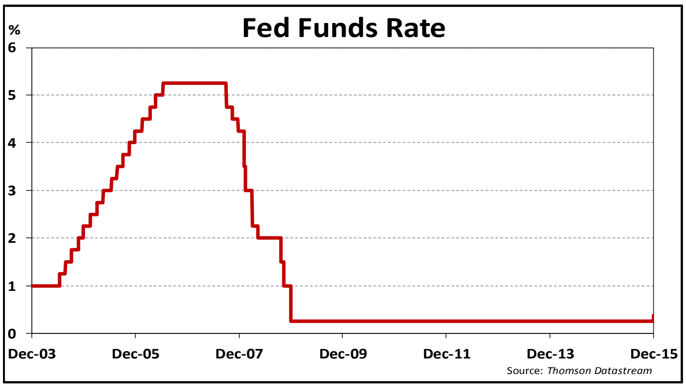
Fed Watch

17th December 2015

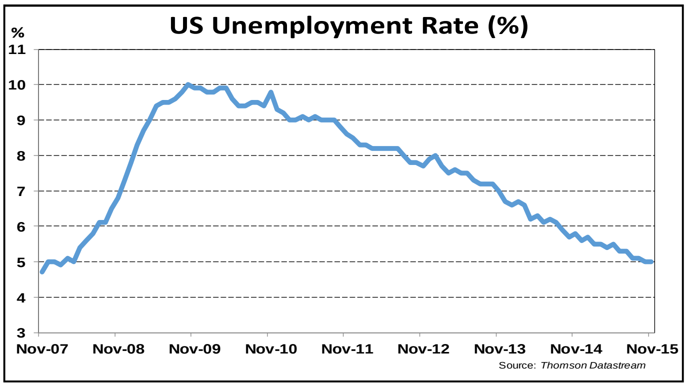
AIB Treasury Economic Research Unit

Fed hikes, but markets see limited further hikes

As expected, the December meeting of the FOMC saw the central bank raise interest rates for the first time since June 2006. The Fed announced a 25bps increase in the federal funds rate to 0.375%, ending a seven -year period where the rate was kept in a target range of 0-0.25%. The decision to hike was unanimous. **The Fed was content to hike given that its two criteria had "been satisfied" since its last meeting back in October.** Namely, "further improvement in the labour market" and being "reasonably confident that inflation will rise over the medium term, to its 2% objective".



Fed Chair Yellen said that the decision to hike "recognises the considerable progress" that the economy has made as well as reflecting the Fed's "confidence that the economy will continue to strengthen". The Chair commented that much of the "recent softness" in inflation is "transitory" and that "diminishing slack in labour and product markets should put upward pressure on inflation as well". She also explained that the Fed did not want to be in situation where it delayed tightening for too long and ended up "having to tighten policy relatively abruptly" and in turn "increase the risk of pushing the economy into recession". At the same time though, both the Fed statement and Yellen's press conference remarks strongly emphasised that the Fed expects that economic conditions will evolve in a manner that will "warrant only gradual increases in the federal funds rate."



In terms of the FOMC members' projections on the likely path of interest rates, there was no change to the 'dots' for 2016 and only a very slight lowering for 2017 and 2018. The median projection for end 2016 remains at 1.375%, while it is now at 2.375% and 3.25% for end 2017 and 2018, respectively. Overall, the above projections are consistent with eight 25bps rate hikes from now till the end of 2017. **Despite the Fed preaching a gradual pace of tightening, it is still indicating a more aggressive path of rate increases than the market is expecting.** Current futures pricing indicates that the market is looking for just two rate hikes by end 2016, taking the Fed funds rate to 0.875%, well below the Fed's projection of 1.375%. Markets see rates at only 1.5% by end 2017, compared to the 2.375% Fed projection.

Whether the actual path of tightening evolves as the FOMC is currently projecting will depend on how the economy performs over the forecast period, in particular, the path of inflation. The FOMC is expecting core PCE inflation to rise from 1.3% currently to 1.6% during next year, reaching 1.9% in 2017 and 2% in 2018. **Initial market reaction to the Fed policy change has been positive. Equities rallied, Treasury yields are largely unchanged, while the dollar has experienced some modest gains.** However, current ten year Treasury yields of 2.25% are hardly consistent with rates rising to 3.25% by 2018 as projected by the Fed. **It strikes us that the most uncertainty surrounds the Fed's inflation forecasts.** Given the strength of the dollar, subdued wage inflation and likely second round effects from lower energy costs, the core PCE inflation rate may not rise to 2% as quickly as the Fed expects. Hence, rates may rise at a slower pace than projected by the Fed. If the Fed is correct, though, expect a sharp sell-off on bond markets and further gains for the dollar. The course of Fed monetary policy could well prove the key call on markets in 2016.

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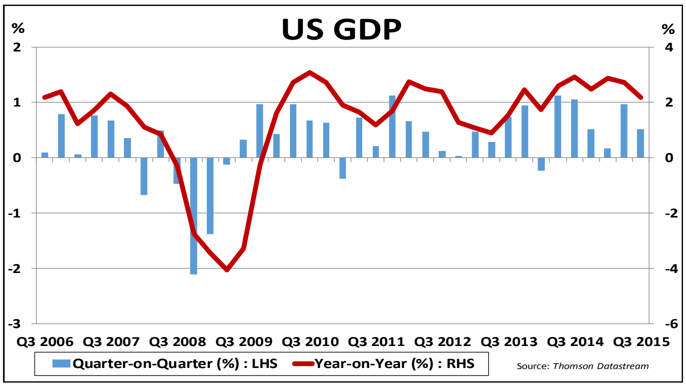
US economy remains solid

The US economy continued to grow at a solid pace in Q3. GDP rose by 2.1% on an annualised basis, following on from the 3.9% growth recorded in Q2.



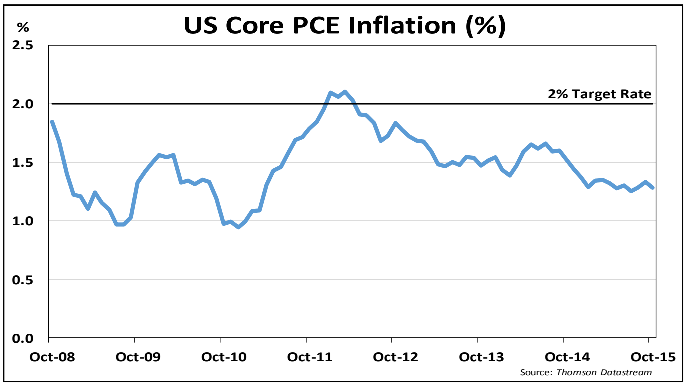
The breakdown of the Q3 data show that the underlying performance of the economy remains solid. Headline growth was dragged down by weaker inventories, which deducted 0.6 percentage points (p.p.). Stripping out this volatile component, the economy grew by closer to 3%. Consumer spending remained the key driver, adding 2 p.p. to growth. Other notable contributions came from business investment (+0.3 p.p.) and government spending (+0.3 p.p.). Net trade was only slightly negative (-0.2 p.p.), meaning the expected drag from the stronger dollar and slower growth in developing economies was not overly apparent in the data.

In terms of the performance of the economy in Q4, the data have suggested a slightly slower pace of growth. For example, the 'control' retail sales measure (used as a proxy for goods consumption in GDP), which performed strongly in the last two quarters, has slowed in Q4. Although, growing by 0.6% in October/ November versus Q3, it remains encouraging. Meantime, industrial production fell by 0.7% in Oct/Nov compared to Q3. Year-on-year growth was -1.2% in November, its weakest rate in six years. This reflects a number of factors, including lower output from and investment in oil extraction and the stronger dollar.

Survey data also suggest a slightly more modest pace of growth in Q4. The key services ISM index remains strong, though, averaging 57.5 in Oct/Nov after 58.7 in Q3. The manufacturing ISM has weakened further, falling below the expansion indicating 50 mark in November (48.6) for the first time in three years. However, the Markit composite PMI averaged 55.3 in Oct/Nov, virtually unchanged from Q3's 55.2.

After a somewhat disappointing performance by the labour market in Q3, recent data have been much improved. Non-farm payrolls averaged monthly gains of 255k in Oct/Nov, compared to 174k in Q3. Meanwhile, the unemployment rate has fallen to 5%, its lowest level since April 2008. Although, it has been aided by falls in the participation rate, which remains around its lowest level since 1977. Meanwhile, year-on-year growth in average earnings has held around 2.3% in recent months.

Growing price pressures on the services side of the economy saw CPI inflation rise to 0.5% in November. It could rise further in the coming months as the drag from falls in oil prices at the end of 2014/ start 2015 begin to drop out. Meanwhile, core CPI inflation (excludes energy) has picked up to 2%. However, the core PCE deflator, the Fed's preferred measure of inflation, remains struck at 1.3%.



Overall, the economy will remain supported by a number of positive growth factors. The accommodative stance of US monetary policy should help in this regard, while the drag from fiscal consolidation has diminished. The robust performance of the labour market and solid wage growth should help to underpin consumer spending. Low energy prices are also providing some support to spending. However, the economy still faces some headwinds, such as a slowdown in emerging markets and the impact from the stronger dollar. The US economy is expected to grow by around 2.5% in 2016 and 2017.

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