Fed Watch
AIB Treasury Economic Research Unit
AIB
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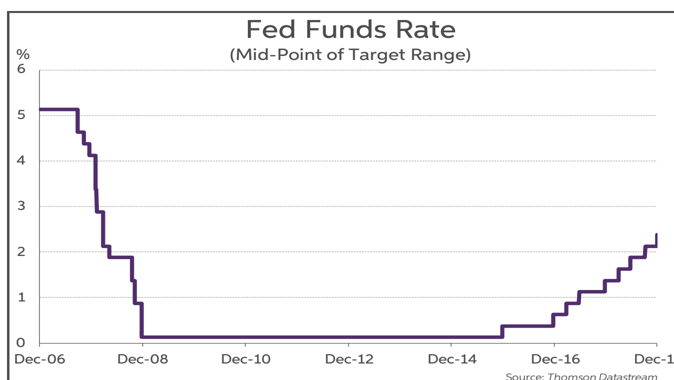
Fed scales back its rate hike plans

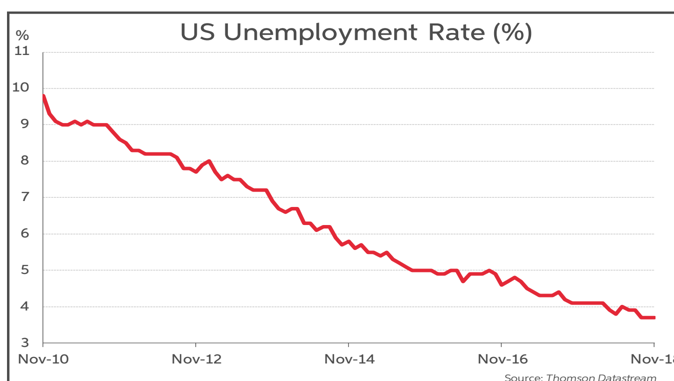
The December meeting of the Federal Reserve Open Market Committee (FOMC) saw rates hiked by 25bps, with the target range for the key fed funds rate raised to 2.25-2.50%. This represented the fourth rate hike this year and is the ninth rate increase in the current tightening cycle. The committee was unanimous in its decision to raise rates. As widely expected, though, **the Fed scaled back its rate hike projections for next year. It now expects two 25bps rate hikes in 2019 compared to three previously,** but still plans to raise rates one more time in 2020. Thus, the Fed now sees rates peaking at 3.125%, rather than 3.375% previously.



The meeting statement laid out the rationale for the latest rate hike. The text made reference to the strong pace of economic growth, as well as the continued strengthening of the labour market, noting that job gains have been strong in recent months.

With the rate hike expected by markets, **the main focus of attention was on the updated interest rate projections from the Fed**, which as noted above, saw the dropping of one of the projected rate hikes in 2019. **The lower guidance from the Fed is still very much in contrast to the markets very benign outlook for the fed funds rate.** Over the past couple of months, the market has scaled back its rate hike expectations, amid signs of a softening in the global economy and increasing risk aversion on financial markets.

Compared to a few weeks ago when the market was expecting two hikes from the Fed in 2019, futures contracts are now consistent with less than one hike next year. They now see the fed funds rate rising to just above 2.50% by end 2019, and are beginning to discount the possibility of a rate cut by end 2020. It is worth noting that markets significantly underestimated the extent of Fed tightening in 2017 and 2018.



The Feds funds rate is now at the bottom of what is considered to be its neutral range. Hence, Fed Chair Powell emphasised at his press conference that **the future path of interest rates is now very much data dependent.** If US economic growth remains solid, with the labour market tightening further, and global growth holds up, then markets are likely to have to start to price in more interest rate increases for 2019.

The Fed lowered its growth and inflation forecasts marginally, but it still sees GDP growing by a solid 2.3% yoy at end 2019 and 2% at end 2020, with inflation remaining around the 2% level. The course of the trade talks between the US and China could have a key role to play in this regard, as a trade deal would provide a big boost to business confidence and financial markets.

Overall then, the Fed's December meeting showed that the central bank retains a clear tightening bias, guiding that further rate hikes are likely in 2019 and 2020. Of course, the extent of this tightening will be very much dependent on incoming macro data and financial market conditions. One interesting change next year, is that the **Fed will be holding a press conference after each of its FOMC meetings** rather than just every second one. This gives the Fed more flexibility in terms of when it can change policy.

In terms of market reaction, the Fed statement seems to have been more hawkish than the stock markets had expected, causing a further slide in equities. The dollar rallied briefly before giving back its gains and is lower this morning. This is reflected in **EUR/USD moving up to near the $1.15 level.** Meanwhile, US bond yields continue to move lower. Overall, the **markets seem increasingly worried about the outlook for the US economy.**

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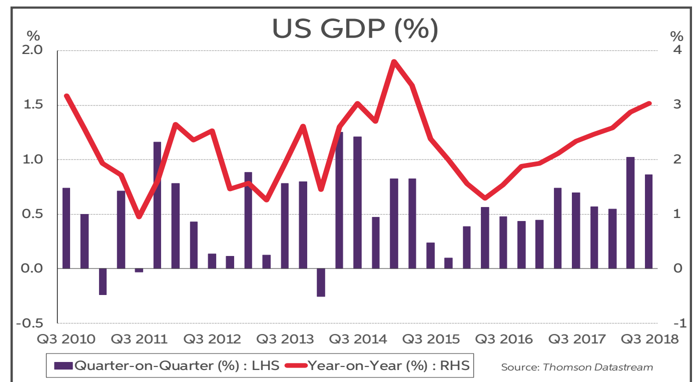
US growth remains very strong

US annualised growth eased to a still robust 3.5% in Q3, from 4.2% in Q2. The underlying data showed that consumer spending remained very strong in Q3, adding 2.5 percentage points (p.p.), while government expenditure contributed 0.4 p.p.. However, the contribution to quarterly growth from fixed investment (0.3 p.p.) declined significantly in the quarter.

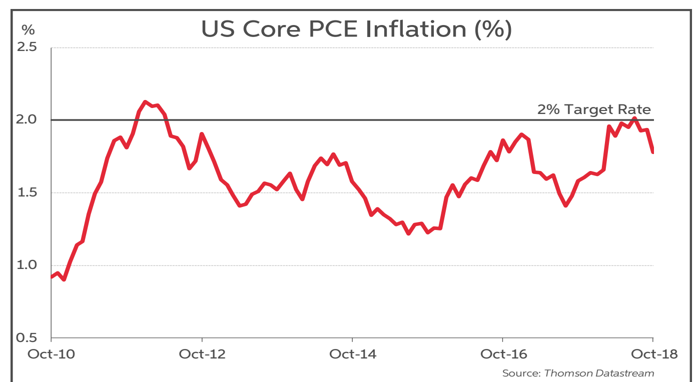


Survey data suggest that the robust rate of GDP growth has been maintained in Q4. The Composite PMI averaged 54.4 in the quarter, relatively unchanged from Q3's 54.8 reading. Both the manufacturing and service sector performed well. Likewise, the ISM indices, which have tended to overstate GDP growth, continue to point to a strong pace of economic expansion. The manufacturing index did edge down in Oct/Nov, but this was compensated for by a move upwards in the non-manufacturing ISM. On the demand side of the economy, the University of Michigan measure of consumer sentiment shows that while confidence dipped slightly in the quarter, it remains at an elevated level.

The limited 'hard' data available for Q4 have been somewhat mixed. For example, industrial output increased by just 0.4% in Oct/Nov, following on from Q3's 1.4% expansion. In contrast, on the key consumer side of the economy, the 'control' retail sales measure (ex-gas, autos and building materials) has risen by a very strong 1.5% already since end-Q3. Consumer spending has been buoyed by a continuing very strong labour market.

Labour market data have been very positive so far in Q4. Non-farm payrolls averaged growth of 196k in Oct/ Nov, a slight improvement on Q3's 190k figure. Meanwhile, the unemployment rate has held at the near 50-year low rate of 3.7%. **The lack of slack in the labour market appears to be manifesting itself in somewhat higher wage growth.** Year-on year growth in average hourly earnings crept up to hit 3.1% in October, a rate at which it held in November. This follows solid wage growth in Q3; the Fed's preferred measure, the Employment Cost Index, ticked up to 2.9% in that quarter.

However, the rise in wages has so far failed to generate an increase in price pressures. Indeed, headline CPI inflation has moderated in recent months, averaging 2.3% in Oct/Nov against 2.6% in Q3. Although, this deceleration has in part been due to falling oil prices. Meantime, the Fed's preferred measure of inflation, core-PCE, edged down to 1.8% in October, from 2% in Q3.



The near-term outlook for the economy remains positive. The strong labour market continues to support the key consumer sector of the economy (c. 70% GDP), indicating that household expenditure will carry on supporting growth. Meanwhile, although monetary policy is tightening, interest rates remain low and hikes are taking place at a gradual pace. Expansionary budgetary measures adopted at the beginning of the year should also continue to aid growth, although their impact will start to fade next year. The recent OECD forecast is for strong US GDP growth of 2.7% in 2019, which is consistent with the Fed forecast of growth slowing to 2.3% yoy by the final quarter of the year.

However, in the medium term there are some risks facing the US economy. The marked loosening of fiscal policy has helped widen the budget deficit, while at the same time boosting demand for imports. This has in turn contributed to a growing US trade deficit. It also risks overheating the economy, with the unemployment rate now below 4% and wage growth beginning to edge up. The housing market is also weakening as interest rates rise. Separately, the US-China trade war remains a risk factor and has contributed significantly to heightened financial market volatility in recent months. Overall, though, growth is expected to remain strong in 2019, especially if the US-China trade dispute can be resolved in the coming months.

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