Fed Watch

AIB Treasury Economic Research Unit

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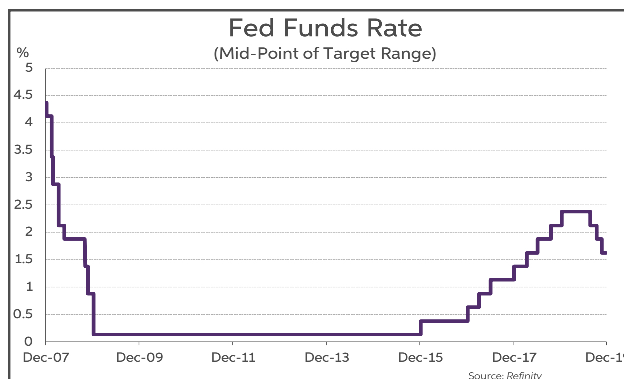
Fed on hold, content with current policy stance

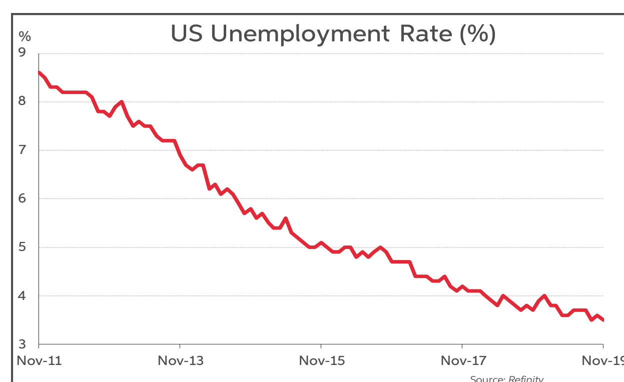
As expected, the final meeting of the Federal Reserve Open Market Committee (FOMC) for 2019 concluded with no changes to policy. The target range for the key fed funds rate was maintained at 1.5-1.75%. In its previous three meetings, the Fed had cut rates by 25bps on each occasion. The decision to leave policy unchanged in December was unanimous. Overall, the view of the Committee is that the "current stance of monetary policy is appropriate" to support the on-going expansion in the US economy and achieve its 2% inflation objective.

The FOMC statement showed no major changes to its description of how the US economy is performing. It continues to assess that the "labour market remains strong" and the economy is growing at a "moderate rate". In its outlook section, the Fed did remove the reference to "uncertainties", while adding in "global developments" and "muted inflation pressures" to the list of factors it is monitoring in assessing the appropriate positioning of its monetary policy.



The lack of significant changes in its economic assessment/outlook was also reflected in its latest economic forecasts. The Fed's real GDP forecasts were left unrevised, at 2.2% for 2019, 2.0% in 2020, 1.9% in 2021 and 1.8% in 2022. Meantime, while the core PCE projection was revised down to 1.6% (from 1.9%) for this year, the 2020 (1.9%), 2021 (2.0%) and 2022 (2.0%) forecasts were not altered.

In his press conference, Fed Chair Powell, noted that the "economic outlook remains favourable". He commented that the Fed believes the easing initiatives it implemented this year mean that monetary policy is "well positioned" to help sustain continued economic growth. Chair Powell also stated that it takes "some time" before the "full effects" of its policy easing measures are seen on the economy. At the same time, he did continue to make clear that if developments emerge that result in a "material reassessment" of its economic outlook, the Fed would respond accordingly. When asked in the Q&A segment of the press conference on the guidance regarding a rate increase in 2021, Chair Powell emphasised that it was his view for this to happen he would want to see inflation that is "persistent, and that is significant".



With no changes to policy announced or expected, the main focus was on the central bank's updated set of interest rate projections (so-called 'dot plot'). In this regard, it is interesting to note that similar to their September edition, the December guidance continued to show that no FOMC member believes that rates will be cut below their current level of 1.625% in the next couple of years. In a change from its previous version, the projection is for rates to remain on hold in 2020 (vs September, when projection was for a 25bps increase). Meanwhile, the Fed is guiding for one rate hike in both 2021 and 2022, which would see the feds fund rate at 2.125% by the end of the period.

In contrast, the market still expects the next move from the Fed to be a rate cut. Indeed, amid an apparent escalation in global trade tensions last week, futures contracts had started to once again price in the possibility of two rate cuts from the Fed in 2020. However, following last Friday's much stronger than expected payroll data, the market was back to pricing in around one rate cut from the Fed next year.

In summary, the Fed has indicated that it does not currently envisage easing policy further as long as the incoming data remain consistent with its economic outlook. It is content that the three rate cuts it has now implemented will be enough to sustain the economic expansion and achieve its 2% inflation target. Of course, if the US macro data deteriorates and the economy slows further, then the Fed could cut again.

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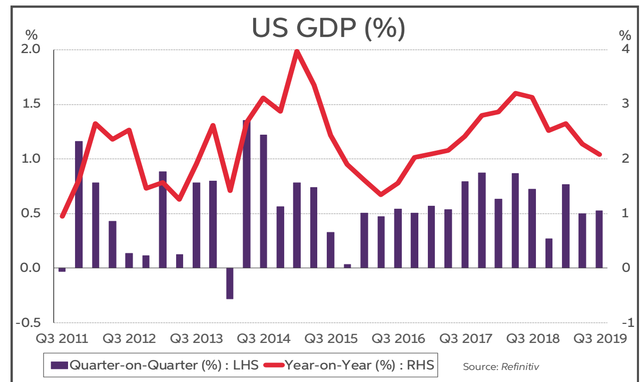
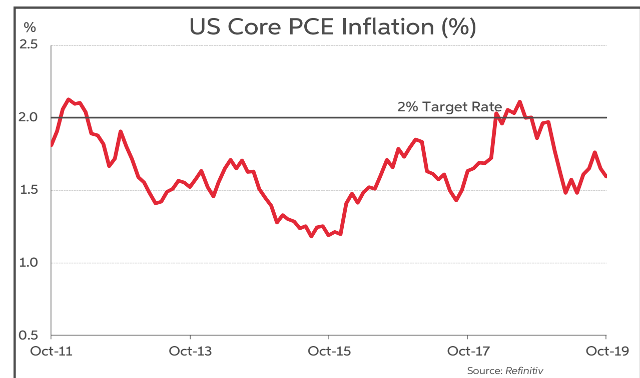
US economy on slower growth path

US annualised GDP growth was recorded at 2.1% in Q3, little changed from 2.0% in the second quarter. However, the year-on-year rate slipped to 2.1%, its weakest reading since Q1 2017. The underlying breakdown showed that consumer spending remains the primary driver of growth, contributing 2.0 percentage points (p.p.) to the quarterly total. Government spending and changes in inventories added a further 0.3 p.p and 0.2 p.p., respectively. Meanwhile, fixed investment (-0.2 p.p.) and net trade (-0.1 p.p.), both acted as drags.



Looking to the final quarter of the year, the composite PMI was recorded at 51.5 in October/November, little changed from Q3. The data have suggested that the downturn in manufacturing is beginning to bottom out, with the sector's PMI rising from a low of 50.3 in August to 52.6 in November. The services index is also trending upward, rising from 50.7 in August to 51.6 in November. However, the ISMs have been more downbeat, with the manufacturing index holding firmly below the 50 level, at 48.1 in November. The non-manufacturing index also lost ground in the same month, declining to 53.9. However, this still represents a level consistent with decent growth in the services sector. Meanwhile, both the University of Michigan and the Conference Board measures of consumer confidence remain close to their Q3's averages.

In regard to labour market data, fears that jobs growth was weakening rapidly have been assuaged by recent strong employment reports and upward revisions to historical data. Employment growth has moderated since 2018 but remains strong, with an average monthly gain of 180k in the year to November. This is particularly impressive given the late stage of the cycle. November's strong payroll figure (266k) was enough to help the unemployment rate edge back down to 3.5%, a joint 50 year low. At the same time, wage inflation remains solid and continues to hover just above the 3% level.



On the inflationary front, price pressures remain contained. The Fed's preferred measure, core-PCE, came in at just 1.7% in October, below the central bank's 2% target. Core CPI was recorded at the higher rate of 2.3% in November. Meanwhile, headline CPI picked up to 2.1% in the same month, as base effects saw the drag from lower energy prices fade slightly.

The limited amount of hard data available for Q4 have been mixed. Retail sales did rise by 0.3% in October, a growth rate that the closely watched 'control' measure (proxy for consumer spending) matched. However, the data were weak on the output side, with industrial production falling by 0.8% in October. Although, the figure may have been distorted by the impact of the aforementioned GM strike. Overall, it is too early to offer a precise forecast on Q4 GDP growth.

To surmise, the US economy has shifted onto a slower growth path. This partly reflects the impact of late cycle dynamics, with the current expansion the longest on record. Fiscal policy is also now less expansionary. However, policy uncertainty, particularly in relation to trade, is playing a significant role. There have been positive developments in this regard recently. Although, despite talk of a 'phase-1 agreement', the US and China have yet to conclude a deal and as it stands the US is set to impose a fresh round of tariffs on Chinese exports on December 15th. It would be beneficial if an agreement could be formalized in the coming weeks, as the removal of uncertainty would help support confidence and potentially lead to a recovery in fixed investment.

Meanwhile, the Fed has positioned its monetary policy to remain supportive of activity to ensure that the US expansion continues. The housing market in particular is being helped by the fall in long term interest rates. Additionally, government spending is expected to continue to rise in the immediate future. The Fed is projecting GDP growth of 2% in 2020 and 1.9% in 2021. This is broadly similar to the IMF, which expects that the economy will expand by 2.1% in 2020 and 1.6% in 2021.

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