Fed Watch

AIB Treasury Economic Research Unit

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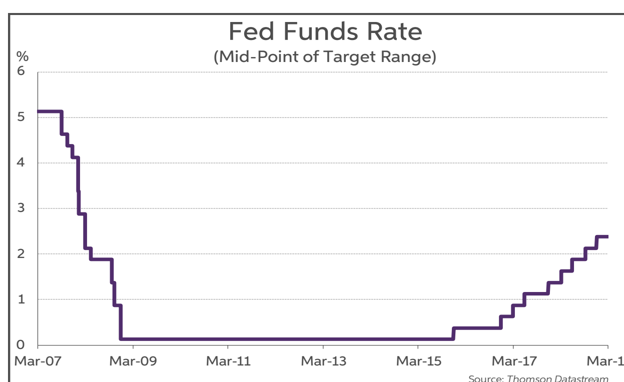
Fed guides rates on hold for this year

The March meeting of the Federal Reserve Open Market Committee (FOMC) saw the target range for the key fed funds rate maintained at 2.25-2.50%. This was in line with market expectations. However, the Fed did announce some policy changes in relation to its balance sheet normalisation programme. It stated that it intends to "slow the runoff" of assets, starting in May, and to end the "runoff entirely" in September.

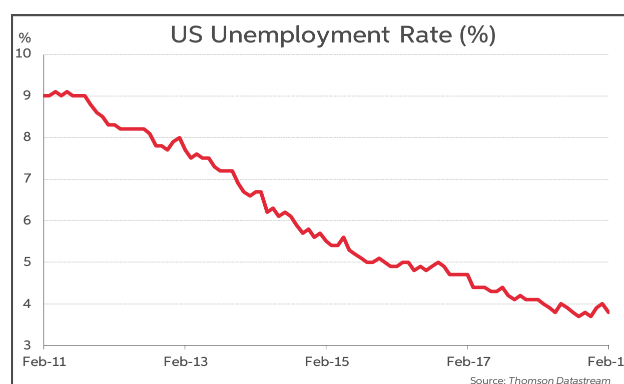
The other key update from the latest Fed meeting was in relation to its interest rate projections. In its updated guidance, the 'dot plot' indicate that the central bank does not envisage hiking interest rates this year. Back in December, the Fed was guiding for two 25bps rate hikes in 2019. Meanwhile, the Fed's projections continue to incorporate one rate hike in 2020. Thus, the central bank now sees rates peaking at 2.625%, rather than 3.125% previously.



The changes to the Fed's interest rate guidance has brought it more in line with market expectations for rates. Future contracts are not pricing in any further rate hikes. In contrast to the Fed, which is projecting a rate hike in 2020, the next move that the market is anticipating from the Fed is a rate cut around mid-2020.

The meeting statement, macro projections and the tone of Fed Chair Powell's press conference provided insight into the Fed's increasingly cautious mindset. The statement saw a downgrading of its description of the economy's performance. The Fed noted that the "growth of economic activity has slowed from its solid rate", it referenced indicators pointing to "slower growth" of household spending and business investment. It also changed its characterisation of job growth from "strong" to "solid".

In line with this assessment, **the Fed revised lower its economic projections,** albeit marginally. It now expects GDP to grow by a still solid 2.1% by end 2019 (was 2.3%) and 1.9% by end 2020 (was 2.0%). Meanwhile, it continues to anticipate inflation remaining around the 2% level.



In the post meeting press conference, Chair Powell commented that US data so far in 2019 has been "somewhat more mixed", including signs of slower growth in consumer spending and business investment, while inflation "has been muted". He also stated that "unresolved policy issues" including Brexit and trade talks "pose some risks to the outlook". Against this backdrop, **Chair Powell said that it was the FOMC's view that it should be "patient in assessing the need for any change" to policy. He also said that it "may be some time before the outlook for jobs and inflation calls clearly for a change in policy**". At the same time, Chair Powell stated that the fed funds rate is now considered to be in the broad range of estimates of neutral.

In conclusion, the March FOMC meeting shows that the Fed is adopting a very cautious approach to the monetary policy outlook. It is no longer projecting any rate hikes for this year while also stating that it may be some time before it has a clearer picture to decide on any change in policy. This suggests that we will not see any rate hikes from the Fed in the near term. **However, if the US economy maintains a solid pace of growth and inflationary pressures rise, a rate hike from the Fed cannot be ruled out this year.**

In terms of market reaction, the dovish tone from the Fed has seen the dollar come under some downward pressure, while US Treasury yields have fallen, with the policy sensitive two-year yield declining by around 10bps to near 2.4%.

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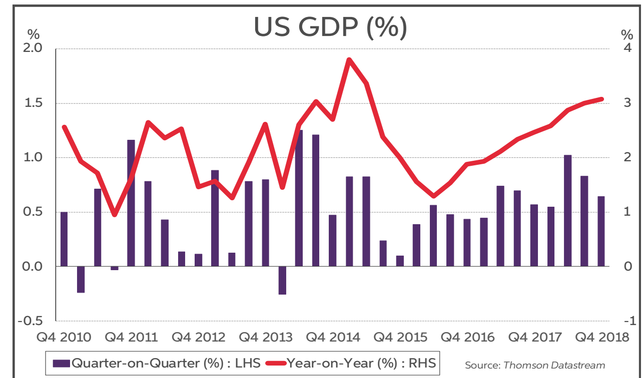
US growth still strong, but slowing

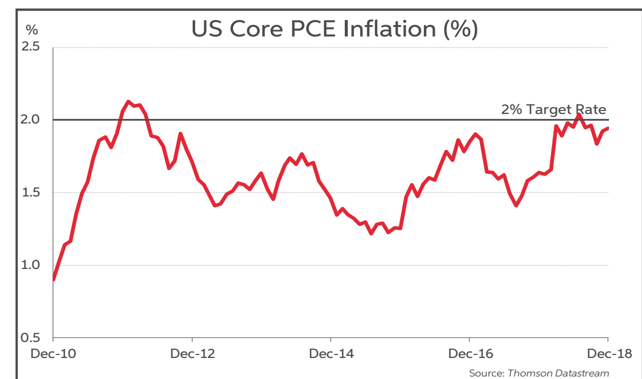


US annualised growth slowed to 2.6% in Q4, from 3.4% in Q4. Overall though, the economy grew by 2.9% in 2018, an improvement on 2017's 2.2% rate. Underlying data showed consumer spending remained the primary driver of growth in Q4, but its contribution declined to 1.9 percentage points, from 2.4 p.p. in Q3. Fixed investment added 0.7 p.p., while the impact of government expenditure (+0.1 p.p.) and net trade (-0.2 p.p.) were less significant.

Survey data for the opening quarter of 2019 have been generally positive. The composite PMI edged up to 55.0 in the first 2 months of the year, from 54.7 in Q4 2018. The sectoral breakdown shows that the marginal improvement was driven by the services index which came in at 55.1 in January/February. In contrast, the steep fall in the manufacturing PMI in February saw the index average 54.0 in the same period. The ISMs, which have tended to overstate growth, paint a similar picture to the PMIs, showing strong growth in the service sector compared to slower growth in manufacturing. On the household side of the economy, having dipped in January (due to the partial federal shutdown and financial market volatility), measures of consumer confidence suggest sentiment improved in recent months.

Meanwhile, the limited hard data we have for Q1 have been somewhat mixed. For example, the 'control' retail sales measure (ex-gas, autos and building materials) rose by a strong 1.1% in January. However, data have been weaker on the output side of the economy. Industrial production declined by 0.3% in January/February versus Q4 2018 in which it grew by 1.1%.

Labour market data have been solid in Q1. Non-farm payrolls expanded by just 20k in February. However, this followed a 311k rise in January. Analysts have suggested that the data could have been distorted by the government shutdown earlier in the year. Meanwhile, the unemployment rate has edged down to just 3.8%. **Tight labour market conditions appear to be translating into higher wage inflation.** The year-on-year growth rate of average hourly wages rose to hit a new cycle high of 3.4% in February.



However, the rise in wages has so far failed to generate an increase in price pressure. CPI inflation has moderated in recent months, decelerating to just 1.5% in February, due in part to lower oil prices. Likewise, the Fed's preferred measure of inflation, core -PCE, remains subdued, averaging 1.9% in Q4.

The aforementioned federal shutdown and severe weather, as well as the usual seasonal adjustment issues, will likely see growth slow further in Q1. Overall though, the near-term outlook remains positive. While the boost from tax cuts at the beginning of last year is fading, a strong labour market continues to support the key consumer sector of the economy (c. 70% GDP). Meantime, with rates remaining low and the Fed turning more cautious, monetary policy remains supportive of growth. **The recent OECD forecast is for strong US GDP growth of 2.6% in 2019. The Fed's own forecasts are more downbeat, with the central bank projecting that growth will slow to 2.1% YoY by Q4.**

However, in the medium term there are some risks facing the US economy. The growing twin deficits are a source of worry**.** The lagged effect from the Fed's rate hikes could act as a headwind to activity. The housing market appears to be weakening as activity looks to have peaked. The flattening US yield curve is also worth watching as it has previously been a forerunner to a downturn in the US economy. The slowdown in the global economy is another headwind, as is the specific risk factor posed by the US-China trade dispute. **Overall, while growth is expected to remain strong in 2019, the downside risks facing the US economy have heightened over the medium term. As a result, the US economy could slow quite noticeably in 2020 and beyond.**

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