). This update was similar to December, in that the median projection was for no change to the fed funds rate through to the end of 2023. In contrast, the market is anticipating that the Fed will hike rates much sooner than this. Indeed, futures contracts are pricing in rate increases to commence in the second half of next year, with the fed funds rate being raised by as much as 25bps by end 2022. Further out, official rates are seen rising to around 2% by end-2025.



A key point of focus and speculation for markets over the coming months will be when the Fed will start to announce a tapering to its QE programme. In the post-meeting press conference, Fed Chair Powell faced numerous questions on this topic. **His responses were very dovish in tone**. He stated that "No. It is not time yet". He reiterated the Fed's assertion that it will want to see "substantial further progress" in the economy's recovery before contemplating tapering. Chair Powell went on to say that recent improving data does not constitute this, adding that "its not close to substantial further progress".

The Fed has indicated, though, that it will give the market plenty of notice about when it will start to taper. If, as we expect, the US economy booms in the coming months, then we would anticipate that such guidance will come over the summer, allowing the Fed to begin tapering around the end of the year or in early 2022.

In terms of market reaction, the generally dovish tone from Chair Powell's press conference coincided with some modest softening in the dollar. This was reflected in EUR/USD moving back above the $1.21 level. Meanwhile, an initial positive response in bond markets was not sustained, with Treasury yields on the rise today.

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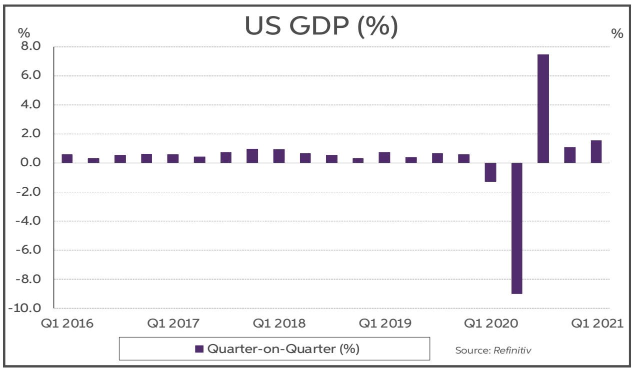
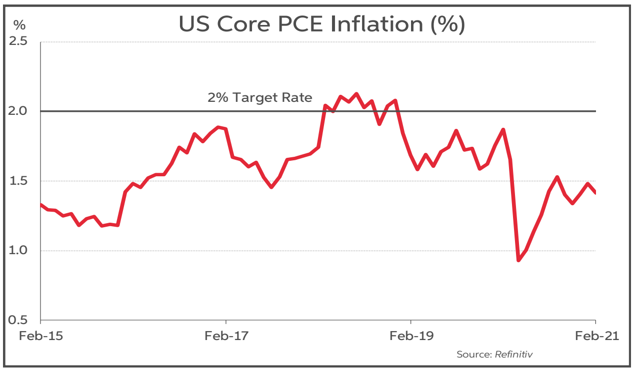
US Economy expected to boom

The US economy grew by an annualised growth rate of 4.3% in Q4, as momentum slowed amid a resurgence in Covid-19 cases. Overall, the US economy contracted by just 3.5% in 2020, much less than was initially feared. Economic activity regained momentum in the opening quarter of 2021, buoyed by the rapid pace of the vaccine rollout and further fiscal stimulus. Today's GDP report showed the economy expanded by 6.4% s.a.a.r in Q1. The expansion was led by a 10.7% rise in consumer spending, which added 7.0 percentage points (p.p.) to GDP. Investment and government expenditure contributed a further 1.8 p.p and 1.1 p.p respectively. A run down in inventories though, subtracted 2.6 p.p from growth, while net trade clipped 0.9 p.p off the total.



Data for March were particularly strong as the Biden fiscal package began to take effect and activity rebounded having being badly impacted by inclement weather in February. Retail sales increased by 9.7% in the month as consumer demand jumped, in part due to substantial fiscal transfers. This lifted the headline index 16.9% above its pre-Covid level. Housing starts rebounded by 19.4% in March, and were 37% higher year-on-year. Industrial production though, rose only modestly in March and contracted by 1.9% in Q1, leaving output 3.4% below its pre-pandemic level, as shortages of semiconductors and severe storms disrupted supply chains and output.

The limited amount of survey data available for April suggests that growth has continued to accelerate. Both the manufacturing and services PMIs moved higher and were above 60 in April. The manufacturing PMI printed at 60.6, its highest level since the series began in 2007, led by a sharp rise in output. Meantime, the services index jumped to 63.1 from 60.4 in March, driven by stronger customer demand and the reopening of businesses. Consumer confidence is also rising. The University of Michigan measure of consumer sentiment increased to 86.5 from 84.9 in April, while the Conference Board index has improved to 121.7 from 109.7.



Meanwhile, the labour market recovery is starting to pick up pace again. Payrolls rose by 916K in March, with over half of the increase coming in the services sector (+597k). The jobless rate edged lower to 6.0% also. More timely, though volatile initial jobless claims data have been trending sharply downwards as well. Nonetheless, the labour market recovery is far from complete, with payrolls some 8.4 million below their pre-pandemic level. Indeed, the underemployment rate, remains elevated at 10.7% in March, highlighting the high level of slack that remains.

Regarding inflation, rising price pressures and base effects have pushed the headline CPI rate above 2%. In March, CPI inflation rose to 2.6% from 1.7% as energy prices fell to very low levels in the same month of last year. The core rate increased to 1.6% from 1.3% as underlying inflation pressures build also. Producers are facing higher costs from stretched supply chains and rising commodity prices. The ex-food & energy annual rate of PPI inflation jumped to 3.1% in March from 2.5%. Higher costs are being passed on in higher prices to customers, with the monthly increase in the March CPI at 0.6%, the highest since June 2009. However, the Fed expects only a transitory rise in inflation, reflecting the unwinding of pent up demand and temporary base effects, which will be contained by the high degree slack in the economy.

Nonetheless, the US economy is expected to grow strongly this year, following a sharp contraction in 2020. The rollout of highly effective vaccines has laid the foundations for the recovery to take hold, while substantial fiscal stimulus and the rundown of high household savings will boost growth further. **The IMF has recently revised upwards its forecast for USD GDP from 5.1% to 6.4% in 2021**. The OECD is also now projecting growth of 6.5% for this year. The IMF and OECD are forecasting further strong growth of 3.5-4.0% in 2022. Thus, the US economy is on the verge of a boom as it rebounds from the Covid-19 pandemic. Longer term, President Biden's proposed infrastructure bills may provide a further boon to GDP over the medium term, but higher taxes could act as a headwind. For now though, the focus remains on ensuring that the Covid crisis is overcome in the US.

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