Fed Watch

AIB Treasury Economic Research Unit

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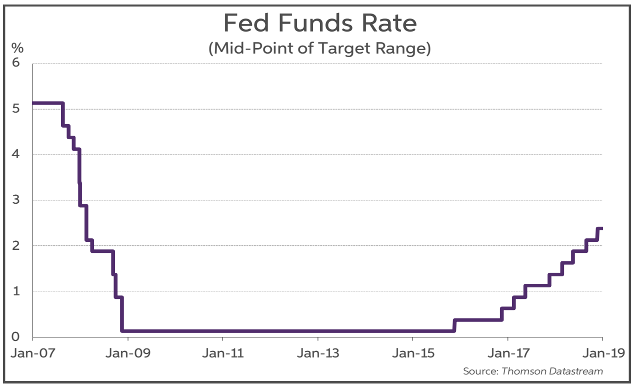
Fed rates clearly on hold for now

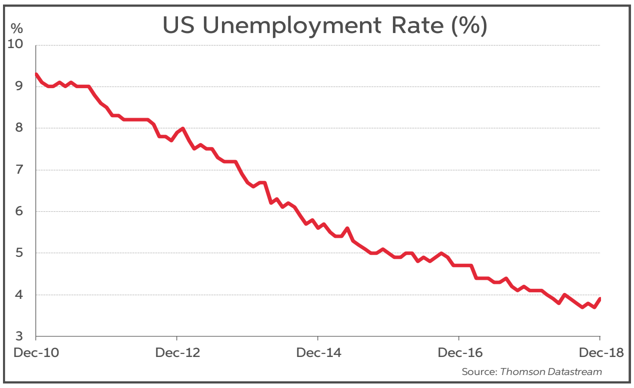
As expected, the January meeting of the Federal Reserve Open Market Committee (FOMC) saw the target range for the key fed funds rate maintained at 2.25-2.50%. However, in a surprise for markets the meeting statement indicated that rates are now on hold. The Fed stated that in light of the global economic backdrop, financial market developments and muted inflation pressures, it would be "patient as it determines what future adjustments" are appropriate for the federal funds rate. Crucially, it removed the reference in its statement to further gradual rate increases. **This suggests that rates could move in either direction.** It also stated that it could adjust the rate of normalisation of its balance sheet, or rundown of the asset portfolio built up as a result of QE, if the economic conditions warranted it.



The subsequent press conference from Fed Chair Powell provided further insight into the Fed's very cautious approach to policy. Powell stated that the US economy remains in a "good place" and that the Fed expects growth will continue at a "solid pace in 2019". However, he also highlighted what he termed **"cross-currents and conflicting signals about the outlook" that give "reason for caution"** as well as suggesting the **"risk of a less favourable outlook".** In this regard, he referenced slowing growth in Europe and China, financial conditions now being less supportive of growth versus earlier in 2018 and more mixed surveys of US business and consumer sentiment.

The Fed Chair also stated that the case for raising rates had "weakened somewhat" in light of more "muted" inflation readings. The Fed's view now is that this has "diminished" the risk to the economy of leaving rates "too low for too long".

While we did not get updated interest rate projections from the Fed (due at March meeting), the tone and content from the meeting statement/press conference suggest there has been a change to its rate outlook. Its December projections indicated that the Fed envisaged hiking rates twice this year, followed by another increase in 2020. It is very likely that the Fed now thinks less rate tightening, if any, is required.



This would bring the Fed more in line with market expectations for rates. Future contracts are not pricing in any further rate hikes. In fact, the next move that the market is anticipating from the Fed is a rate cut around end-2020/early-2021.

Overall, it is very clear from the January FOMC meeting that the Fed is taking a very cautious approach to the monetary policy outlook. Chair Powell explicitly referenced a "patient, wait and see approach to future policy changes", hinting that rates could move in either direction. The extent of the change in tone from the Fed is surprising given that there has been very little new economic data since the Fed's last meeting in December (due to the government shutdown), except for a very strong payrolls reading last month. The Fed Chair again emphasised last night that monetary policy is now very much data dependent. Thus, if the US economy maintains a strong pace of growth and inflationary pressures rise, a rate hike from the Fed would still be likely this year.

In terms of market reaction, the surprising dovish shift in tone from the Fed has seen the dollar come under some modest downward pressure, while US Treasury yields have fallen, with the policy sensitive two-year yield declining by around 10bps to near 2.5%**.** Meanwhile, US equity markets rallied at the prospect of no more hikes from the Fed.

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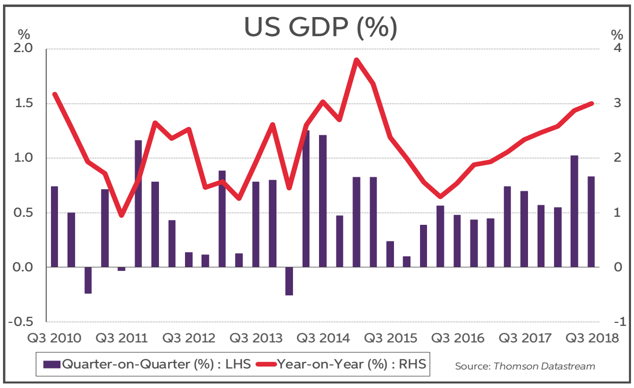
US growth remains robust

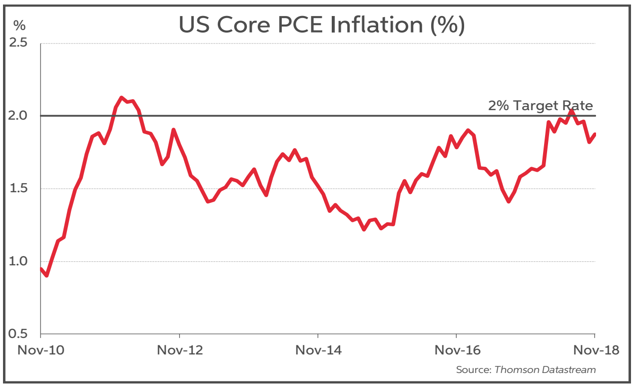
US annualised growth eased to a still strong 3.4% in Q3, from 4.2% in Q2. The underlying data showed that consumer spending remained very robust in Q3, adding 2.4 percentage points (p.p.) to growth, while government expenditure contributed 0.4 p.p. However, the contribution from fixed investment (0.2 p.p.) declined significantly in the quarter.



The shutdown of the federal government has resulted in a delay in the publication of a number of economic data releases, including Q4 GDP figures. **However, available data suggest that a strong rate of GDP growth has been maintained in the quarter.** The Composite PMI was little changed in Q4, averaging 54.7 compared to 54.8 in Q3. Likewise, the ISMs also point to a strong pace of economic expansion. Meanwhile, the University of Michigan measure of consumer sentiment shows that confidence dipped slightly in the quarter, but it remained at an elevated level. The shutdown means that December's retail sales report has not been released. Sales were strong in October and November, with the control measure (ex-gas, autos and building materials) rising 1% on Q3 levels. Meantime, the quarterly growth rate of industrial output eased slightly to a still strong 0.9% in Q4, from 1.1%.

Labour market data were very positive in Q4. Non-farm payrolls averaged growth of 254k in the quarter, a significant improvement on Q3's 190k figure. Meanwhile, an increase in labour force participation saw the unemployment rate edge up slightly to a still very low 3.9%. **Tight labour market conditions appear to be translating into higher wage inflation.** The year-on-year growth rate of average hourly wages has now been above the 3% level for three consecutive months.

On the inflation front, headline CPI has moderated on lower oil prices in recent months, averaging 2.2% in Q4, compared to 2.6% in Q3. The rise in wages has so far failed to generate an increase in underlying price pressures. The Fed's preferred measure of inflation, core-PCE, remains subdued, averaging 1.8% in Oct/Nov.



Meanwhile, survey data for January suggest the economy is continuing to perform well at the beginning of the year. The composite PMI was broadly unchanged in the month. However, consumer sentiment did fall sharply, partly due to the shutdown and December's financial market volatility.

Despite the 'shutdown' ending, it will likely have a negative impact on growth in this quarter. Overall, though, the near-term outlook remains positive. While the boost from tax cuts at the beginning of last year is fading, the strong labour market continues to support the key consumer sector of the economy (c. 70% GDP). Meantime, with interest rates remaining low and the Fed turning cautious on more hikes, monetary policy remains supportive of growth. **The recent IMF forecast is for strong US GDP growth of 2.5% in 2019, which is consistent with the Fed forecast of growth slowing to 2.3% YoY by Q4.**

However, in the medium term there are some risks facing the US economy. The growing twin deficits are a source of worry**.** The lagged effect from the Fed's rate hikes could act as a headwind to activity. The housing market appears to be weakening as activity looks to have peaked. The flattening US yield curve is also worth watching as it has previously been a forerunner to a downturn in the US economy. The slowdown in the global economy is another headwind, as is the specific risk factor posed by the US-China trade dispute. **Overall, while growth is expected to remain strong in 2019, the downside risks facing the US economy have heightened over the medium term. As a result, the US economy could slow quite noticeably in 2020 and beyond.**

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