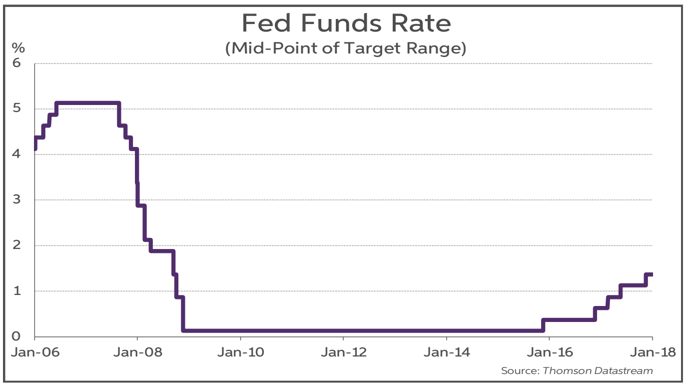
Fed Watch
AIB Treasury Economic Research Unit
1st February 2018

Fed set to hike again in March

The first Federal Reserve policy setting meeting of 2018 concluded, as expected, with no changes to monetary policy. The Central Bank maintained the target range for the fed funds rate at 1.25-1.50%. At its previous meeting back in December, the Fed announced its third rate hike of 2017. The decision to leave rates unchanged at its latest meeting was unanimous.

With no press conference or new staff projections accompanying this meeting, attention was centred on the statement. The text contained no major surprises and only minor changes compared to the December version.

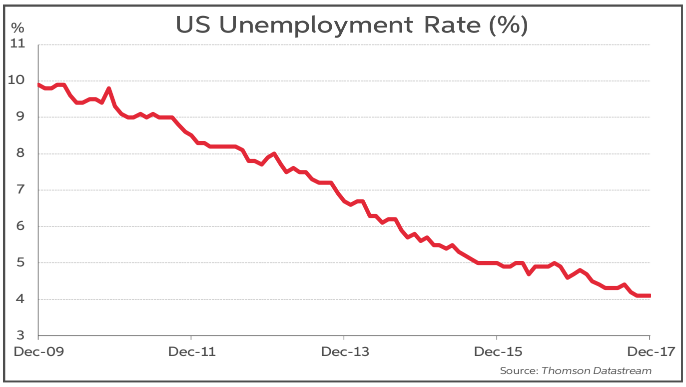
The description of the economy remained upbeat in tone, continuing to note that it is growing at a "solid rate". On the issue of inflation, the Fed upgraded its language slightly by stating that it expects it to "move up this year". It remains of the view that it will start to "stabilise" around its objective over the medium term.



In terms of its economic forecasts (which assume that the US tax reform will likely provide some boost to activity), the Fed upgraded its view on the outlook during its last forecasting round in December. It is expecting real GDP growth of 2.5% (previously at 2.1%) this year, with the rate of expansion moderating to 2% by 2020.

The most recent set of interest rate projections were also released at the December FOMC. The Fed is indicating that it will hike three times this year, with the median projection for end-2018 unchanged at 2.125%. For 2019, it is guiding that it expects rates to finish the year at around 2.75%. Meanwhile, it is envisaging rates edging up to 3.1% in 2020.

Market expectations have become more hawkish on the rate outlook over the past six months, with the gap between the market and the Fed narrowing. Futures contracts indicate that the market is now broadly in line with the Fed's guidance of three hikes this year. This has put some upward pressure on bond yields. However, over the period 2019-2020, the market is anticipating a much less aggressive path of rate hikes than the Fed is guiding. Current pricing suggests that the market is expecting just one additional 25bps increase in 2019, taking rates up to 2.375%, with rates edging up to near 2.5% by end 2020, well below the Fed's projections. **This suggests that the market may either be expecting inflation to remain at very subdued levels and/or the economy to slow, which would mean that the Fed would be unable to raise rates by as much as it is currently guiding.**



Overall, the Fed January meeting statement remains consistent with the consensus view that the Fed will raise the fed funds rate by 25bps at its next meeting in March (20th/21st). This meeting, which will also include updated economic projections as well as a press conference, will be the first under new Chair Jerome Powell. In his previous comments as an FOMC member, he has expressed similar views on the economy and pace of monetary tightening as Janet Yellen.

Of course, the extent of rate hikes over the next 2-3 years will remain dependent on the incoming data continuing to point to solid growth and financial market conditions remaining appropriate. Inflation is also a key consideration. The core PCE rate at 1.5%, remains below the Fed's 2% target and some FOMC members have indicated that continuing below target inflation could mean that rates would not rise as much as projected by the Fed.

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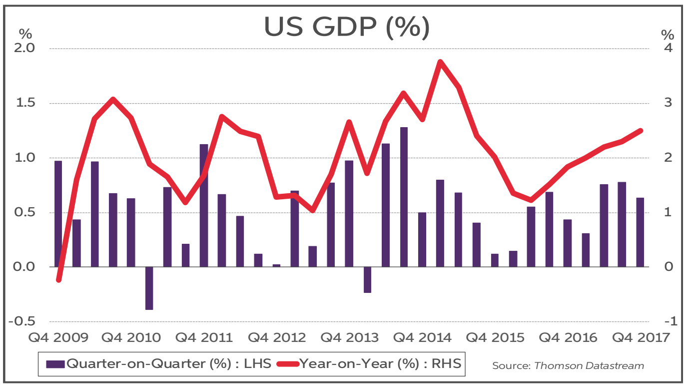
US growth improves in 2017

US annualised growth slowed to 2.6% in Q4, from 3.2% in Q3. Overall though, the economy grew by 2.3% in 2017, an improvement on 2016's soft 1.5% increase. **The underlying data showed that much of the slowdown in Q4 was due to a strong drag from net trade** (deducted 1.1 percentage points, p.p.) due to a big surge in imports. Inventories were also a significant drag (0.7 p.p.), as stocks of vehicles were sold to replace those destroyed by extreme weather in Q3.

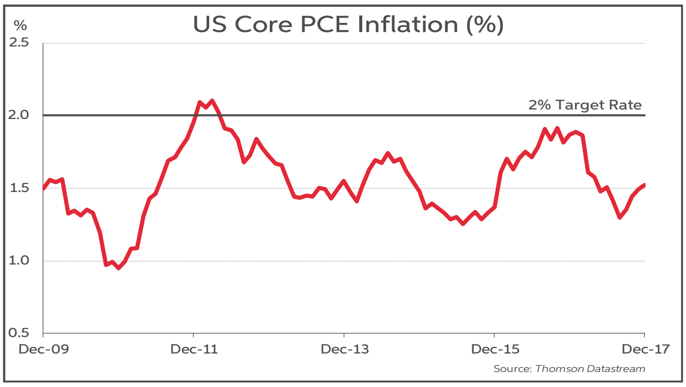


However, **lower inventories also reflect very strong consumer spending (+2.6 p.p.) in Q4**. Indeed, final sales to domestic purchasers (GDP ex. trade and inventories) rose by 4.3% in Q4, its strongest rate since Q3 2014, showing that despite slower headline growth, underlying economic activity strengthened, including a strong performance from business investment.

Labour market data remained solid in Q4. Non-farm payrolls averaged growth of 204k in the quarter, an improvement from Q3's weather impacted 128k. Year-on-year growth in household employment slowed, though, to 1.2% from 1.4%. The slower pace of growth may partly reflect less spare capacity in the labour market. Indeed, the unemployment rate held at just 4.1%, its lowest level in 17 years, throughout Q4. This slowdown in employment expansion could continue, with labour force growth slowing to 0.5% year-on-year in the fourth quarter, compared to 1.3% in the same period in 2016. Furthermore, survey data suggest that employers are finding it harder to get workers. The NFIB 'few or no qualified applicants' for job openings index rose to an all-time high in December, while its 'jobs hard to fill' index remained close to a 17-year high.

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 Q3 2015, coming in at 2.5% in December. The Fed's preferred measure of wage inflation, the 'wages & salaries' component of the Employment Cost Index remained at 2.5% in Q4.

Headline CPI inflation has settled at just above 2% in recent months, after having been as high as 2.7% in February. Core inflation (ex. food and energy) has been stuck in a tight 1.7-1.8% range since May. The Fed's preferred measure of price pressures, core-PCE inflation edged up slightly in Q4, from 1.4% to 1.5%, though it is still below the c.2% levels seen at end-2016/start-2017.



Overall, the outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption will continue to support growth. Meantime, interest rates remain low, while stock markets have risen strongly over the past two years. At the same time, the raft of tax cuts passed by the US Congress at the end of last year should provide a fillip to growth in the next couple of years. **The IMF estimated recently that the fiscal stimulus would provide a cumulative 1.2% boost to growth between this year and end 2020.** The IMF is now expecting growth in 2018 of 2.7% (was 2.3% previously) and 2.5% in 2019 (was 1.9%).

The IMF does highlight some risks to the economy too. These include the possibility that the fiscal stimulus will increase the demand for imports, widening the current account deficit further. There is also the possibility that the stimulus could put further pressure on the labour market, leading to higher inflation. This may see the FOMC hike rates more quickly/to a greater extent than markets currently expect, while it could also lead to a "correction" in equity prices. The 'protectionist' stance of the Trump Administration is also a risk to growth.

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