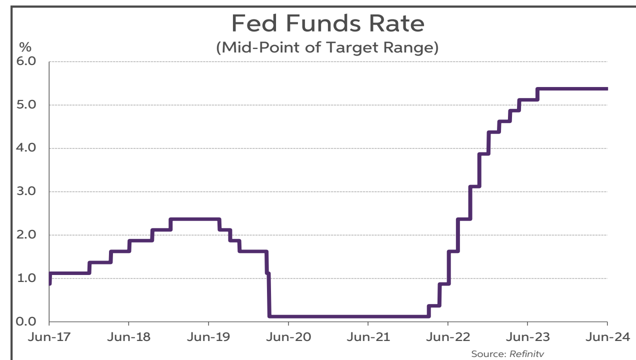
Fed Watch

AIB Treasury Economic Research Unit

13th June 2024

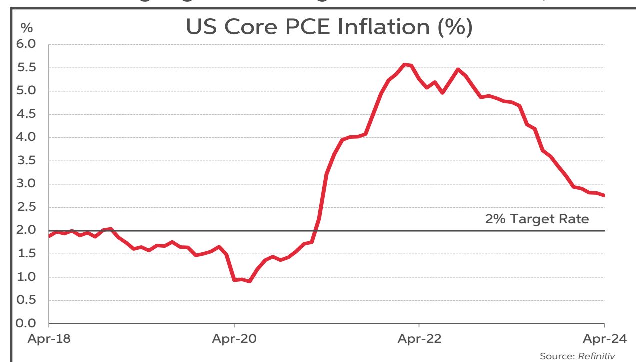
Fed less dovish on near term rates outlook

As expected, the US Federal Reserve Open Market Committee (FOMC) meeting for June saw the central bank leave its key interest rate policy unchanged. The target range for the Fed funds rate remains at 5.25-5.50%, a 22-year high. It marks the seventh consecutive meeting that policy was left on hold. Once again, the decision by the FOMC to leave rates unchanged was unanimous.



The FOMC statement showed only minimal changes from its previous version in early May. The Fed acknowledged the recent easing in US inflation numbers. It noted that "there has been modest further progress" towards its 2% inflation objective. In the May statement, it referenced "a lack of further progress" in this regard. Similar to May, it stated that recent macro data indicate that "economic activity has continued to expand at a solid pace". It also continued to emphasise that **it does not expect to lower interest rates "until it has gained greater confidence that inflation is moving sustainably toward 2%".**

With the hold in rates very much in line with consensus expectations, a key point of focus from the June FOMC was on the central bank's updated interest rate projections, known as the 'dot plot'. The median projection for this year now signals just one 25bps rate cut, compared to 75bps in the last update published in March. This would see the fed funds rate at 5.125% by end year. Looking at the individual dots for 2024, eight participants were of the view that two 25bps cuts would be appropriate, seven anticipated one 25bps cut, while four FOMC members were envisaging no cuts this year. In the lead up to the meeting, market speculation had been converging to the view that the dots would signal 50bps of easing for 2024. Meanwhile, the Fed's dots for 2025 now see rates ending the year at 4.125%. This compares to 3.875% in its March projections. The 2026 interest rate projection was left unchanged at 3.125%. Over the longer term, the Fed envisages rates settling around 2.75% versus a 2.6% projection in March. **Overall, the latest interest rate 'dots' from the Fed indicate that it anticipates rates remaining higher for longer in the near term, but still sees rates near 3% by end 2026.**



The June meeting also saw the Fed publish its latest macro economic forecasts. It made no changes to its growth projections for the US economy. It continues to envisage GDP growth of 2.1% y/y for Q4'2024 and 2.0% for Q4'2025 and Q4'2026, respectively. It did however, revise higher its inflation projections. It now anticipates core-PCE inflation of 2.8% for Q4'23 (was 2.6%) and 2.3% for Q4'25 (from 2.2%). It left its Q4'2026 core inflation forecast unchanged at 2%. In terms of its assessments of the risk weightings to its outlook, the Fed is of the view that for inflation, the risks are still to the upside, while for growth, it sees them as being broadly balanced.

Futures contracts suggest that the market is pricing in around 40-45bps of rate cuts by year end, which is slightly more dovish than currently indicated by the Fed's dot plot. At the start of the week, this pricing was nearer to 30bps, however, market expectations softened in the aftermath of Wednesday's weaker than forecast CPI data for May. The market sees rates near 4% by end 2025, which is in line with the Fed's own projections. However, by end 2026, the market envisages US official rates settling near 3.7%, which is higher than the Fed's 3.1% projection.

The timing and extent of rate cuts from the Fed, similar to the other main central banks will remain very much determined by data, especially in relation to inflation as well as the labour market. In the post-meeting press conference, Fed Chair Powell stated that FOMC will need to see more "good data" which shows an easing in inflation in order "to bolster our confidence that inflation is moving sustainably toward 2%". If inflation declines further over the coming months, then rate cuts in the region of 50bps by year end cannot be ruled out.

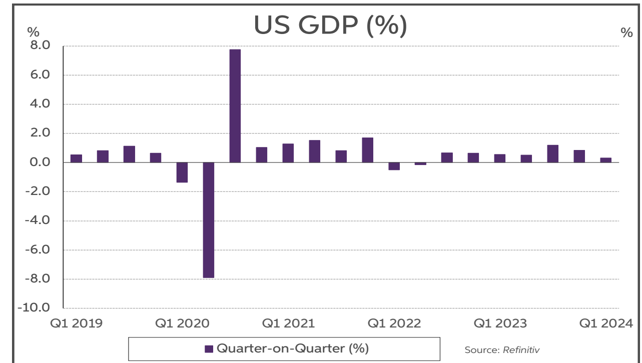
David McNamara
Chief Economist
david.g.mcnamara@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

US economy loses momentum in 2024 as disinflation stalls

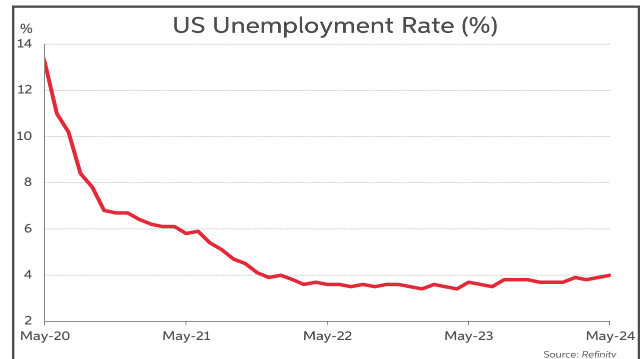
Having confounded expectations last year, growing by 2.5% up from 1.9% in 2022, US GDP expanded more slowly than anticipated in Q1 2024. GDP is estimated to have increased by 1.3% annualised at the start of the year. Despite elevated levels of inflation and interest rates, consumer spending and fixed investment remained the main drivers of growth, rising by 2.0% and 6% annualised in the quarter, and contributing 1.3 percentage points (p.p.) and 1.0 p.p., respectively, to the total. Government expenditure added a further 0.2 p.p. to growth. However, a sharp 7.7% jump in imports was only slightly offset by a meagre 1.2% increase in exports, meaning net trade knocked 0.9 p.p. from GDP. Changes in inventories clipped a further 0.4 p.p. from the total.



Hard data for April have tended to disappoint to the downside and suggest a slowdown in activity at the start of Q2 also. Headline retail sales flat-lined in the month, albeit they were 3% higher in year-on-year terms. Meantime, the control group measure of retail sales - an important core sales measure - declined by 0.3% in April. Similarly, real consumer spending contracted by 0.1% in the month. Elsewhere, industrial production also stagnated in April, meaning it was 0.4% lower year-on-year. Activity in the housing sector seems to have slowed as well, with the number of building permits and existing home sales falling from already subdued levels at the start of Q2.**Meanwhile, the available survey data for Q2 have been mixed.** Both the services and manufacturing PMIs deteriorated in April, with the latter inching back into contraction territory, at 49.9. Similarly, the manufacturing and non-manufacturing ISMs moved into contraction mode in April also. However, both sector PMIs improved and printed in expansion mode in May. Likewise, the non-manufacturing ISM moved higher and rose above the key 50 level in May. In contrast though, the manufacturing ISM declined further to 48.7 from 49.6. Overall, the data suggest the services sector is outperforming manufacturing so far in Q2. Elsewhere, the Michigan and Conference Board measures of consumer sentiment fell in April, before reversing the declines in May.

Regarding the labour market, conditions remain tight, albeit there are signs they are starting to soften. The unemployment rate rose to 4% in May, its highest level since January 2022. Meantime, having slowed to +3.9% y/y in April, average earnings growth reaccelerated to +4.1 y/y in May. Furthermore, the monthly increase in average earnings remained elevated at +0.4% m/m in May. Meanwhile, payrolls have expanded by an average of +248k, in the first five months of 2024, just below the average of +251k per month in 2023.

In terms of inflation, the disinflationary trend in headline inflation throughout 2023 has stalled. After declining sharply in the first six months of last year, headline CPI has been in a 3.1-3.7% range since June 2023. Worryingly, this year it has accelerated from its low of 3.1% in January, rising to 3.5% in March and printing at 3.3% in May. Furthermore, the headline PCE deflator, rose to 2.7% in March from 2.5% in January and February, and remained at that level in April. Meantime, core inflationary pressures are slowly dissipating. Core-CPI has fallen in 18 of the last 20 months, but it was still elevated at 3.4% in May. Similarly, core-PCE inflation has been declining slowly. It fell to 2.8% in February, its lowest level since March 2021, and stayed at that level in March and April. The Fed is forecasting core-PCE will stay at 2.8% in Q4 2024, before falling to 2.3% in Q4 2025 and to 2.0% by Q4 2026.



To summarise, the economy came into 2024 in rude health, on the back of strong growth, a tight labour market and falling inflation last year. Against this backdrop, the IMF is forecasting US GDP will expand by 2.7% this year. However, there has been some loss of momentum in the economy at the start of 2024, reflected in weaker GDP growth and survey data, as well as some softening in the labour market. Furthermore, the large amount of excess savings build up during the pandemic have been entirely run-down. Thus, the risks to the outlook are tilted to the upside for inflation and to the downside for growth. **Meantime, amid sticky inflation, the Fed has become much less dovish on the rates outlook then it was at the turn of the year.** A resumption of the disinflationary trend in the first half of 2023 will be needed for policy easing to get underway later in the year.

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by AIB Northern Ireland (NI). In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and Allied Irish Bank (NI) are trade marks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street, Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit