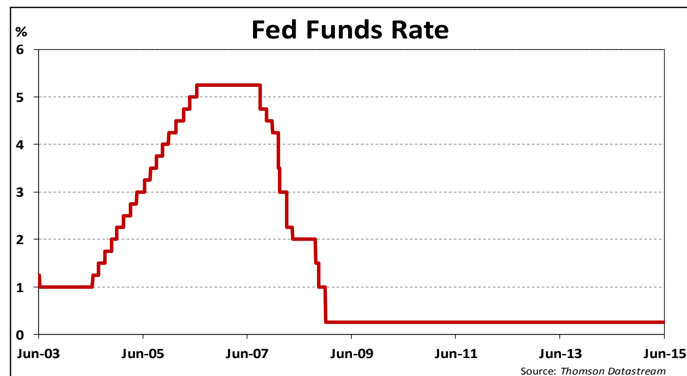
Fed Watch

18th June 2015

AIB Treasury Economic Research Unit

Fed still on course to hike rates this year

The June meeting of the FOMC concluded with no changes to policy, which was in line with the market consensus. The decision to leave policy unchanged was unanimous, for a fourth consecutive meeting.



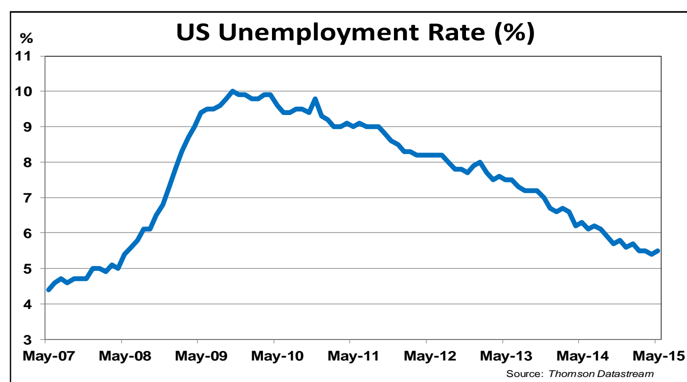
In her post meeting press conference, Fed Chair Yellen, stated that the FOMC "**judged that economic conditions do not yet warrant an increase**" in interest rates. The Committee would "**like to see more decisive evidence** that a moderate pace of economic growth will be sustained" before deciding it appropriate to hike rates.

As expected, the meeting statement showed some upgrading in the description of the economy's recent performance. The Fed noted that activity "has been expanding moderately" after its Q1 soft patch. It also commented that the "pace of job gains picked up".

The updated macro forecasts contained only minimal changes. GPD growth for this year was revised down to take into account the weak start to the year, while the unemployment rate was revised up slightly. **Overall, the Committee's view on the economic outlook has generally not altered since its last meeting. It continues to "see the risks to the outlook for economic activity and the labour market as nearly balanced".**

In terms of the FOMC members projection's on the likely path of interest rates, the median projection for end 2015 remains at 0.625%, while both the end 2016 and end 2017 numbers were lowered by 25bps to 1.625% and 2.875% respectively, emphasising that the pace of policy tightening will be gradual. **However, while the 2015 median projection was not altered, and is consistent with two rate hikes this year, there has been some dovish shifts in terms of individual participants.** There are now five members indicating that only one rate increase is likely to be appropriate this year, compared to only one member in March. Nonetheless, ten FOMC members still see two rate hikes later this year.

The FOMC is still indicating a more aggressive path of rate hikes than the market is currently expecting. Market pricing at the moment suggests that the first full 25bps increase is not expected 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, the June FOMC meeting provided no clear signal as to the exact timing of when the Fed may start to increase interest rates. Indeed, the breakdown of the interest rate 'dots' suggests there is no clear consensus within the FOMC on when to start increasing rates. **Instead, the Fed has made sure it has not tied itself to a specific start date and has flexibility in deciding on the appropriate timeframe.** It continues to emphasise that future policy decisions remain very dependent on incoming data.

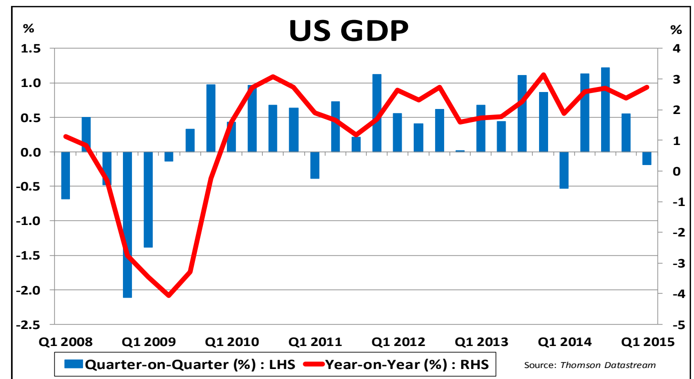
Nonetheless, 15 of the 17 FOMC members expect rates to rise the year. If the incoming data (in particular, employment, wage growth and inflation indicators) continue to register improvement, the Fed may have enough evidence by its September meeting to be comfortable to start to increase interest rates.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

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

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

US Economy Rebounding in the Second Quarter



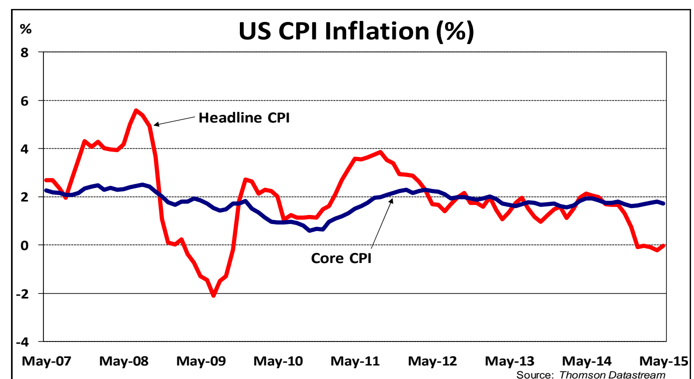
The US economy contracted in the first quarter of the year, with annualised GDP growth falling from 2.2% in Q4 2014 to -0.7%. While most of the main sectors of the economy struggled in Q1, the bulk of the decline in growth was accounted for by the jump in the US goods trade deficit, which may in part reflect the impact from the stronger dollar, as well as the West Coast port strike. Bad weather was also a key factor in the decline in GDP in Q1.

The macro data for Q2 have indicated that the economy has overcome its soft patch in Q1. This is particularly evident in the labour market data. Non-farm payrolls increased by an average of 251k in April/May, representing a solid rebound from Q1's somewhat disappointing 195k average. Meantime, the US unemployment rate hit a fresh 7-year low of 5.4% in April, though it did edge back up slightly to 5.5% in May.

Monthly earnings data for April/May have also shown further improvement. Thus, we could see the annual growth in the wage component of the quarterly 'Employment Cost Index' continue to pick-up pace in Q2. The Q1 data showed that wages grew by 2.6% year-on-year. The Fed has stated that it views annual wage growth of 3-4% as being a 'normal' pace.

In terms of other 'hard' data measures of Q2's performance, **retail sales have performed strongly in April/May, with sales up 1.7% compared to Q1,** in which they declined by 1%. Vehicle sales have been particularly strong, with the annualised level hitting a 10-year high in May. Meanwhile, housing starts rose by 12.5% in April/May from their average level in Q1.

Industrial output, though, has remained a cause for concern for the US economy. Indeed in the first two months of Q2, output was down 0.6% compared to Q1, which itself recorded a 0.1% quarter-on-quarter fall. Overall, production has not increased on a monthly basis since November last year. The main reason for the weak industrial data in recent months has been the decline in energy production due to lower oil prices.



The fall in oil prices has seen CPI inflation decline sharply since the end of last year. It stood at just 0% in May. However, core CPI inflation (excludes energy) has been much firmer, standing at 1.7% in May. But, this is quite different from the Fed's preferred core PCE inflation measure, which was at 1.2% in April, well below the 2% target rate.

The expectation is that, as in 2014, the US economy will recover from its Q1 setback and grow solidly over the remainder of the year. There are a number of factors underpinning this expectation, not least of which is the on-going strong recovery in the labour market. The accommodative stance of US monetary policy should also support growth, while the drag from fiscal consolidation has diminished. Solid growth in employment and wages should underpin consumer confidence and household spending. Lower energy prices are providing a further significant fillip to consumer spending. The latest Fed economic projections show that it expects GDP growth of around 2% this year, a downward revision from around 2.5% in March, reflecting the weak performance in Q1. Growth of around 2.5% is being pencilled in for 2016.

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AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomicresearch.com

AIB Treasury Economic Research Unit