Fed Watch

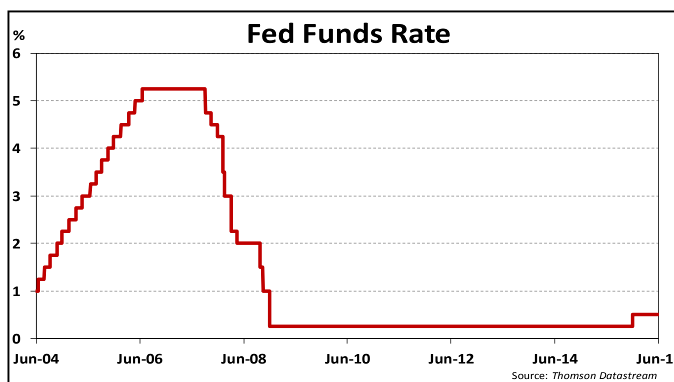
16th June 2016

AIB Treasury Economic Research Unit

Fed less hawkish on rate tightening cycle

As anticipated, the June meeting of the US Federal Reserve concluded with the FOMC maintaining the fed funds rate at 0.375% for a fourth consecutive meeting. The decision to leave policy unchanged was unanimous, with all ten of the voting FOMC members in agreement.

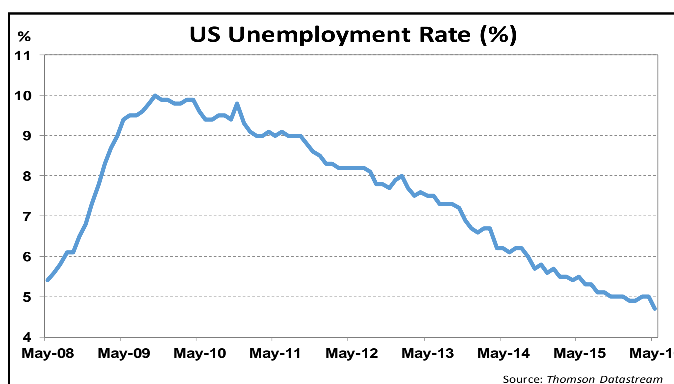
The meeting statement, while acknowledging the recent weakness in the jobs data, also emphasised the positives on the economy. It noted that the "pace of improvement in the labour market has slowed" and that business investment "has been soft". However at the same time, the Fed also commentated that the "growth in economic activity appears to have picked up". It stated that consumer spending "has strengthened", while the housing sector "has continued to improve" and the "drag from net exports appears to have diminished".



The Fed did "slightly lower" some of it economic forecasts from the March FOMC. The median growth projection "now remains at 2 percent through 2018". At the same time, it raised marginally its inflation projections to 1.4% this year and "then rises to 1.9% next year and 2 percent in 2018".

Meanwhile, the Fed's latest set of projections on the likely path of interest rates show a less aggressive pace of rate rises. While the 'dots' continue to indicate two rate hikes this year, the number of FOMC members in favour of one rate hike in 2016 has increased from one to six. Meantime, in terms of 2017 and 2018, the interest rate projections now indicate three rate hikes per year versus four per year in the March projections. This would mean the Fed funds rate increasing to just 2.375% by end 2018, rather than 2.875% previously.

Despite the less aggressive path of interest rate hikes suggested by the Fed over the forecast horizon, the market continues to expect an even more gradual pace of rate increases. Indeed, following the latest Fed meeting, futures contracts have pushed further out the timing of the next rate increase. Prior to the meeting, the market was pricing in a 25bps increase around March 2017, however, this is now not fully priced in till September 2017. Markets are pricing in just two rate increases by end-2018, taking the fed funds rate to just 0.875%.



In summary, the Fed retains its tightening bias, although the strength of this bias has weakened somewhat from its March meeting. It continues to emphasise that the "evolution of the economy will warrant only gradual increases in the federal funds rate". The timing of the next interest rate increase will depend on incoming US macro data, especially on the labour market, as well as developments in the global economy and financial market conditions, including any fall-out if the UK votes to leave the EU.

If there is no material deterioration in global macro and market conditions and if the non-farm payroll data over the summer months show improvement, then a rate increase could be on the cards in September. This would be a major surprise for markets.

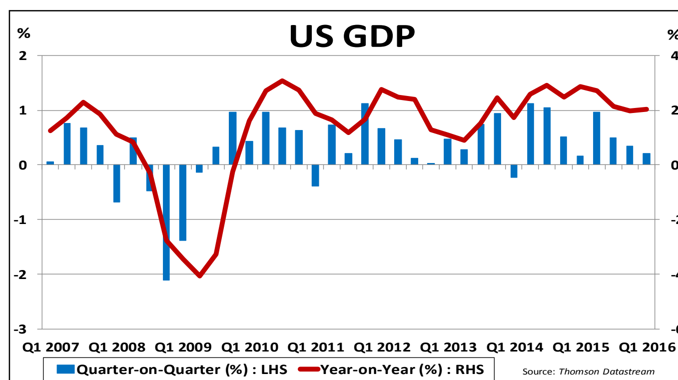
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Economy regaining some momentum

The US economy grew by a weak annualised rate of 0.8% in Q1, following Q4's sluggish 1.4% figure. This represents a third consecutive quarter of slower growth. Personal consumption remained the main source of growth. Although, it did slow again, not helped by a decline in motor vehicle sales. Business investment fell, with the data suggesting the sector may still have been impacted by the fall in oil prices. Net exports continued to drag on GDP, but government spending did remain a fillip.



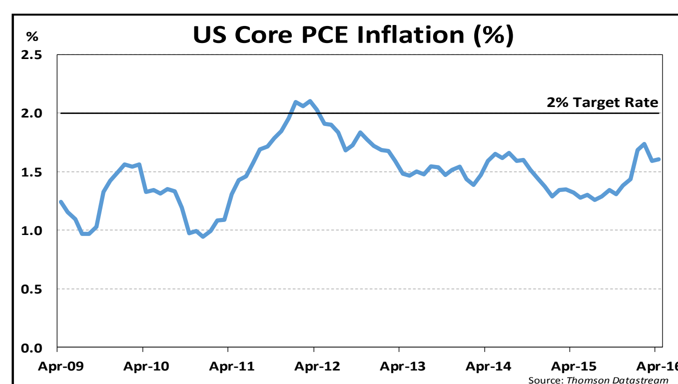
Some leading indicators of activity for Q2 have shown some modest pick up compared to Q1. The ISM services index averaged 54.3 in April/May compared to 53.8 in Q1. Interestingly, the manufacturing ISM averaged 51.1, compared to 49.8. This tentatively suggests that the sector could return to growth in the quarter, albeit very modest. Meantime, the Markit PMIs point to little major change in growth. The composite PMI averaged 51.3 in April/May following Q1's 51.6 performance.

In terms of 'hard' data, consumer spending looks to have strengthened. Retail sales grew by 1.4% in nominal terms in the first two months of Q2, versus Q1, in which sales declined by 0.1%. On the production side, industrial output fell by 0.4% in April/May after declining by the same amount in the first quarter. The data suggest that weakness in the energy sector remains a significant drag.

Meanwhile, **employment growth has slowed in the last couple of months.** The key non-farm payrolls number averaged monthly growth of just 81k in April/May. This compares to averages of 196k in Q1 and 282k in Q4 last year. While the slower pace of economic growth is a likely factor in the slowdown in employment growth, tighter supply of labour may also be becoming an issue. **Despite the weak payrolls number, the unemployment rate fell to 4.7% in May, from 5%.**

Despite the very low level of unemployment, year-on-year growth in wages, as measured by the Fed's preferred Employment Cost Index, has been stuck around 2% since Q2 2015. There is some evidence to suggest that this reflects 'compositional' factors, as older higher-paid workers leave the labour market and lower-paid workers enter, rather than significant labour market 'slack'. The Atlanta Fed's measure of wage growth, which seeks to control for compositional changes, put wage inflation at 3.4% in April. Growth in average hourly earnings has steady around 2.5% in recent months.

CPI inflation held at 1.1% in May. Although, the core measures, which excludes the drag from oil prices, remained above 2%. It has been lifted by price increases in the services sector, particularly medical and housing costs. However, **core PCE prices, the Fed's preferred measure of inflation came in at 1.7% in Q1, still below its 2% target.**



Overall, growth in the economy appears to be regaining some momentum. Low energy prices are providing some support to spending, while interest rates remain very low. However, the economy does face some headwinds, such as a slowdown in emerging markets, financial market volatility, the impact from the stronger dollar and uncertainty over November's elections. **The Fed expects that the US economy will grow by 2.2% in 2016 and 2% in 2017.**

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AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com