

Fed hikes by 75bps, provides confusing signals on policy

The November meeting of the US Federal Reserve saw the central bank implement its fourth consecutive 75bps rate hike, as it continued to front load its tightening cycle in an attempt to bring inflation back under control and on a sustainable path to its 2% target. The rate increase brings the target range for the Fed funds rate to 3.75-4.00%.

The decision to raise rates by 75bps was unanimous. The Fed has now enacted 375bps worth of rate increases since it commenced its tightening cycle in March of this year. Given that the 75bps increase was well sign-posted and fully priced-in by markets, the main point of interest was on what signals, if any, the Fed would provide, regarding the magnitude of rate hikes going forward.

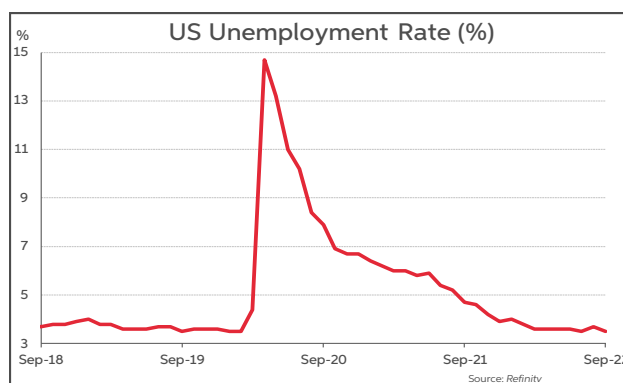
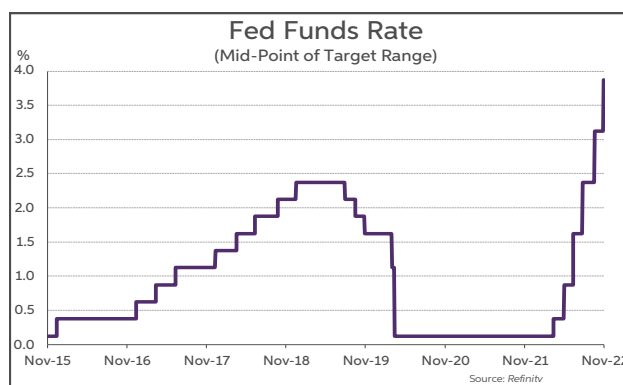
In this regard, the meeting statement gave a signal that the FOMC was considering a 'pivot'. In a notable addition to the text, the Fed commented that in deciding on the pace of future rate increases, it would take into account three factors. These are (1) the cumulative tightening of monetary policy, (2) lags with which monetary policy impacts the economy and (3) the economic and financial developments.

However, the statement proved to be rather misleading, with Fed Chair Jerome Powell espousing a more hawkish tone in the post meeting press conference. He commented that the Fed has still "some way to go" in its tightening cycle as well as stating that it is "very premature to be thinking about pausing". Instead, he noted that the macro newsflow since their last meeting, in September, suggests that the "ultimate level of rates will be higher than previously expected". He guided that any decision on reducing the magnitude of rate hikes will be data dependent. He said the Fed may opt to slow the pace of rate hikes, "as soon as the next meeting or the one after that". Chair Powell emphasised it is more important to focus on where rates will end up at the end of its current tightening phase, rather than the pace of rate hikes to get there. He stated "Let me be clear, let me say again, the question of when to moderate the pace of increases is now much less important than the question of how high to raise rates and how long to keep monetary policy restrictive which will be our principle focus".

The most recent set of interest rate projections provided by the Fed were released at its previous meeting in September. These showed that the Fed saw rates peaking at 4.625% next year. Ahead of the meeting, markets were pricing in that rates would reach 5% next year. The next set of Fed rate projections will be released at its December meeting. In terms of market expectations, following the press conference, futures contracts have firmed and are now anticipating that rates will get to 5.25% by the middle of next year. The Fed is expected to begin cutting rates by the end of 2023, but still keep policy restrictive over the medium-term.

Nearer term, the market is undecided between a 50bps or 75bps hike at the December 15th meeting. As Chair Powell guided, incoming data between now and then will play a key role in determining the Fed's decision. Therefore, the market will be very much in 'data watching' mode over the coming weeks as well as closely following FOMC members comments, as they look for signals on the magnitude of the rate hike at the December meeting.

The Fed meeting outcome was a source of market volatility. Initially, on the release of the meeting statement which suggested a 'pivot', Treasury yields move lower, the dollar weakened and stocks moved higher. However, following Fed Chair Powell's more hawkish comments in the press conference, these moves reversed. The 10-year Treasury yield moved back above the 4% threshold, while the dollar strengthened. This is reflected in EUR/USD falling below the \$0.98 mark and GBP/USD trading down into the \$1.12-1.13 band. Meantime, the S&P 500 index fell sharply in the aftermath of the press conference, and was down 2.5% at the closing bell on Wall Street last night.



US economy is expected to largely stagnate in 2023

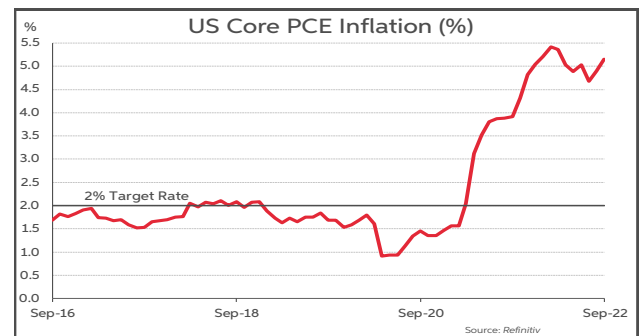
Having contracted by 1.6% in annualised terms in Q1, and by 0.6% in Q2, US GDP expanded by 2.6% in the third quarter. In the first half of the year, volatility in trade and inventories - a hangover from the supply chain issues caused by the pandemic - led to the fall in output. Real final domestic sales (which excludes external trade and inventories), though, increased in both quarters. In Q3, a sharp fall in imports as businesses had already rebuilt their stockpiles boosted the headline GDP figure. Meantime, real final domestic sales increased by a far more modest 0.5%.



Regarding the breakdown of GDP for Q3, consumption grew by 1.4%, vs. 2% in Q2, contributing 1.0 percentage points (p.p.) to growth. Investment fell sharply for a second quarter, subtracting 0.9 p.p. from the total, largely due to a big 26% fall in residential investment. Government spending made a positive contribution to GDP for the first time since Q1 2021, boosting output by 0.4 p.p., in large part due to a pick-up in defence expenditure. Elsewhere, exports increased by 14% and imports fell by 7%, meaning net trade added a combined 2.8 p.p. to growth in the quarter. Meanwhile, inventories, clipped 0.7 p.p. from GDP.

In terms of the labour market, conditions remain very tight against the backdrop of continued strong job growth. Payrolls have been increasing at a rapid pace, rising by circa 3.8m in the first three quarters of the year. The unemployment rate has continued to fall, and stood at 3.5% in September. Labour force participation is still 1p.p. below its pre-pandemic level though. The tight conditions in the labour market have placed further upward pressure on wages, with average earnings 5.0% higher year-on-year in September. However, wage growth has moderated somewhat more recently, with the rise in average hourly earnings falling to 0.3% in September and August, from 0.5% in July.

Meanwhile, inflation has proved to be more persistent and stickier than anticipated. In September, headline CPI inflation rose by 0.4% in the month, while the annual rate edged lower to 8.2% from 8.3%. However, the core CPI rate jumped to 6.6% from 6.3% in August, indicating that price pressures have become more broad-based. Headline and core-PCE inflation were at 6.2% and 5.1%, respectively, in September. Inflation is expected to move back slowly to near the 2% target level over the next couple of years. The latest projections, from the September Fed meeting, show core-PCE inflation easing to 3.1% by Q4 2023 and 2.3% in Q4 2024.



The limited amount of survey data available for October suggests the economy lost momentum at the start of Q4. The manufacturing PMI declined to 50.4, its lowest level since June 2020. The manufacturing ISM also moved lower, to 50.2 in October. Meanwhile, the services PMI slumped to 46.6 in October, consistent with a contraction in activity in the sector. Consumer confidence also remained very weak at the beginning of Q4. The Michigan measure of consumer sentiment has stayed moribund near its all-time low, at 59.8, while the Conference Board measure of consumer confidence fell to 102.5 from 107.8 in October.

Having rebounded by a robust 5.7% in 2021, the US economy will grow much more slowly this year, and the risks of a recession are rising. Very high inflation is weighing on real household incomes and consumer spending power. Inflation is also proving to be much stickier than anticipated. In response, the Fed continues to tighten monetary policy very aggressively, while financial conditions have already tightened significantly since the start of the year. The housing market in particular is coming under severe pressure from higher interest rates. Meantime, the global economy has also weakened, a further headwind facing the US economy. There are some positives for the US economic outlook, though. Jobs growth has remained very robust, with payrolls now above their pre-pandemic level. Overall though, growth forecasts are being revised markedly lower for the US economy. The IMF recently downgraded its growth forecasts to 1.6% for 2022 and 1% in 2023. Meantime, the OECD has cut its US GDP forecast to 0.5% for next year, which would point to a largely stagnant economy for much of 2023.

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