Fed Watch

AIB Treasury Economic Research Unit

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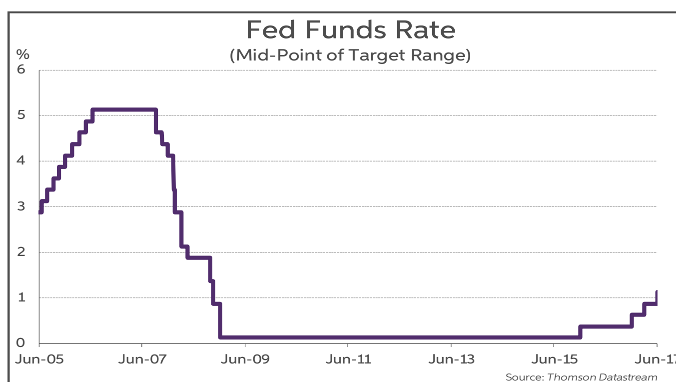
Fed hikes and signals more tightening on the cards

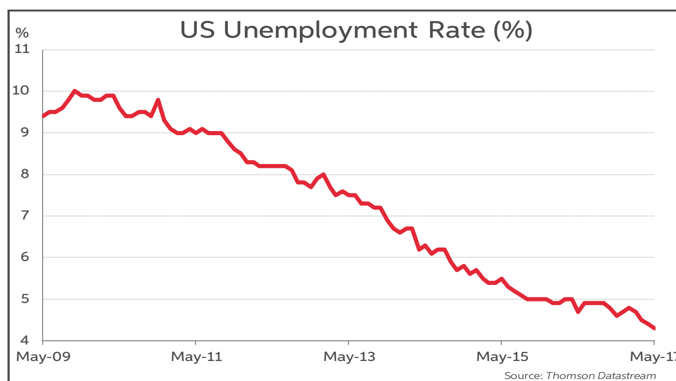
As expected, the Federal Reserve announced a 25bps hike in the target range for the fed funds rate to 1-1.25% at its June meeting. This represents the Fed's fourth hike in the current tightening cycle and the second rate increase since the start of this year. The decision to raise rates was once again not unanimous, with Neel Kashkari continuing to state his preference for no change to the target range.

The meeting statement outlined the economic backdrop that formed the basis of the Fed's decision to hike rates. It noted that the labour market had "continued to strengthen" while household spending had "picked up in recent months" and business fixed investment "continued to expand". In short, **the economy is broadly progressing in line with the Fed's expectations for a moderate pace of expansion.**



On the issue of inflation, the Fed stated that "inflation had declined recently" and is "running somewhat below 2 percent". **However, in her post-meeting press conference, Fed Chair, Janet Yellen, indicated that while the FOMC will be "monitoring inflation developments closely" it was not overly concerned about recent softer readings.** She emphasised that these recent lower inflation readings "have been driven significantly by what appear to be one-off reductions". The FOMC "still expects inflation to move up and stabilize around 2 percent over the next couple of years" given the fact that employment is "near its maximum sustainable level" as well as continued strengthening in the labour market.

The June meeting also included the Fed's latest interest rate projections ('dots'). There was very little change to these. The median projections for end-2017 and end-2018 were unchanged, at 1.38% and 2.13% respectively, consistent with three hikes per annum over the period. The FOMC did slightly revise lower its end 2019 projection from 3% to 2.9%.



Futures contracts continue to indicate that the market is expecting a less aggressive path of rate hikes than the Fed is guiding. Current pricing indicates that the market is looking for rates to rise to just below 2% by end-2019. This suggests that the market is factoring in only around three additional rate hikes over this period.

The Fed also provided more information on how it will start to reduce down the size of its balance sheet, which represents another form of policy tightening. The FOMC intends to "gradually reduce the Federal Reserve's securities holdings by decreasing its reinvestment of the principal payments". At the moment, the Fed is maintaining the size of its balance sheet by reinvesting proceeds from maturing securities. Chair Yellen stated that **if the "economy evolves broadly" as anticipated, the Committee "expect to begin implementing a balance sheet normalization program this year"**

Overall, the June FOMC meeting shows that the Fed remains comfortable with, and intends to, follow through on its policy tightening bias. Based on its guidance, this means that between now and the end of this year, the Fed is likely to implement another 25bps rate hike and start to gradually reduce the size of its balance sheet as part of its policy tightening process. Speeches and comments from FOMC members will be closely followed over the coming months for indications on the likely sequencing/timing of these policy tightening measures.

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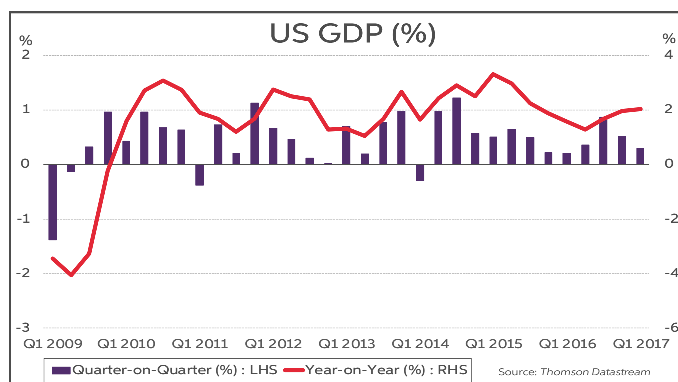
Signs economy is picking up after Q1 slowdown

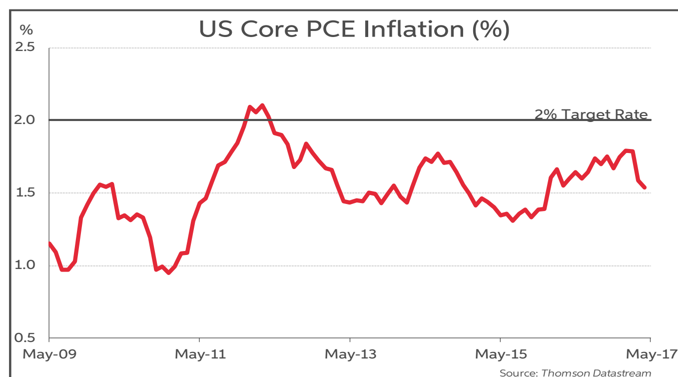
US annualised growth slowed further in Q1 to just 1.2%. However, **there appears to be an issue with the seasonal adjustment of the figures,** which has given an overly negative view of growth in the first quarter for the last number of years. Although, temporary factors such as the later timing of Easter and delayed tax refunds did have negative impacts on GDP in the first quarter.



The underlying GDP data show that a marked weakening in consumption was the primary cause of the slowdown in Q1. It added just 0.4 percentage points (p.p.) to growth, compared to 2.4 p.p. in Q4'16. Declines in vehicle sales and services, particularly healthcare spending, were the main drivers of this. Net exports were broadly flat in Q1, while inventories deducted 1.1 p.p. A rise in business investment (+1.3 p.p. from +0.1 p.p.) was a positive development. A key part of this improvement was a rebound in investment in oil extraction.

Recent labour market data have been solid. Non-farm payrolls averaged +156k in April/May, a slight slowdown from Q1's +166k. Year-on-year growth in household employment picked up to 1.3%, from 1% in the period. The helped to put downward pressure on the unemployment rate, which fell for a fourth consecutive month in May to 4.3%, a 16-year low. This decline also partly reflects a sharp fall in the labour force.

Despite a tightening labour market, **US average hourly earnings growth has generally remained stuck in the 2.5-2.8% range that it has occupied since Q2 2016,** edging down to 2.5% in May. Although, the Atlanta Fed's national wage tracker, which seeks to control for compositional changes in the jobs market, has picked up in recent months, rising to 3.5% in April. The NFIB 'jobs hard to fill' index rose further to its highest level since end 2000 in May. This suggests that we could see wages begin to rise more strongly as companies compete for workers.



At the same time, **both headline and core CPI inflation have softened in recent months from their peaks at the start of the year.** This reflects a broad based easing in price pressures. The Fed's preferred measure of price pressures, core -PCE inflation, fell back to 1.5% in April.

Leading indicators of activity for Q2 have been somewhat mixed. The manufacturing PMI has slowed further, averaging 52.8 in April/May, versus 54.2 in Q1. However, the services index has been more positive, averaging 54.1 after Q1's 53.4. The non-manufacturing and manufacturing ISM indices have mirrored the trend in the PMIs. **'Hard' data have generally been positive.** For example, the 'control' measure of retail sales growth (seen as a proxy for goods consumption in GDP) rose by 1% in April/May versus Q1. Meantime, industrial production grew by 1.3% in April/May compared to Q1, partly due to a rebound in vehicle production.

Overall, the outlook for the US economy remains positive. The economy is expected to regain momentum after the slowdown in GDP growth in Q1. The continued improvement in the labour market will be helpful to the key consumer side of the economy. **President Trump's proposed expansionary fiscal policies, if implemented, should provide a boost over the medium-term,** though it seems unlikely that Congress will be willing to support all of his proposals. **However, the economy still faces some headwinds.** These include the stronger dollar, the potential for any fiscal stimulus to lead to a more rapid pace of monetary policy tightening and some political uncertainty, with the new President retaining protectionist views on trade. It also remains to be seen if the improvement in business investment seen in Q1 will prove to be sustained. **The most recent Fed forecasts show that it expects US growth of 2.2% in 2017 and 2.1% in 2018.**

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