Fed Watch

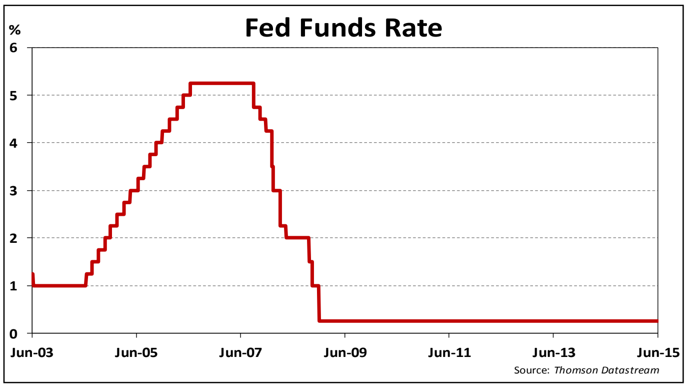
30th July 2015

AIB Treasury Economic Research Unit

Fed keeping its options open

As expected, the July meeting of the FOMC concluded last night with no changes to monetary policy. The decision to leave policy unchanged was unanimous, for a fifth consecutive meeting.

The text of the meeting statement contained some minor tweaks, which were positive in tone on the economy. The Fed noted that the labour market continued to improve with "solid job gains". It commented that the underutilisation of labour resources has "diminished since early this year". The Fed also upgraded its characterisation of the housing market, noting that the sector has shown "additional improvement".

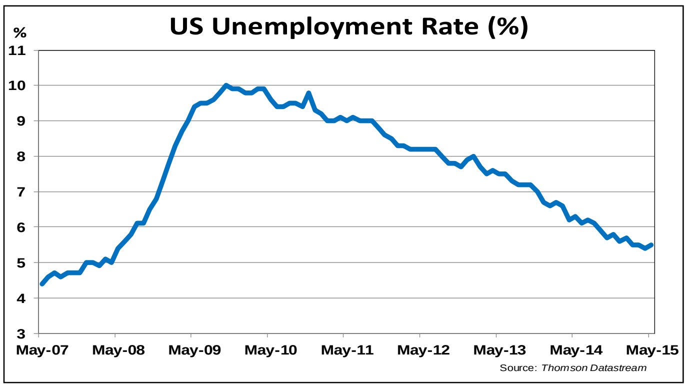


Elsewhere, within its forward looking section, the Fed made a slight, but nonetheless important change in regard to the labour market. It is now saying that there needs to be only "some" further improvement in the labour market for it to be appropriate to start increasing interest rates. The **addition of the word "some" in this month's statement suggests the degree of improvement required in the jobs market for the Fed to be comfortable with hiking rates is now somewhat less than in June**. This may partly reflect the latest data showing a further fall in the unemployment rate to 5.3%.

There was no press conference after last night's meeting. Thus, the most recent public comments we have from Fed Chair Yellen on monetary policy were made during her semi-annual testimony to Congress. In her testimony, she gave an upbeat assessment of the economy, noting that "prospects are favourable for further improvement in the US labor market and the economy more broadly". **She also stated that the FOMC was of the view that it would likely be appropriate to increase interest rates "at some point this year".**

The FOMC has indicated a more aggressive path of rate hikes than the market is currently expecting. The FOMC's most recent projections on the likely path of interest rates were released at the June meeting. They showed that the median projection for the key Fed funds rate at end 2015 was 0.625%, and 1.625% for end 2016. In terms of the spread of views within the FOMC members, 15 of the 17 members expect rates to rise in 2015, while ten members envisaged that there would be two rate hikes this year.

In contrast, market pricing at the moment suggests that the first full 25bps increase will not occur until end 2015. The market is looking for the Fed funds rate to rise to 1.25% by end 2016, below the Fed's projection of 1.625%.



Overall, yesterday's July FOMC meeting statement provided no strong signal as to the exact timing of when the Fed may start to increase interest rates. The Fed continues to keep its options open on the appropriate timeframe, with the decision remaining very much data dependent. If the incoming data (in particular, employment and wage growth) continue to register improvement over the next two months, then the Fed may have enough evidence by its September meeting (16th-17th) to start to hike interest rates.

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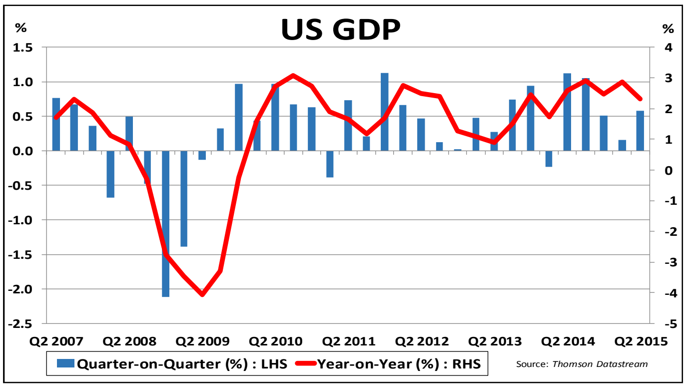
US economy overcomes Q1 soft patch



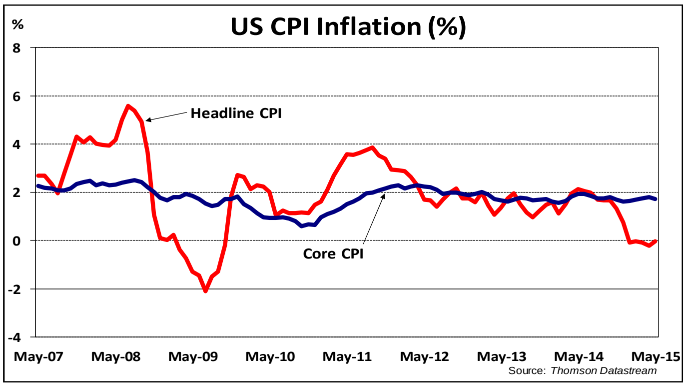
The first reading of US GDP for Q2 showed that the economy grew by 2.3% on an annualised basis, slightly below market expectations for a 2.6% print. Although, this shortfall was offset by an upward revision to Q1 GDP to 0.6% from −0.2%.

The breakdown of the Q2 data show that, once again, the US economy relied heavily on consumer spending. Personal consumption contributed 2 percentage points (p.p.) to growth. Meanwhile, net trade made a small positive contribution to growth (0.13 p.p.) in Q2, after being a drag in the previous two quarters, due mainly to an increase in export growth. One disappointment though, is the sharp slowdown in investment. Its contribution to growth was just 0.14 p.p. in the second quarter, with a big decline in spending on business equipment. However, this was largely offset by a pick-up in residential investment.

The pick-up in GDP growth is in line with other data showing an improved performance in the second quarter. For example, retail sales rebounded in Q2, growing by 1.5%, after they fell by 1% in Q1. It was also an encouraging quarter from the point of view of the construction sector, with housing starts rising to levels not seen since end 2007. Meantime, manufacturing output recorded a 0.4% increase in Q2.

The pick-up in the economy in Q2 coincided with a reacceleration in the pace of improvement in the labour market. Non-farm payrolls rose by an average of 221k in the second quarter, following on from Q1's 195k average. At the same time, the unemployment rate has fallen to 5.3%, its lowest level since April 2008. Although, part of this decline can be attributed to a fall in the labour force participation rate.

Meanwhile, monthly earnings continued to show some modest improvement in Q2. However, on a year-on-year basis, growth in average earnings continued to struggle for upward momentum, with the most recent data showing growth had slowed slightly to 2% in June.



On the inflation front, lower oil prices have seen CPI inflation remain very subdued, coming in at 0.1% in June. The core CPI rate (ex-food & energy), though, stands at 1.8%. Meantime, core PCE, the Fed's preferred measure of inflation, remained at 1.3% in Q2, still a way below its 2% target rate.

In terms updates on the economy in Q3, Markit PMI data for July (manufacturing and services indices) **suggest the US broadly maintained its momentum.** However, consumer sentiment (Michigan & Conference Board measures) moved lower in July.

Going forward, the US economy will remain supported by a number of positive drivers of growth, not least of these is the on-going strong recovery in the labour market. The accommodative stance of US monetary policy should also help to support growth, while the drag from fiscal consolidation has diminished. Solid growth in employment and wages should underpin consumer confidence and, in turn, the solid performance on the consumer side of the US economy. Lower energy prices are providing a further significant fillip to consumer spending. Thus, **in its recent 'World Economic Outlook', the IMF forecasts that the US economy will grow by 2.5% in 2015 and 3% in 2016.**

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