Fed Watch

AIB Treasury Economic Research Unit

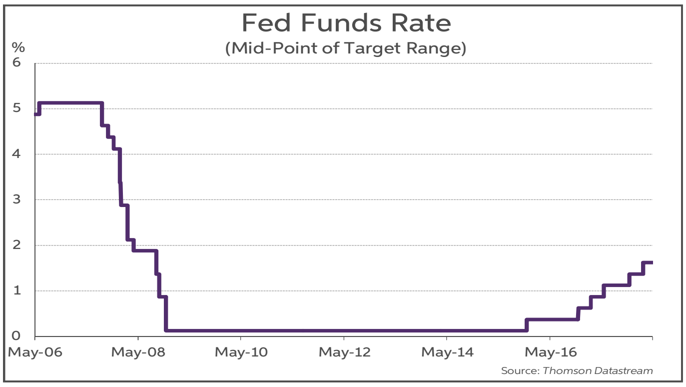
14th June 2018

Market remains unconvinced on extent of Fed hikes

As expected, the June meeting of Federal Reserve Open Market Committee (FOMC) saw rates hiked by 25bps, with the target range for the key fed funds rate raised to 1.75-2.0%. This represented the second rate hike in 2018 (previously hiked in March) and is the seventh rate increase in this tightening cycle, which began back in December 2015. The decision at yesterday's meeting was unanimous.

The meeting statement outlined the rationale for the latest rate hike. The description of the economy's performance was upgraded, with activity now being characterised as "rising at a solid pace" compared to its previous assessment of a "moderate pace". The Fed also noted that that household spending has "picked up", while the unemployment rate has "declined".

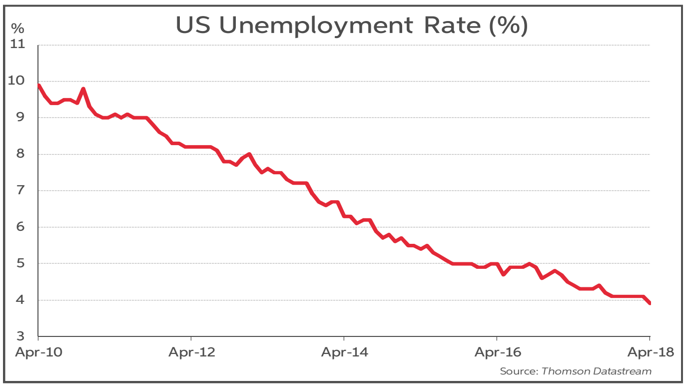
Meantime, in the post meeting press conference, Fed Chair Powell commented that the "main take away is that the economy is doing very well". Another point of interest to arise from the press briefing is that starting in January 2019, the Fed will hold a press conference after every FOMC policy setting meeting (currently every second meeting of the eight per year). Although, Chair Powell was keen to emphasise that this change "does note signal anything about the timing or pace of future interest rate changes".



Given that the 25bps rate hike was already priced in by markets, the main focus of attention was the Fed's updated interest rate projections. The Fed did make a slight shift in this regard. It increased its guidance for 2018 from three to four 25bps rate hikes. This would bring the Fed funds rates up to a target range of 2.25 to 2.50% by end year. Its projections for 2019 now see rates rising to 3.125% (from 2.875%). However, its end-2020 projection remains unchanged at 3.375%, so the Fed envisages the same amount of policy tightening in the next two years.

The market continues to expect a less aggressive pace of tightening from the Fed. Futures contracts show that it has not fully priced in two further rate hikes this year. Meantime, it is expecting just two further rate hikes in total over the 2019-2020 period. This would take the mid-point of the fed funds target range up to around 2.75% by end 2020. **By contrast, the Fed is envisaging taking rates up to near 3.4% by end 2020**, which is over 60bps above the level expected by the market.

The reason for the Fed's more hawkish outlook on the rate tightening process is its upbeat assessment of the outlook for the US economy. The June edition of its economic forecasts released last night show that the Fed expects US GDP to grow by 2.8% this year, 2.4% in 2019 and 2% in 2020 (Q4 over Q4). The unemployment rate is forecast to drop to 3.5%, with core PCE inflation picking up to 2% and headline inflation rising above this level.



In our view, we expect that continuing strong growth by the US economy over the next year, combined with a pick up in inflationary pressures, will force the market to re-evaluate its view on rates. This is likely to result in the market pricing in additional policy tightening than it currently envisages. We anticipate that the Fed funds rate will rise above 3% by the end of 2020.

The market reaction to the Fed meeting outcome saw the dollar get an initial boost, but this proved to be very short lived. This may in part be due to the fact that it only took one FOMC member to change their projections to shift the 2018 median from three to four. Further, the Fed did not change its end-2020 rate guidance, as it still sees rates peaking near 3.4%.

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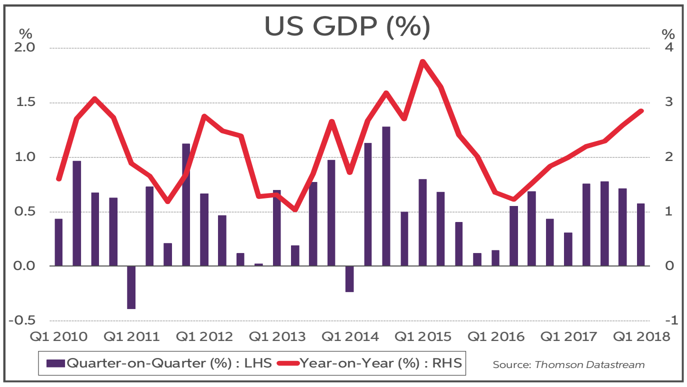
US data suggest a strong pace of growth in H1’18



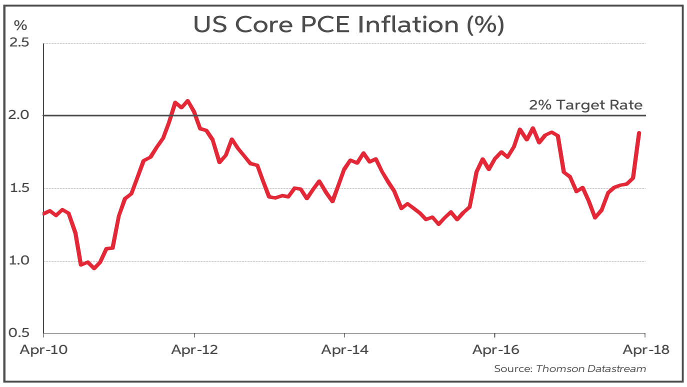
US annualised growth slowed somewhat to 2.2% in Q1, from 2.9% in Q4 2017. Overall though, the economy has grown at a relatively steady pace of between 2.2-3.2% for the past four quarters. Meanwhile, the year-on-year growth rate in Q1 picked up to 2.8%, its strongest level since Q2 2015.

In terms of the second quarter, survey data for April/May suggest that the economy continues to grow at a solid pace. The manufacturing and services ISM indices both registered gains in May (to 58.7 and58.6 respectively), after falling back in April. The Markit Composite PMI, which has tended to be a more accurate indicator of US GDP of late, averaged 55.8 in April/May compared to 54.7 in the first quarter, suggesting we should see an improved pace of growth in Q2.

The limited hard data for Q2 which have been released, have also been encouraging. Real personal consumption increased by 0.4% in April, though the data were flattered by an 8.5% jump in energy spending, due to colder than usual weather. Meantime, industrial production recorded a second consecutive 0.7% monthly gain in April. This did partly reflect a jump in utilities output, also due to the colder weather. There was also a marked fall in the trade deficit in April. Overall, GDP growth could be close to 4% (annualised basis) in the second quarter.

Labour market data have remained solid. Non-farm payrolls recorded an average increase of 191k in April/May. This was slightly below the Q1 monthly average of 218k. Solid employment growth and a fall in the participation rate recently have seen the unemployment rate decline further to an 18-year low of just 3.8%. However, **wage growth has remained modest.** Year-on-year growth in average hourly earnings remains in the 2.3-2.8% range it has occupied since Q3 2015, coming in at 2.7% in May. However, leading indicators such as the NFIB ‘jobs hard-to-fill’ index suggest a tight labour market could see wage inflation pick-up.

Meantime, **the Fed’s preferred inflation measure, core-PCE prices, was stable at 1.8% in May.** There are indications though that price pressures are building, meaning that underlying inflation could rise above the Fed’s 2% target in the coming months.



Overall, the outlook for the US economy remains positive. Business and consumer surveys suggest that investment and consumption should remain robust. At the same time, the raft of tax cuts passed by Congress at the end of last year should provide a fillip to growth in 2018 and 2019. **The OECD now forecasts US GDP will rise by 2.9% this year and 2.8% in 2019,** before likely slowing in 2020 as the impact from the fiscal stimulus fades.

Although, there are also some risks to the economy. **The fiscal stimulus will likely boost demand for imports, further widening the US trade deficit.** It will also increase the size of the budget deficit and, thus, add to upward pressure on US Treasury yields, increasing borrowing costs. So too will the Fed’s steady removal of monetary policy accommodation. On-going uncertainty related to the Trump Administration’s protectionist trade policies also remain a risk factor. The OECD’s recent report on the US economy also cited high leverage ratios, “particularly in the non-financial corporate sector”, as being a cause for concern. Overall, though, growth is expected to remain strong in 2018 and 2019.

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