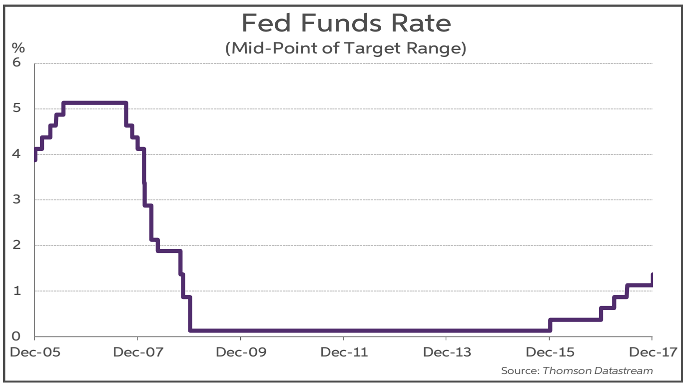
Fed Watch

AIB Treasury Economic Research Unit

14th December 2017

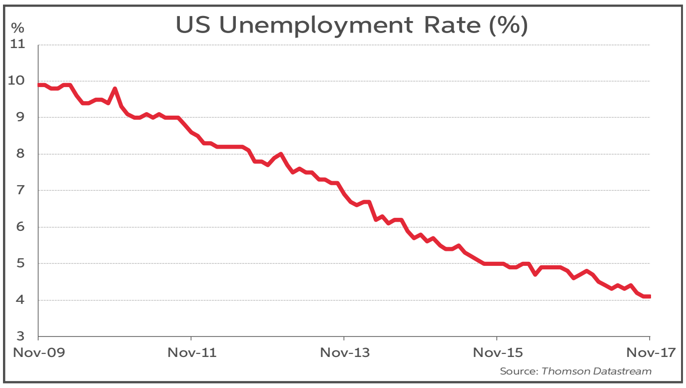
Fed hikes as expected, more to come in 2018

As expected, the December meeting of the Federal Reserve concluded with a 25bps hike in the target range for the fed funds rate to 1.25-1.50%. This represents the Fed's third rate hike this year and the fifth since it began its current tightening cycle back in December 2015. The decision to raise rates in December was not unanimous, with two members voting for no change.



The description of the economy in the meeting statement remained upbeat in tone. It noted that the economy is growing at a "solid rate". On the issue of inflation, the Fed continues to envisage that it will remain below its 2% target in the near term but start to "stabilise" around its objective over the medium term. Chair Yellen once again repeated that the softness in inflation "primarily reflects transitory developments that are largely unrelated to broader economic conditions". In its updated economic projections (which assume that the proposed tax reform will likely provide some boost to activity), real GDP is "a little stronger" with growth of 2.5% being pencilled in for next year (was 2.1%), "moderating" to 2% by 2020. Meantime, its unemployment rate projection has been revised slightly lower, with the Fed forecasting it to fall to 3.9% in 2018 (was 4.1%), edging back to 4% by 2020. Despite these upgrades, the Fed's inflation forecasts were "essentially unchanged".

The December meeting also included the Fed's latest interest rate projections. There was very little change in these compared to September. The FOMC is still indicating that it will hike three times next year, with the median projection for end-2018 unchanged at 2.125%. It also kept its end-2019 projection unaltered, expecting rates to finish the year at around 2.75%. Meanwhile, it is now envisaging rates edging up to 3.1% (was 2.9%) in 2020. **Market expectations have become more hawkish on the rate outlook since October, with the gap between the market and the Fed narrowing.** Although, based on futures contracts, it is still anticipating a less aggressive path of rate hikes than the Fed is guiding over the next 2-3 years. Current pricing suggests that the market is looking for rates to rise to around 2% by end-2019 compared to the Fed's projection of 2.75%.



Overall, the Fed December meeting showed that the Central Bank remains comfortable with, and intent on, implementing a very gradual pace of policy tightening. Indeed, 2017 represents the first time in this tightening cycle that the Fed has been able to follow through on its interest rate projections. **Looking ahead to next year and beyond** (when the Fed will be under a new Chairperson, Jerome Powell, from the February meeting onwards), **if the incoming data continue to point to solid growth and financial market conditions remain appropriate, this scenario will increase the chances of the Fed following through on its projected rate hike trajectory**. However, inflation is a key consideration and if it remains subdued, then the FOMC may not tighten policy as much as it has indicated.

It is interesting to note in the context of Fed tightening that the US yield curve has flattened considerably over the past year. While two year Treasury yields are up around 60bps to 1.8% since December 2016, 10-year yields have fallen by around 20bps to below 2.4%, with 30-year yields down by 40bps to 2.75% over the same period. The fall in long term yields suggests that the market may either be expecting inflation to remain at very subdued levels and/or the economy to enter a downturn, resulting in the Fed being unable to raise rates by as much as it is currently guiding.

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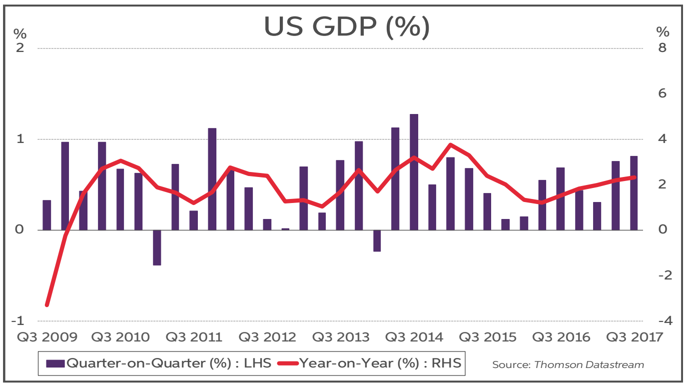
US economy remains on a solid footing

US annualised growth was broadly stable at 3.3% in Q3, versus 3.1% in Q2. The stronger than expected rise in Q3 indicates the negative impact from the hurricanes was less severe than had been feared. **However, the headline GDP figure was flattered by a large increase in inventories, which boosted growth by 0.8 percentage points.** Indeed, domestic demand slowed from an annualised rate of 2.7% to 2% in the third quarter, as consumer spending growth slowed from 3.3% to 2.3%, in part due to weaker clothing and household services sales.



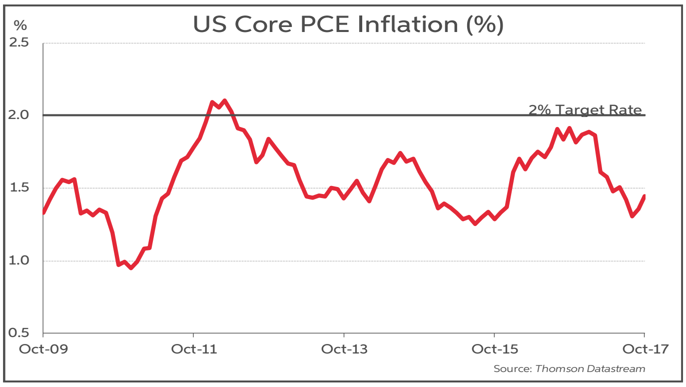
Survey data for Q4 have suggested that growth continued at a solid pace. The Composite PMI averaged 55.2 in October/November, broadly unchanged from 54.9 in Q3. The ISM indices, which have tended to be less accurate than the PMIs in predicting US GDP, have been more upbeat. The non-manufacturing index averaged 58.8 in Oct/Nov (vs 56.3 in Q3), while the manufacturing ISM averaged 58.5 (58.6).

The little 'hard' data we have had in Q4 have been generally positive. Real consumer spending edged up by 0.1% in October, following on from Q3's somewhat modest 0.4% increase. Year-on-year growth remained at 2.6% in the month. On the output side of the economy, industrial production jumped by 0.9% in October, reflecting a post-storm rebound in activity.

Labour market data have been strong so far in Q4. Non-farm payrolls averaged growth of 236k in Oct/Nov, an improvement on Q3's weather impacted 128k. Although, year-on-year growth in household employment slowed further to 1.2% in November. The slower pace of growth likely partly reflects less spare capacity in the economy. Indeed, the unemployment rate fell to just 4.1% in Oct/Nov, its lowest level in 17 years. This squeeze could continue, with labour force growth slowing, standing at 0.7% year-on-year in November compared to 1.3% in the same month of 2016.

Despite this, wage growth has been, to use the Fed's words, "modest". Annual growth in average hourly earnings has been mostly confined to a 2.3-2.8% range since the summer of 2015, coming in at 2.5% in November. The Fed's preferred measure of wage inflation, the 'wages & salaries' component of the Employment Cost Index was at 2.5% in Q3.

Headline CPI inflation has 'levelled off' around 2.2% in recent months, after having been as high as 2.7% in February. The Fed's preferred measure of price pressures, core-PCE inflation (excludes energy costs), has moved down this year from 1.9% in February, to a low of 1.3% in August. It edged up slightly to 1.4% in Sept/Oct, remaining well below its 2% target rate.



Overall, the outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption will continue to support growth. At the same time, likely pro-growth fiscal measures should provide a further fillip to activity.

The OECD, assuming tax reforms taking effect in mid-2018, is forecasting GDP growth of 2.2% in 2017, 2.5% in 2018 and 2.1% in 2019. It does highlight some risks to the economy, including that the Fed may have to tighten policy more quickly and/or by a greater degree than currently expected, slowing labour force growth constraining consumption and current elevated leverage rates in parts of the corporate sector.

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