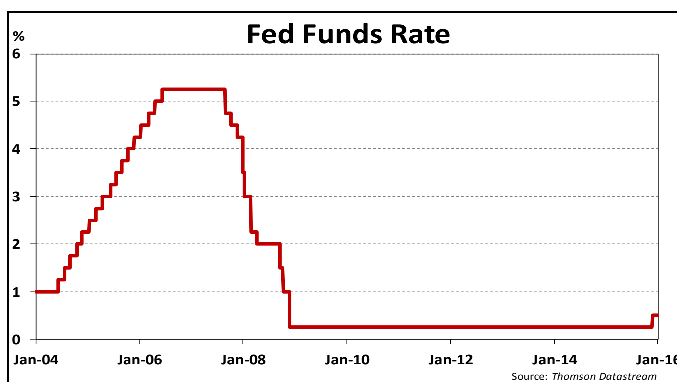
Fed Watch

28th January *2016*

AIB Treasury Economic Research Unit

Fed in 'assessing' mode

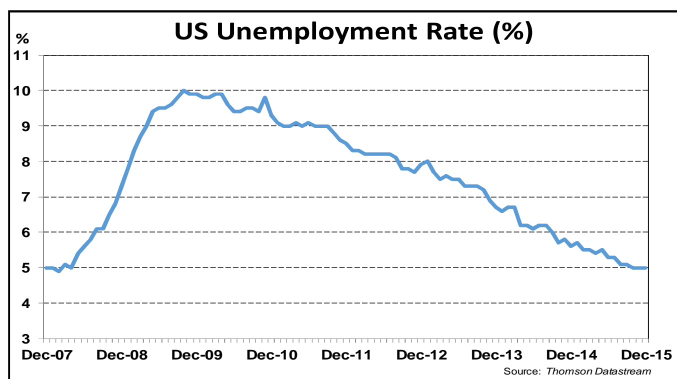
The first FOMC meeting of 2016 concluded with no change to policy. This was in line with market expectations as the Fed had only increased interest rates as recently as December (by 25bps to 0.375%), for the first time in nearly a decade. The decision to leave policy unchanged was unanimous. With no updated projections or press conference, the main interest was in the meeting statement.



The statement did contain some changes compared to last month. It takes into account recent market turbulence and increased global macro risks, showing some concern about these developments. It stated that the Fed is "closely monitoring global economic and financial developments". As part of its on-going deliberations it "is assessing" the implications of these factors for the "labour market and inflation, and for the balance of risks to the outlook". The Fed's caution was most evident in this sentence, as throughout last year, it had described the risks to the outlook as being "balanced".

However at the same time, the Fed's characterisation of the US economy remained generally positive in tone. It stated that the information released since its last meeting in December "suggests that labour market conditions improved further" and the data point "to some additonal decline in underutilization of labour resources". The Fed continues to expect that "economic activity will expand at a moderate pace and labour market indicators will continue to strengthen". Based on this outlook, it remains of the view that inflation will "rise to 2 percent over the medium term" as the "transitory effects of declines in energy prices and import prices dissipate".

The **Fed's most recent set of projections** on the likely path of interest rates were releasesd at the December meeting. They showed that the median projection for the Fed funds rate at end-2016 was 1.375%, **which is consistent with one 25bps rate hike per quarter this year.** In contrast, **current market pricing suggests a much less aggressive path of rate hikes**, with futures contracts indicating just one rate hike in 2016, towards the end of the year.



In summary, the January statement portrays the Fed as being in an 'assessing' mode regarding its decision on when to tighten policy again. The changes in the text suggest the Fed has some concerns based on recent market and macro developments. However, the statement wording **neither rules in or out a March rate hike**, thereby allowing the Fed to keep its options open. **Overall though, the chances of a rate hike in March are now slighlty lower than they were before last night's statement.** The market is currently not expecting a rate rise in March.

Between now and the March FOMC (15th/16th), the Fed will have almost two months of data to be able to assess global economic and financial market developments and see if these are negatively impacting the performance of the US labour market and the Fed's inflation outlook. Therefore, the market will be paying close attention to the incoming data as well as market conditions. Another important event in the coming weeks is **Fed Chair Yellen's semi-annual testimong to Congress (10th Feb), where the market will be looking for further signs on the chances of a March rate hike.**

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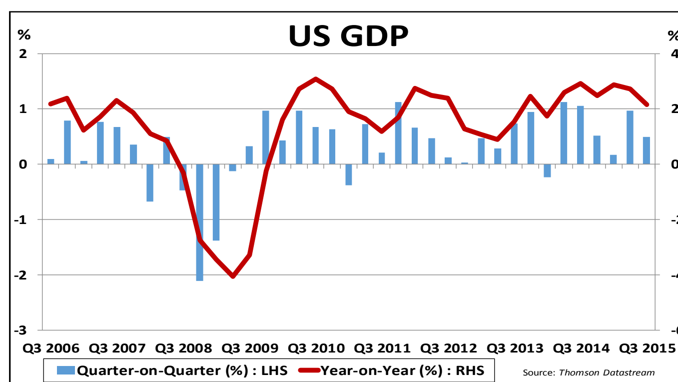
Moderation in US Growth Recently

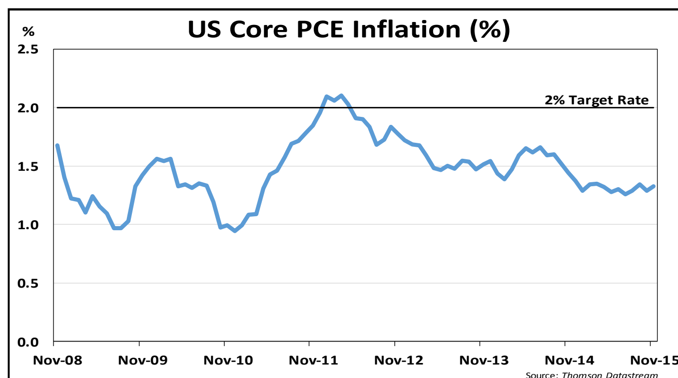
Data available for the first three quarters of 2015 show that the US economy grew by 2.6% year-on-year in the period. Growth was underpinned by a solid performance on the consumer side of the economy. Private investment also provided a healthy fillip, helped by house building. Net exports proved to be a drag on GDP once again, with the trade balance not helped by dollar appreciation.



While we do not yet have an official estimate of Q4 GDP, it is expected that annualised growth could have slowed to 1% or below. This is in part due to slower inventory accumulation. However, most indicators also point to slowing activity. Real personal consumption grew by 0.4% in October/November, following growth of 0.7% in Q3 and 0.9% in Q2. Meantime, industrial production fell by 0.9% in the fourth quarter. The data were likely weather impacted, with the 'utilities' (i.e. energy) component soft. Meanwhile, housing starts fell in Q4, with year-on-year growth slowing to 7.4% from 12.6% in Q3.

In contrast to the apparent slowdown in economic growth in Q4, job growth strengthened. The key non-farm payrolls averaged monthly gains of 284k, compared to Q3's 174k performance. Meantime, the unemployment rate declined further in Q4, finishing the year at 5%, its lowest level since April 2008. This is all the more impressive given the recent increase in the size of the labour force, while the participation rate has started to edge back up from a four decade low. Despite these developments, year-on-year growth in average earnings has been confined to a 2.2-2.5% range since the middle of last year.

Growing price pressures on the services side of the economy saw CPI inflation accelerate to 0.7% at the end of 2015. The pick-up in inflation also reflects some abating in base effects from the sharp fall in oil prices at the end of 2014. The 3.9% month-on-month fall in gasoline prices in December represents a far smaller decline than December 2014's 9.2% fall. CPI inflation should rise again in January due to base effects. However, core PCE (excludes energy), **the Fed's preferred measure of inflation, has been stuck at 1.3% since the start of last year, well below its 2% target rate.**



In terms of a timelier look at the US economy, **the Markit composite PMI for January pointed to a slower start to the year, coming in at 53.7 compared to the Q4 average of 54.7.** Although, a pick-up in consumer confidence (both Michigan and Conference Board measures) suggests growth on the all-important consumer side of the US economy remains solid.

Overall, the economy should 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 moderate 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, volatility on financial markets and the impact from the stronger dollar. **Overall, the US economy is expected to grow by close to 2.5% in 2016 and 2017, assuming there is no downturn in the global economy.**

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