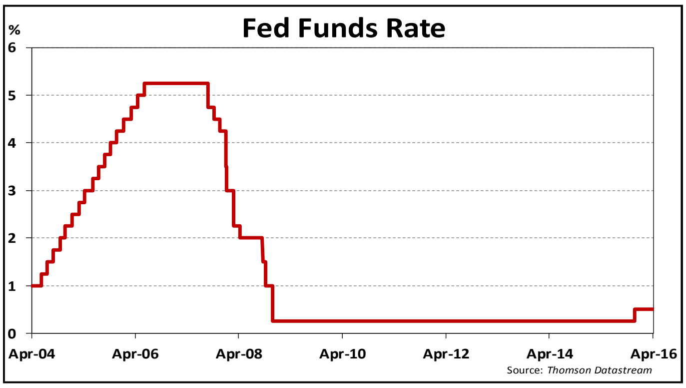
Fed Watch

28th April 2016

AIB Treasury Economic Research Unit

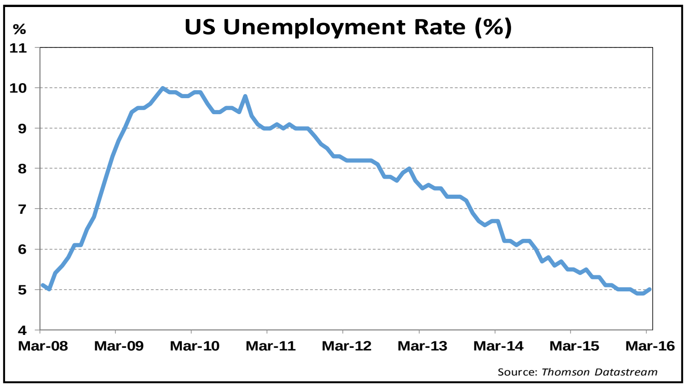
Fed keeps door open for rate hikes

The April meeting of the US Federal Reserve concluded in line with market expectations for no change to policy, with the FOMC maintaining the Fed funds rate at 0.375% for a third consecutive meeting. As was the case in March, the decision to leave policy unchanged was not unanimous, with one of the ten voting FOMC members (Esther George) preferring to raise interest rates.



The meeting statement was broadly similar to the March version. **The changes that were made suggest the Fed is now less concerned about developments abroad.** Back in March, the Fed referred to global economic and financial developments continuing to "pose risks". However, in this month's statement, this was removed and replaced with "the Committee continues to closely monitor inflation indicators and global economic and financial market developments". **The removal of the reference to "risks" is the Fed acknowledging that since its last meeting, financial conditions have improved, while there have been some signs of stabilisation in China.**

The April statement also indicates that the Fed is taking encouragement from on-going recovery labour market. The FOMC commented that "labour market conditions have improved further even as growth in economic activity appears to have slowed". This suggests that the Fed is content to look through slightly slower GDP growth as long as the improvement in the jobs market continues. Growth has slowed in the last two quarters but is expected to rebound during the course of this year.



The Fed's most recent set of projections on the likely path of interest rates were released at the March FOMC. **They showed that the median projection for the Fed funds rate at end-2016 was 0.875%.** The 'dots' are consistent with two 25bps rate hikes this year. The Fed envisages rates rising to 3% by 2018.

Despite the March projections being less aggressive than the December version (i.e. from four to two hikes in 2016), the Fed is still indicating a more aggressive trajectory of rate hikes than the market is expecting**. Current futures pricing suggests that the market is just about pricing in one 25bps rate hike at end year, taking the Fed funds rate to 0.625%.**

In summary, the modest changes that the Fed has made to its latest FOMC statement, provide it with some flexibility in terms of the timing of any further policy tightening. At the margin, the Fed appears to be slightly more hawkish compared to its March meeting. While still paying close attention to developments abroad and financial conditions, the level of concern in relation to these issues has lessened. The Fed also noted that the labour market continues to perform well despite the economy registering slower growth.

Overall then, the Fed is keeping its options open. The timing of the next rate hike will depend on incoming US macro data as well as developments in the global economy and financial market conditions. Therefore, the market will be paying close attention to the macro data and financial markets over the coming weeks as well as public comments from FOMC members. Growth would want to strengthen appreciably in Q2 to bring a rate hike on the agenda at the next FOMC meeting in June. So **a rate hike seems more likely in the second half of the year.**

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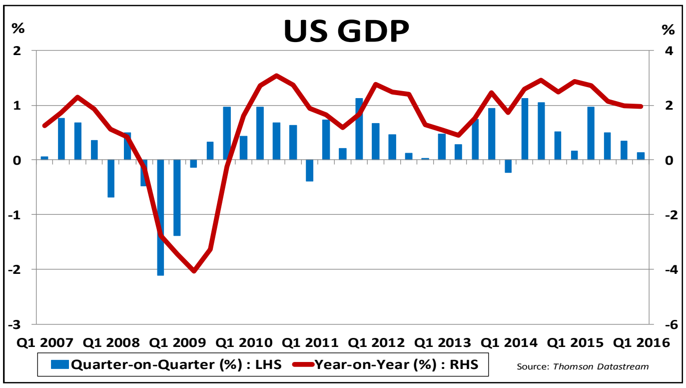
US economy slowed further in Q1

The US economy grew by a very weak annualised rate of 0.5% in Q1, following Q4's sluggish 1.4% figure. This represents the third consecutive quarter of slower growth. The continued economic slowdown reflects a number of factors, including a collapse in investment in the oil sector, a rise in personal saving, a slowdown in inventory accumulation, the stronger dollar and weaker global growth. Seasonal factors related to the early timing of Easter may also have impacted.

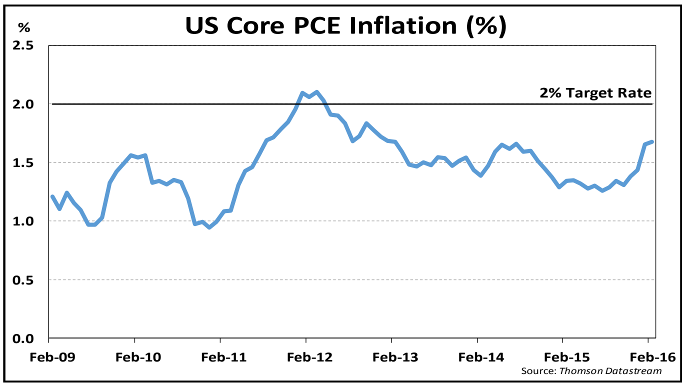


The breakdown of Q1 GDP showed that personal consumption remained the main driver of growth, contributing 1.3 percentage points (p.p.). Consumption was weighed down, though, by a significant decline in auto sales. Government spending also provided some support (0.2 p.p.). However, net exports deducted 0.35 p.p. from GDP, maintaining their recent negative trend. Meantime, **business investment was very weak. It took 0.8 p.p. from growth,** its largest drag in nearly seven years. Changes in inventories weighed on growth (-0.3 p.p.) for a third consecutive quarter.

The GDP figures are generally reflective of the macro data from the first quarter. For example, retail sales declined by 0.1% in Q1, following on from Q4's already weak 0.3% growth. Meanwhile, industrial output contracted for a second consecutive quarter (-0.6%). It was impacted by the aforementioned lower auto sales, as well as weak oil prices and the firmer dollar. Key housing market indicators (incl. starts, existing home sales) showed little change in the quarter, despite advantageous weather conditions.

While the overall economy has slowed, the labour market continues to perform strongly. The key non-farm payrolls number averaged monthly growth of 209k in Q1. While this is slower than Q4's 282k, that performance was particularly strong, representing the highest quarterly average in 10 years. Meantime, while the unemployment rate edged back up to 5% in March, from February's eight year low of 4.9%, this largely reflects a continued recovery in the participation rate from the near 40 year low reached in September last year. Despite these developments, year-on-year growth in earnings, as measured by the Employment Cost Index, has been stuck at 2.1% since the second quarter of 2015.

Price pressures in areas such as rents and medical costs saw CPI inflation rise to above 1% in Jan/Feb. However, it slowed to 0.9% in March, in part due to a stronger drag from energy and food prices. Notably, though, core inflation (excludes energy) is currently near a four-year high at 2.2%. Meantime, **the Fed's preferred measure of inflation, core PCE, rose to 1.7% year-on-year in Q1,** from 1.4% in Q4 last year.



Overall, the economy should regain momentum as the recent slowdown is partly due to temporary factors. Furthermore, robust job growth and moderate wage increases should help to spur some improvement on the key consumer side of the economy. Low energy prices are also providing some support to spending, while interest rates remain very low. However, the economy faces some headwinds, such as a slowdown in emerging markets, financial market volatility, the impact from the stronger dollar and uncertainty over November's elections. **The Fed expects that the US economy will grow by 2.2% in 2016 and 2% in 2017.**