Fed Watch

AIB Treasury Economic Research Unit

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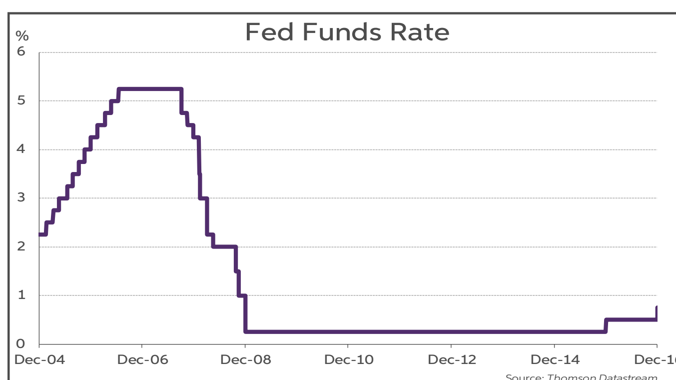
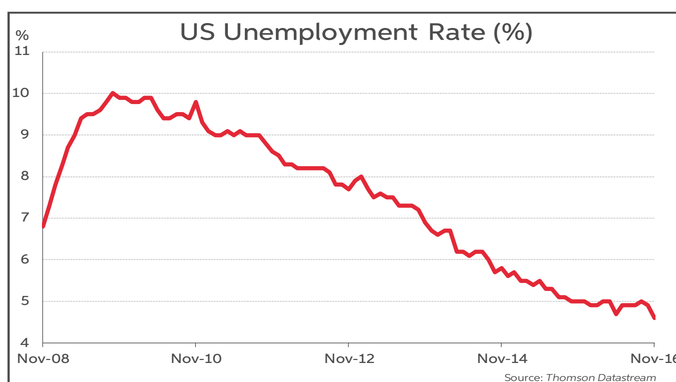
Fed now indicating slightly faster pace of rate hikes

As anticipated, the December meeting of the US Federal Reserve concluded with the Central Bank increasing the target range for the federal funds rate by 25bps to 0.5-0.75%. This is only the second time in the last ten years that rates have been increased, with the previous hike coming last December. The decision to hike was unanimous. The FOMC statement referenced the "realised and expected labour market conditions and inflation" underpinning the decision to increase interest rates. The statement also noted that market based measures of inflation "have moved up considerably", while still remaining low.



In her post-meeting press conference, Fed Chair, Janet Yellen, stated that the interest rate increase was in recognition of the "considerable progress the economy has made" towards the Fed's "dual objectives of maximum employment and price stability". She added that the FOMC "expect the economy will continue to perform well" over the next couple of years, while noting the updated economic projections were "very similar" to those in September.

However, the Fed is now indicating a slightly faster pace of rate increases than it was in September. The median projection for end-2017 is now 1.38% versus 1.13% back in September, which is now consistent with three rather than two rate hikes next year. The FOMC now envisages rates rising to 2.17% be end-2018 and to 2.88% by end-2019, higher than in September. In the aftermath of the surprise US presidential election outcome, the market had come more into line with the Fed's projections. However, following the December update to the FOMC's interest rate projections**, the Fed is now guiding a more aggressive pace of rate increases than the market is expecting.** Current futures pricing indicates that the market is looking for roughly two 25bps rate hikes per year out to the end of 2019, whereas the Fed's projections are consistent with three 25bps increases per annum.



The Fed continues to emphasise that its expects that "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate". **However, as Fed Chair Yellen noted the "economic outlook is highly uncertain". A key aspect to this uncertainty is the policies of incoming President Donald Trump and the impact these will have on the US economy.** These policies have not been embodied in the Fed's forecasts. In reference to this, Chair Yellen stated that "changes in fiscal policy or other economic policies could potentially affect the economic outlook" and that it is "far too early to know how these policies will unfold".

It must be noted that the Fed failed to deliver on similar rate hike projections for 2016. However, if Trump's policies are implemented next year, the chances of the Fed delivering on its rate projections will increase and market rate expectations may fully fall into line with the Central Bank's projections.

Market reaction to the Fed's higher interest rate projections has seen the dollar rally and US Treasury yields rise. The dollar index, which measures the dollar's performance against a basket of other currencies is up at 102, representing a 14-year high. Dollar strength is also reflected in EUR/USD trading down near $1.04, its lowest level since 2003. Meanwhile, the policy sensitive US two year Treasury yield is up around 15bps to near 1.3%.

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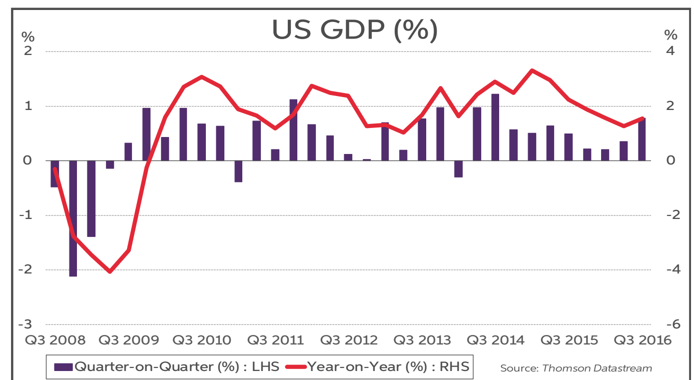
Growth in US economy reaccelerating

The US economy grew by an annualised rate of 3.2% in Q3, up from 1.4% in Q2. While the headline figure was strong, the breakdown of the data suggests that underlying domestic growth was more muted. Indeed, final sales to domestic purchasers (GDP minus net trade and changes in inventories) slowed from 2.4% to 1.7% in the third quarter. There is also evidence that GDP was strongly boosted by a spike in soybean exports, which is unlikely to prove sustained. Growth in business investment also remained lacklustre.

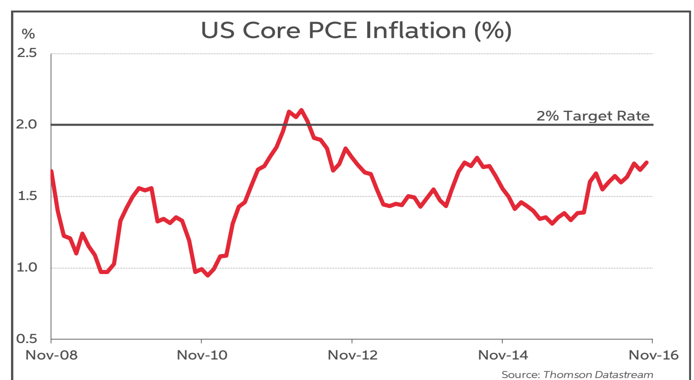


However, survey data for Q4 suggest that the economic growth may have accelerated further. The non-manufacturing ISM averaged 56 in October/November compared to 54.7 in Q3, while the manufacturing index averaged 52.6 versus 51.2. The more positive view of the ISMs is also supported by the Markit PMI data. The headline composite index averaged 54.9 in Oct/Nov following Q3's 51.7 result.

'Hard' data measures of the economy have been mixed in nature. The 'control' measure of retail sales growth (used as a proxy for goods consumption in GDP) rose by 0.9% in Oct/Nov versus Q3. A marked rise in consumer confidence measures in Nov/Dec suggests the sector will continue to grow at a solid pace. Industrial output fell by 0.3% in Oct/Nov, not helped by some unusually warm weather, which weighed on 'utilities' output. Meanwhile, the US trade deficit rose from $36.2bn in September to $42.6bn in October.

The US labour market has continued to improve in the fourth quarter. Non-farm payrolls recorded solid growth in Oct/Nov (average 160k). This, combined with a decline in the size of the labour force, saw the unemployment rate fall to 4.6% in November, its lowest level since August 2007. In terms of survey data, the Conference Board labour market differential (jobs plentiful minus jobs hard to get) is at levels not seen since the end of 2007, suggesting further improvement.

Despite this, the pace of wage growth remains moderate. **Year-on-year growth in the 'wages' component of the Employment Cost Index, the Fed's preferred earnings measure, slowed slightly to 2.4% in Q3, from 2.5%.** Meantime, growth in average hourly earnings fell back to 2.5% in November, from 2.8%.



Meanwhile, CPI inflation remains on an upward trend, rising to 1.6% in October, a two-year high. It has been boosted by the reduced drag from energy prices. The Fed's preferred inflation measure, core-PCE, has been steady at 1.6-1.7% this year, below its 2% target. The most recent Fed projections show that it does not expect inflation to reach its target until Q4 2018. Although, some growing price pressures could see the level reached sooner than that.

Overall, the outlook for the US economy remains positive. President-elect Trump's expansionary fiscal policies should provide a boost to growth over the medium-term. While his exact programme remains uncertain, the OECD recently estimated that his proposals could boost US GDP by around 0.4 percentage points in 2017 and 0.8 p.p. in 2018, seeing growth of 2.3% and 3% in the respective years. Furthermore, still low energy prices are also providing some support to spending, while the labour market continues to improve. Both of these will be helpful to the key consumer side of the economy. **However, the economy does still face some headwinds.** These include the stronger dollar, the potential for fiscal stimulus to lead to a more rapid pace of monetary policy tightening and some political uncertainty, particularly in relation to the future direction of US trade policies. Weakness in business investment also remains a concern.

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