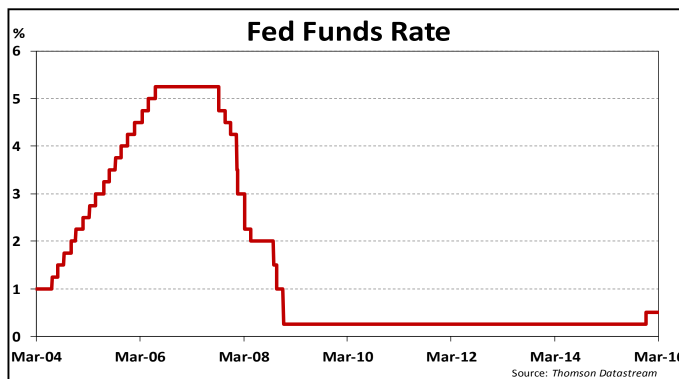
Fed Watch

21st March 2016

AIB Treasury Economic Research Unit

Fed proceeding cautiously in its tightening cycle

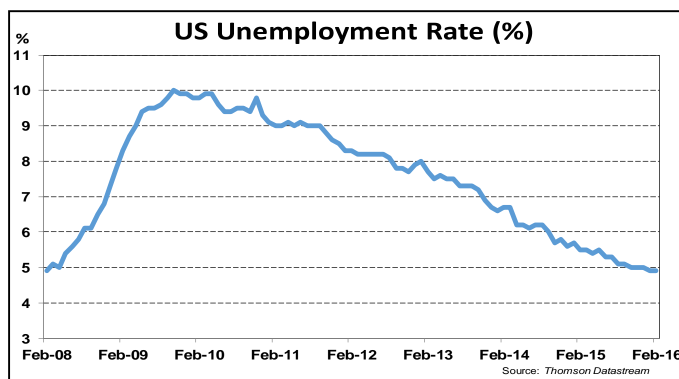
As expected, the March meeting of the US Federal Reserve saw the FOMC maintain the Fed funds rate at 0.375% for a second consecutive meeting. The decision to leave policy unchanged was not unanimous, with one of the ten voting FOMC members (Esther George) preferring to raise interest rates.



The tone of the meeting statement showed that the Fed remains positive on the prospects for the US economy, but at the same time, it is very cognisant of the risks emanating from the global economy and financial markets. The statement describes the economy as "expanding at a moderate pace despite the economic and financial developments of recent months".

The FOMC noted that a range of indicators, including "strong jobs growth" point to an "additional strengthening of the labour market". It remains of the view that the economy should continue to expand at a "moderate pace" and that "labour market indicators will continue to strengthen". **However, it stated that "economic and financial developments continue to pose risks".**

In her post meeting press conference, Fed Chair Yellen commented that **against the backdrop of heightened global economic and financial market risks, the "Committee judged it prudent to maintain the current policy stance**". Overall, Yellen struck a fairly cautious tone. While noting that core inflation has picked up, she said "it remains to be seen if this firming will be sustained". She also commented that "economic growth abroad appears to be running at a somewhat softer pace than previously expected".



Fed Chair Yellen also emphasised that by **"proceeding cautiously" in the rate tightening cycle, it will allow the FOMC to "verify that the labour market is continuing to strengthen** despite the risks from abroad". She also once again repeated the line that the Fed expects economic conditions will "warrant only gradual increases" in interest rates.

This more cautious approach to hiking interest rates is reflected in the FOMC members' projections on the likely path of interest rates. The dots for 2016 indicate only two rate hikes this year compared to the four suggested in the December projections. This would leave the Fed funds rate at 0.875% by year end. It still sees rates rising to 3% by 2018.

Despite the rowing back on its expectations for the future path of rate increases, the Fed is still indicating a slightly more aggressive trajectory of rate hikes than the market is expecting. Current futures pricing suggests that the market is looking for only one 25bps this year, taking the Fed funds rate to 0.625% by end 2016.

Of course the extent of any Fed tightening will depend on how the US economy performs, including on-going strengthening in the labour market and the path of inflation. The Fed will also be paying close attention to developments "abroad" and on financial markets and the risks these could present to the economic outlook. **Market expectations that US rates will rise to just 1.25% by end 2018 suggest it expects that there may well be continuing constraints on the ability of the Fed to tighten policy.**

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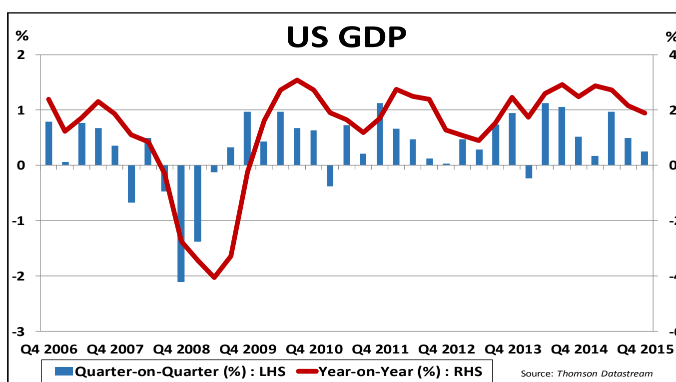
US growth has moderated

The US economy grew by 1% on an annualised basis in Q4. This represents a further slowdown after growth of 3.9% and 2% in Q2 and Q3, respectively. Much of the slowdown in Q4 can be accounted for by weaker spending on goods (added just 0.4 percentage points), and drags from business investment and net exports (both -0.25 p.p.). US exports have been negatively impacted by the strength of the dollar. Overall, **the US economy grew by 2.4% in 2015, matching its performance from 2014.**

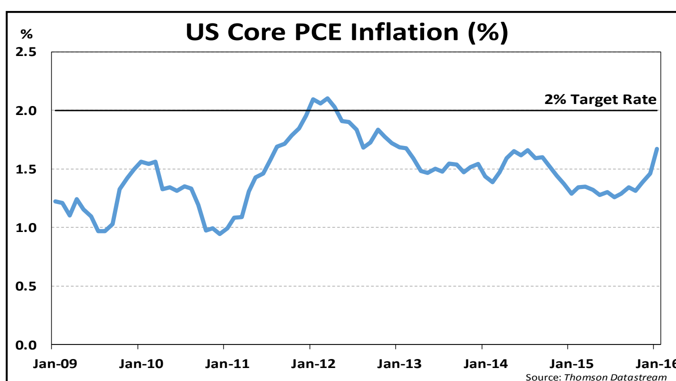


In terms of this year, recent data suggest that the economy has maintained a more modest pace of growth in early 2016. The 'control' retail sales measure, used as a proxy for goods spending in GDP, rose by 0.2% in value terms in January/February versus Q4. Although, real personal consumption, which accounts for changes in prices, rose by a strong 0.4% in January. On the output side of the economy, industrial production was flat in Jan/Feb compared to Q4, in which it fell by 0.8%. The sector continues to be negatively impacted by weak oil prices. Meanwhile, growth in housing starts has reaccelerated this year, picking up to 13% year-on-year in the three months to February from 7.6% at the end of 2015.

Leading indicators of activity have suggested that the economy struggled somewhat in the first quarter. The manufacturing ISM averaged 48.9 in Jan/Feb, continuing to point to contraction in the sector. Meanwhile, the services ISM has weakened, averaging 53.5 in Jan/Feb after 56.9 in Q4. Another measure, the Markit composite PMI, has also pointed to a weaker performance (51.9 vs 54.7).

In contrast to the apparent slowdown in economic growth, job growth has remained strong. The key non-farm payrolls increased by a strong 242,000 in February. This translated into year-on-year growth in employment of 1.9%, up from 1.6% in January. Meantime, the unemployment rate held at 4.9% in February, an eight year low. This is all the more impressive given the recent increase in the size of the labour force. Despite these developments, year-on-year growth in earnings, as measured by the Employment Cost Index, has been stuck at 2.1% since the second quarter of 2015.

Price pressures on the services side of the economy have seen CPI inflation pick up in recent months. However, it fell to 1% in February, from 1.4%, as the drag from the fall in oil prices reasserted itself. Notably, though, core inflation (excludes energy) rose to 2.3%, a four year high. Meantime, **the Fed's preferred measure of inflation, core PCE, picked up to 1.7% in January, close to its 2% target rate.**



Overall, the economy should remain supported by a number of positive growth factors. This includes the accommodative stance of US monetary policy, 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. **The Fed expects that the US economy will grow by around 2.2% in 2016 and 2% in 2017.**

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