Fed Watch

29th October 2015

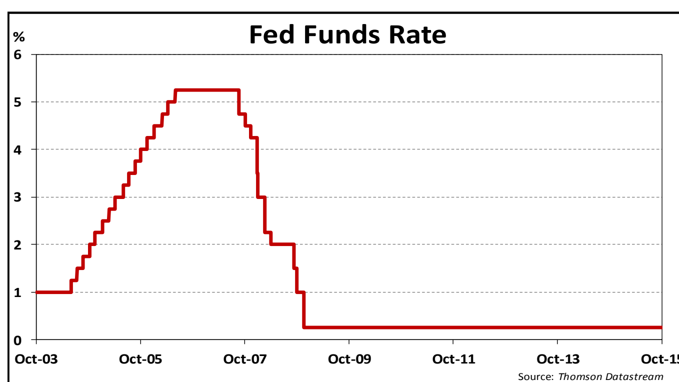
AIB Treasury Economic Research Unit

December rate hike under serious consideration

The October meeting of the FOMC concluded last night with no changes to monetary policy. This was in line with the market consensus. The decision to leave policy unchanged was not unanimous, with one member (Lacker) voting for a 25bps rate hike for a second consecutive meeting.

However, the meeting statement was more hawkish in tone, containing some important changes. A key change in this regard was the rephrasing of the context of its policy deliberations. The FOMC amended the language from "in determining how long to maintain its target range" to "**in determining whether it will be appropriate to raise the target range at its next meeting".**

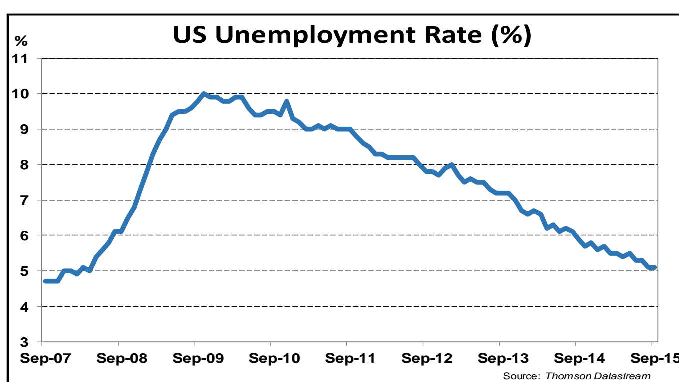
The statement also indicated that the FOMC is now less concerned about risks to the US economy from external developments compared to its September meeting. In its previous meeting statement, the Fed commented that "global economic and financial developments" could "restrain economic activity" and "put further downward pressure on inflation". This reference was removed from this month's release, with the Fed simply stating that it "is monitoring global economic and financial developments".



Meanwhile, the Committee's description of the economy contained only minor tweaks. The FOMC noted that the "pace of job gains slowed" recently. Overall though, it continued to be of the view that labour market indicators show the underutilisation of labour resources has "diminished since early this year".

Despite yesterday's 'hawkish' update from the FOMC, the market continues to expect a less aggressive path of rate hikes than the Fed is currently suggesting. The FOMC's most recent projections on the likely path of interest rates were released at the September meeting. They showed that the median projections for the key Fed funds rate at end 2015 was 0.375%, 1.375% for end 2016 and 2.625% for end 2017.

In contrast, market pricing suggests that the first full 25bps rate hike is not expected until the first quarter of 2016. The market is looking for the Fed funds rate to rise to 0.75% by end 2016, below the Fed's projection of 1.375%.



In summary, the Fed used its October meeting statement to put markets on notice that a rate hike at "its next meeting" (i.e. 15th/16th December) is under serious consideration. Therefore, the chances of a Fed rate hike in December have increased following yesterday's meeting.

At the same time, the FOMC statement was worded so as to allow the Fed flexibility on when it decides to start to increase interest rates. Of course, any policy tightening remains dependent on the Fed being content with what it sees from the incoming data, including "measures of labour market developments" as well as "readings on financial and international developments". Therefore, the market will be paying close attention to incoming data on the US economy over the coming weeks, as well as speeches/comments from FOMC members to try and ascertain the likelihood of a Fed rate hike in December.

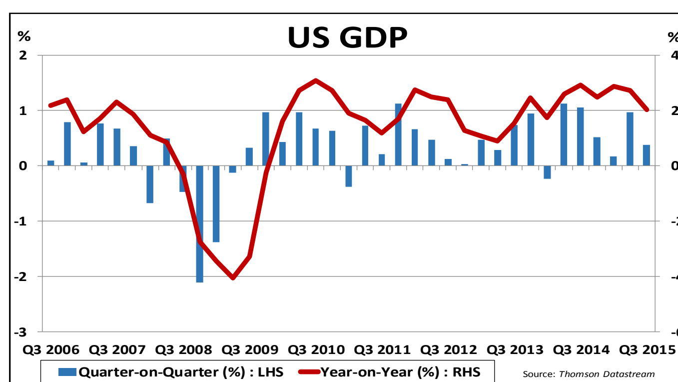
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

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

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

Underlying trend in the US remains solid

The first reading of US GDP for Q3 showed that the economy grew by 1.5% on an annualised basis. This represents a slowdown from the 3.9% growth recorded in Q2.

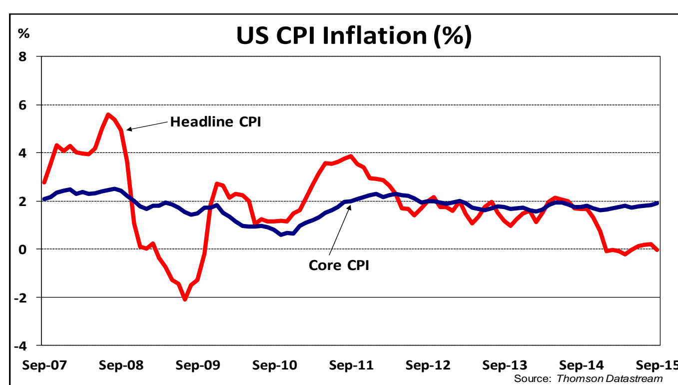


However, the breakdown of the Q3 data show that the performance of the economy was not as soft as the headline figure suggests. Consumption grew by a robust 3.2%, which suggests that the domestic economy remains strong. Thus, consumer spending was the key driver, contributing 2.2 percentage points (p.p.) to growth. Business investment remained somewhat soft, adding just 0.3 p.p. to GDP. The contribution from net trade was neutral, meaning the expected negative impact from the stronger dollar and slower growth in developing economies was not apparent in the data. The only significant drag came from changes in inventories, which took 1.4 p.p. off headline GDP growth (largest negative impact since Q4 2012). This drag is unlikely to prove to be sustained.

Other hard data for Q3 also suggested solid growth. Retail sales rose by a healthy 1.2% in the quarter. This figure would have been even stronger had it not been for the fall in prices of commodities (especially oil) and imported goods (due to stronger dollar). The housing market also continued to exhibit encouraging signs. Housing starts remained strong, showing year-on-year growth of 13% in Q3. Existing home sales also continued to show solid growth in Q3, increasing by 8.3% year-on-year. Meantime, industrial production rose by 0.5% in the third quarter, after having declined in the two previous quarters. This in part reflects an easing in the drag from the fall in oil extraction, as well as strong growth in the production of motor vehicles.

The pace of recovery in the labour market slowed somewhat in Q3. Non-farm payrolls averaged monthly gains of 167k in the quarter, a decline from Q2's 231k average. Year-on-year growth in employment slowed to 1.5% in September. Meanwhile, the unemployment rate held steady at 5.1% in September. Although, it has been aided by further falls in the participation rate, which declined to 62.4% in September, its lowest level since 1977. Year-on-year growth in average earnings remained in the 2-2.3% range which has been broadly in place since the end of 2012.

On the inflation front, lower oil prices have seen CPI inflation remain very subdued, coming in at 0% in September. The core CPI rate (ex-food & energy), though, stands at 1.9%. Meantime, core PCE, the Fed's preferred measure of inflation, remained stuck at 1.3% in Q3.



Overall, the US economy will remain supported by a number of positive drivers of growth. The accommodative stance of US monetary policy should help in this regard, while the drag from fiscal consolidation has diminished. The still robust performance of the labour market and consistent wage growth should help to underpin consumer confidence and, in turn, the encouraging performance on the consumer side of the economy. Lower energy prices are also providing a significant fillip to consumer spending. However, the economy does still face some risks from a slowdown in emerging markets, as well as the impact from the stronger dollar. **In its most recent 'World Economic Outlook', the IMF forecasted that the US economy will grow by 2.6% this year and 2.8% in 2016.**

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