Fed Watch

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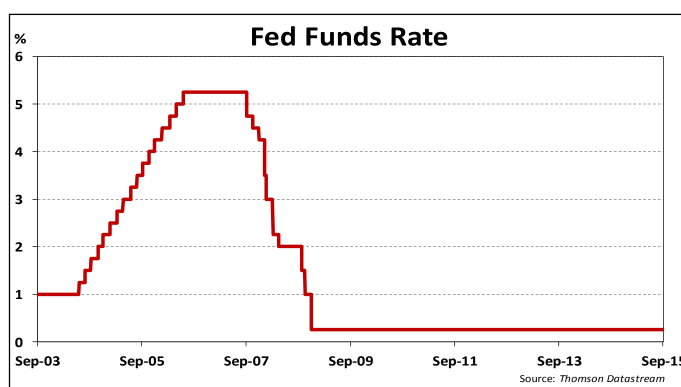
AIB Treasury Economic Research Unit

Cautious Fed monitoring developments abroad

The much anticipated September meeting of the FOMC concluded with the Fed erring on the side of caution, making no changes to policy. This was in line with market expectations. The decision to leave policy unchanged was not unanimous, with one member (Lacker) voting for a 25bps rate hike.

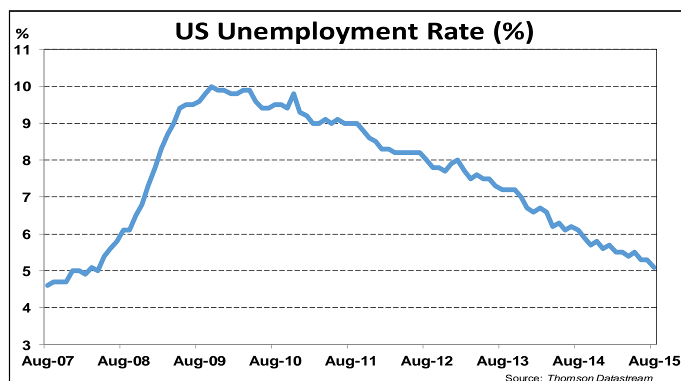
It is clear from the meeting statement and Fed Chair Yellen's press conference that the risks posed to the US economy from recent global macro and financial market developments were a key determining factor in its decision not to hike interest rates. The meeting statement noted that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term".

In her post-meeting press conference, the Fed Chair stated the decision to remain on hold was "in light of the recent heightened uncertainties abroad and a slightly softer than expected path for inflation". She also commented that "given the significant economic and financial interconnections between the United States and the rest of the world, **the situation abroad bears close watching"**



However, at the same time, **Fed Chair Yellen was keen not to "overplay the implications of these recent developments" and stressed that they have not "fundamentally altered" the Fed's outlook.** It views that the "economy has been performing well" and it expects it to continue to do so. It also remains of the view that the effect of recent dollar appreciation and falling energy prices on inflation will be 'transitory'. As a result, the latest macro forecasts contained only minor changes.

In terms of the FOMC members' projections on the likely path of interest rates, there was a dovish shift in the 'dots'. The median projections for end 2015, end 2016 and end 2017 were lowered by 25bps in each year to 0.375%, 1.375% and 2.625% respectively, emphasising that the pace of policy tightening will be gradual. **Most participants, though, "continue to expect that economic conditions will make it appropriate" to raise interest rates "later this year**". However, the number of participants who hold this view has fallen to 13 (from 15 in June) of the 17 FOMC members, with the Fed appearing to be split on when to hike interest rates.



Despite this dovish change to its interest rate projections, the Fed is still indicating a more aggressive path of rate increases than the market is currently expecting. Market pricing at the moment suggests that the first full 25bps rate hike is not expected until next spring. 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%.

Overall, the September FOMC meeting was more cautious in tone than had been expected. There was a 'dovish' interpretation from markets to the meeting, with the dollar weakening and yields on US treasuries falling. As noted above, the Fed continues to indicate that it expects rates to rise this year. With two meetings left before year end, the December meeting seems the more likely starting point than October. Of course, this is dependent on the Fed being content with what it sees from its "monitoring of developments abroad" with particular focus on China, as well as the requirement for "some further improvement" in the US labour market.

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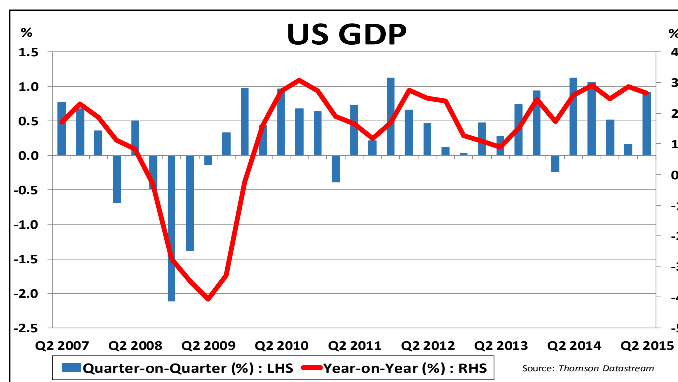
Data point to continuing solid growth

The second reading of US Q2 GDP showed that the economy grew by 3.7% on an annualised basis. This represents a marked improvement from Q1's soft 0.6% performance. The breakdown of Q2 GDP was encouraging, with all of the main sectors of the economy providing a positive contribution. Personal consumption was the key driver, contributing 2.1 percentage points (p.p.) to growth, while investment (0.7 p.p.) and government spending (0.5 p.p.) were solid.



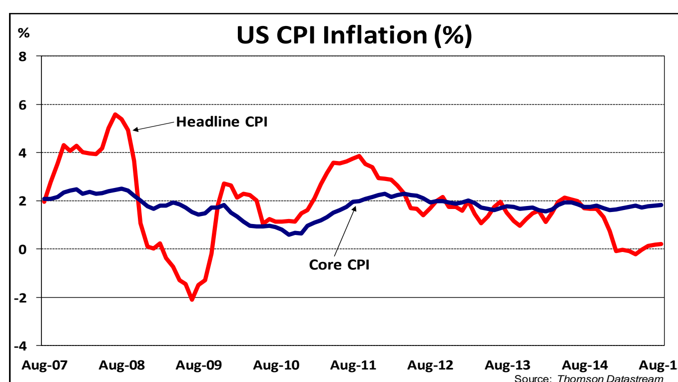
In terms of a timelier look at the performance of the economy, the ISM surveys for July/August suggest the US has maintained its improved pace of growth. The key services sector ISM index has picked up further, averaging 59.7 compared Q2's 56.5 average. However, the manufacturing ISM indicates that the sector has continued to struggle, averaging 51.9 in July/August after a 52.6 average in Q2.

Most hard data measures of the economic performance in Q3 have been encouraging. The 'control' retail sales measure (used as a proxy for goods consumption in GDP), which performed strongly in Q2, has remained strong in July/August, growing by 1.3% versus Q2. Meantime, while year-on-year growth in industrial output has remained weak, there has still been some tentative signs of improvement in the sector. Output increased by 0.5% in July/August versus Q2, in which it contracted by 0.7%. On the housing market, growth in new and existing home sales remained on an upward trajectory in July, while housing starts continued to show a strong year-on-year performance in August.

The solid performance of the US economy has continued to have a positive impact on the labour market. Payrolls growth has remained robust, averaging 209k in July/August (and could be revised up), following Q2's 231k average. The increase in employment, as well as weak labour force growth, helped the unemployment rate fall to 5.1% in August, its lowest level since April 2008.

Meanwhile, monthly earnings data have shown further modest improvement. However on a year-on-year basis, growth in average earnings has continued to struggle for upward momentum. Indeed, growth has remained largely confined to a narrow 2-2.3% range since the end of 2012. The most recent quarterly 'Employment Cost' data show that wage growth slowed in Q2 to 2.1% from 2.6%.

On the inflation front, lower oil prices have seen CPI inflation remain very subdued, coming in at just 0.2% in August. 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.



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 strong performance of the labour market and consistent wage growth should help to underpin consumer confidence and, in turn, the solid performance on the consumer side of the economy. Lower energy prices are providing a further significant fillip to consumer spending. However, the economy does 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 2.5% this year and 3% in 2016.**

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