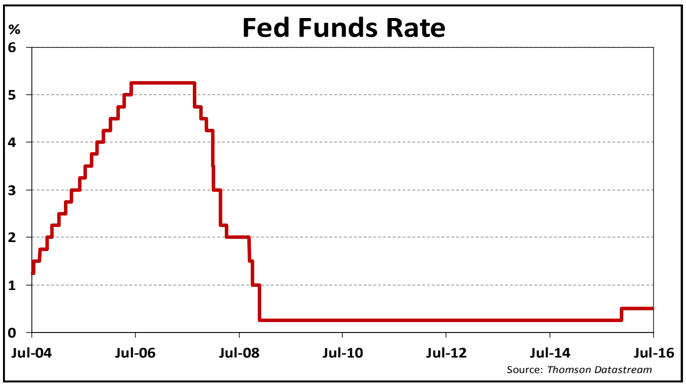
No clear signal that a rate hike is imminent

The July meeting of the US Federal Reserve concluded as expected with the FOMC not making any changes to its current policy stance. The Fed funds rate has been left at 0.375% for five consecutive meetings now. The decision to leave policy unchanged was not unanimous, with one of the ten voting FOMC member (Esther George) preferring to raise interest rates.

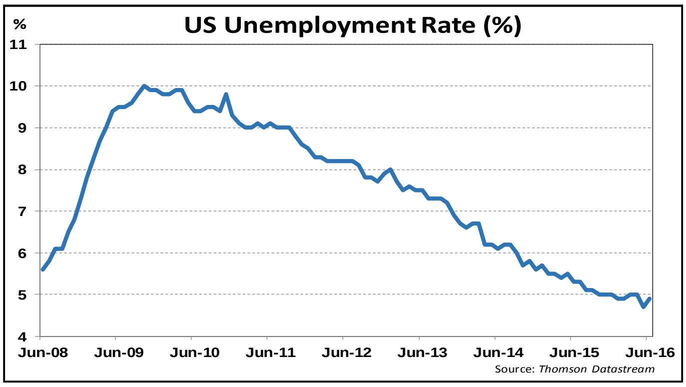


With no press conference scheduled, or updated macro projections, the focus was centred on the meeting statement. The Fed's description of the economy was upgraded compared to the June statement.

The Central Bank acknowledged the improvement in the economy in recent months. It noted the pick-up in employment growth, commenting that "the labour market strengthened" and that "job gains were strong in June following weak growth in May". It described the economy's overall performance as "expanding at a moderate pace".

In terms of the outlook, the Fed said that "near term risks to the economic outlook have diminished". However notwithstanding this, the Fed continues to state that it will "closely monitor" inflation indicators as well as developments in the global economy and financial markets.

The Fed's most recent set of projections on the likely path of interest rates were released at the June FOMC. They showed that the median expectation for the Fed funds rate at end-2016 was 0.875% (i.e. two 25bps rate hikes). However, the number of FOMC members in favour of just one rate hike increased from one to six, which represents around one third of the FOMC.



Despite the June projections being less aggressive than in March, the Fed is still indicating a more hawkish trajectory of rate hikes than the market is expecting. **Current futures pricing suggests that the market is not fully pricing in a 25bps hike till the third quarter of next year.** Overall, markets are pricing in just two rate increases by end-2018, taking the Fed funds rate to just 0.875%. **The Fed envisages rates rising to 2.375% by end 2018.**

In summary, the July meeting statement was somewhat more hawkish in tone than the June version. **However, there was no clear signal from the Fed that a rate hike is imminent.** There was no reference in the statement to the 'appropriateness' of rate hikes, something which preceded its rate hike back in December 2015. Also, the Fed is still not back to characterising the risks to the economic outlook as being "nearly balanced".

Overall then, the Fed is keeping its options open for hiking rates later this year. There are three FOMC meetings (September, November, December) between now and year end. Our view is that December is the mostly likely timing of the next rate hike. By then, the Fed will have had a number of months of labour market data to assess if the recent pick-up is being sustained as well as being able to monitor financial market developments. The Presidential election will also be over by then.

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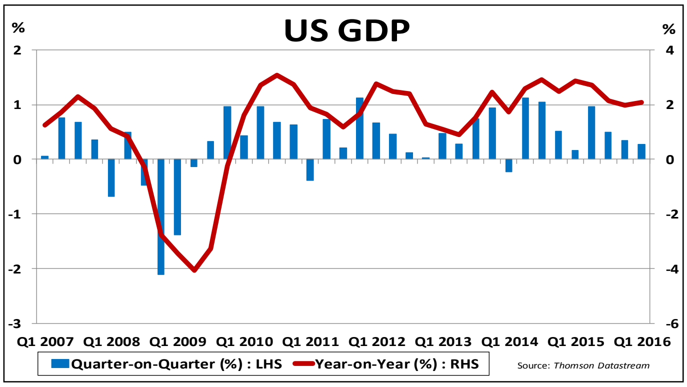
Economy has regained some momentum

The US economy grew by a soft annualised rate of 1.1% in Q1, following Q4's sluggish 1.4% figure. This represented a third consecutive quarter of slower growth. Personal consumption remained the main source of growth, though it slowed again, contributing 0.65 percentage points less to growth than in Q1.

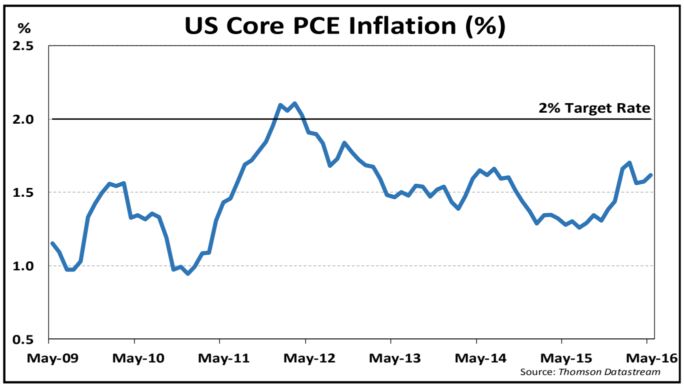


Data for Q2 point to a stronger pace of growth in the quarter. The retail sales 'control' measure, used as a proxy for expenditure on goods in GDP, rose by 1.7% versus Q1, in which it grew by 0.7%. Personal consumption grew by a strong 1% in April/May versus Q1. Industrial production continued to decline in Q2 (-0.3%), though at a slower pace than in Q1 (-0.5%) and Q4 (-0.8%). Trade data (goods & services) from April/May suggest, though, that net trade could have weighed on growth. Meantime, leading indicators of activity, such as the ISM indices, pointed to a stronger pace of growth in Q2. As a result, markets expect the US economy to have grown by an annualised rate of 2.6%.

While the economy looks to have improved in Q2, employment growth slowed. The key non-farm payrolls grew by 318k in Q2, their weakest performance since Q2 2012. Although, this largely reflects weakness in April/May, with payrolls rising strongly in June. Notwithstanding this, year-on-year growth in household employment stood at 1.6% at the end of Q2, from 2% at end Q1. While the slower pace of economic growth in the lead up to Q2 may have been a factor in the slowdown, tighter supply of labour may also be becoming an issue. The US unemployment rate stood at 4.9% in June, near an 8½-year low.

Despite the very low level of unemployment, the Fed's preferred measure of wage inflation, a sub-index of the Employment Cost Index, has been stuck around 2% since Q2 2015. There is some evidence to suggest that this reflects 'compositional' issues, as older higher-paid workers leave the labour market and lower-paid workers enter, rather than significant labour market 'slack'. Growth in the official average hourly earnings measure has been steady around 2.5% in recent months.

Meanwhile, CPI inflation held at 1% in June. Although, the core measure, which excludes food and energy, rose to 2.3%. It has been boosted by price increases in the services sector, particularly medical and housing costs. However, core-PCE price deflator, **the Fed's preferred measure of inflation held around 1.6% in April/May, still below its 2% target rate.**



In terms of Q3 data, leading indicators of activity for July have been generally weaker. The services PMI fell to 50.9 (from 52), though the manufacturing index did rise to 52.9 (51.6). Both the NY and Philly Fed indices fell, as did the Conference Board measure of consumer sentiment and the NAHB homebuilders' sentiment index.

Overall, growth in the economy appears to have regained momentum in recent months. Low energy prices are providing some support to spending, while the labour market remains strong. Both of these should help to support the consumer spending. There are also signs that investment in the energy sector may start to pick-up again. Expansive fiscal policy is also boosting GDP. Overall, the underlying fundamentals in the US economy remain solid. However, the economy does still face some headwinds, such as a slowdown in emerging markets, heightened global uncertainty following the UK Brexit vote, the stronger dollar, a tighter labour market and uncertainty over November's US elections. **The IMF's recent updated projections show that it expects US growth of 2.2% in 2016 and 2.5% in 2017.**

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