Fed Watch

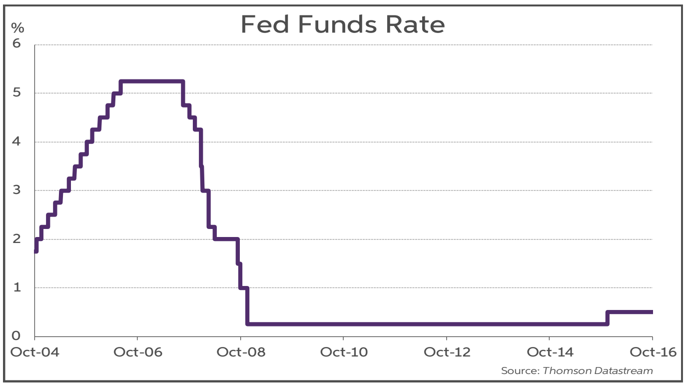
AIB Treasury Economic Research Unit

3rd November 2016

Fed rate hike remains on the cards for December

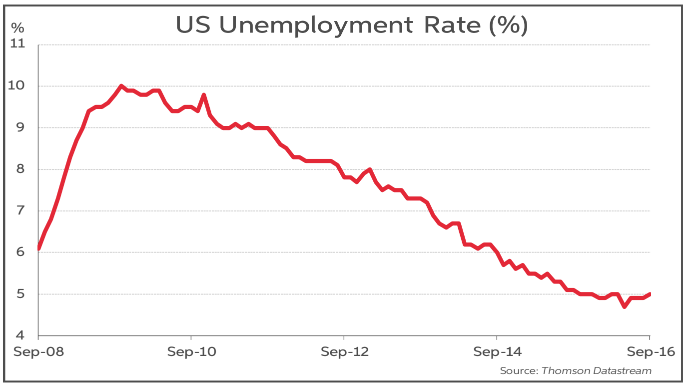
The November meeting of the US Federal Reserve concluded, as expected, with no change to monetary policy. The decision to keep the fed funds rate at 0.375% was not unanimous. Two of the ten FOMC members (Lorretta Mester and Esther George) voted for an immediate 25bps rate hike. This compares to September's 7-3 split, when Eric Rosengren had also voted for a rate increase.

Given that there was no press conference following the meeting, or updated staff projections (due at December 13th/14th FOMC), **the sole focus for markets was the meeting statement.** The statement contained no major surprises or alterations compared to the September version



The overall tone of the meeting statement continued to indicated the tightening bias that exits within the FOMC. The Fed noted that the "labour market has continued to strengthen and growth of economic activity has picked up". At the same time, it was cognisant of the recent softer pace of growth in consumer spending stating that "household spending has been rising moderately" versus the description in September of spending "growing strongly". On the inflation front, the Fed acknowledged that "inflation has increased somewhat since earlier in this year". It also said that market-based measures of inflation compensation had "moved up".

In terms of the outlook, the Fed continues to be of the view that the near term risks for the US economy "appear roughly balanced" and it expects the economy to expand "at a moderate pace" and for the labour market to "strengthen somewhat further". Following this assessment of the macro and market conditions, **the Fed's view is that the case for a rate increase "has continued to strengthen", however, it decided to "wait for some further evidence of continued progress towards its objectives".**



The Feds most recent set of projections on the likely path of interest rates were released at its September policy meeting. They showed that the median projections for the fed funds rate at end-2016 was 0.625%, which would represent a 25bps rate hike before year end. This is in line with market expectations for a rate hike in December.

However, the Fed is still indicating a more aggressive path of rate increases then the market is expecting over the next two years. Current futures pricing suggests that the market is expecting just one additional rate hike (on top of December's expected 25bps increase) over the period 2017-2018, which would take the fed funds rate to 0.875%. In contrast, the Fed envisages rates rising to 1.875% by the end of 2018.

Overall, the content of the November meeting statement keeps the prospect of a December rate hike very much on the cards, while at the same time not pre-committing the Fed to a hike next month. The FOMC's decision to increase rates remains dependant on incoming macro data as well as financial market conditions. In this regard, the outcome of next week's US presidential election and the market reaction to this result could also have a bearing on the timing of the next Fed rate hike. Barring any major upheaval in financial market conditions over the coming weeks, we expect that the Fed will hike interest rates in December. Thereafter though, the pace of rate increases over the next two to three years are likely to be of a gradual nature.

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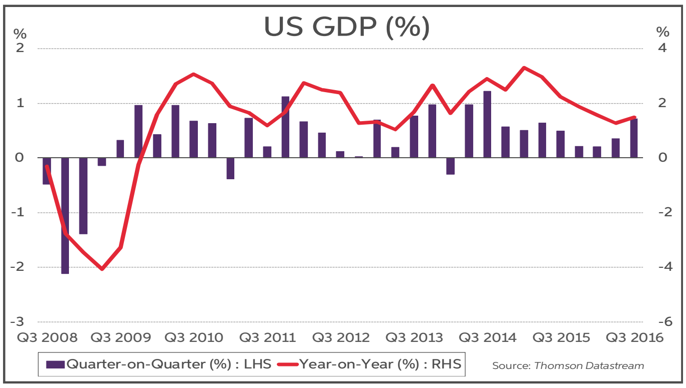
US data provide mixed signals

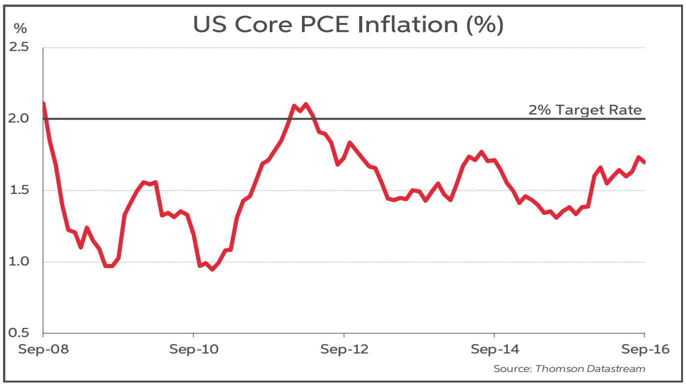
The US economy grew by an annualised rate of 2.9% in Q3, up from 1.4% in Q2. This represents a second consecutive quarter of improved growth, following a period of slowing economic activity. While the headline figure was strong, the breakdown of the data suggests that underlying domestic growth was not as encouraging. Indeed, real final sales to domestic purchasers (GDP minus net trade and changes in inventories) declined from 2.4% to 1.4%.



Consumer spending remained the key driver of growth in the third quarter, adding 1.5 percentage points (p.p.) versus 2.9 p.p. in Q2. The weaker performance compared to the second quarter was partly due to a decline in nondurable good sales and weaker healthcare spending. Net trade added 0.8 p.p. as exports recorded their best performance since Q4 2013. However, this was mostly attributable to a very large jump in soybean exports, which is unlikely to be repeated in Q4. Business investment provided only modest support (+0.15 p.p.), with 'equipment' spending remaining a drag (-0.16 p.p.). Although, increased energy production on higher oil prices saw 'structures' post its first positive contribution (+0.14 p.p.) since Q4 2014.

Meanwhile, **the US labour market registered improvement in the third quarter, following its 'soft patch' in Q2.** The key non-farm payrolls rose by an average of 192k in the quarter, up from 110k. Meantime, the unemployment rate edged up to 5% in September, from 4.9%, largely reflecting on-going strong labour force growth. Despite the increase in the size of the labour force, there are signs of tightening labour market conditions. For example, the Conference Board labour market differential (jobs plentiful minus jobs hard to get) is back at levels not seen since the end of 2007.

However, the pace of wage growth remains subdued. **Year-on-year growth in the 'wages' component of the Employment Cost Index, the Fed's preferred earnings measure, slowed slightly to 2.4% in Q3, from 2.5%.** Meantime, growth in average hourly earnings has been largely stuck in a 2.3-2.6% range since H1 2015.



Meanwhile, CPI inflation hit 1.5% in September, a two-year high. It has been boosted by the reduced drag from energy prices. Core CPI inflation came in at 2.2%. The Fed's preferred inflation measure, core-PCE prices, has been steady at 1.6-1.7% since the start of the year, below its 2% target rate. The most recent Fed projections show that it does not expect inflation to reach target until Q4 2018. Although, some growing price pressures could mean the 2% level could be reached earlier than that.

Early indictors of activity at the start of Q4 have generally indicated that the economy started the quarter on a solid footing. The Markit services PMI rose to 54.8 (from 51.9), hitting a one-year high. Likewise, the manufacturing index rose to 53.4 (from 51.5), also a one-year high.

Overall, growth in the economy should remain at a solid level in the final quarter of the year. Low energy prices are providing some support to spending, while the labour market continues to improve. Both of these will be helpful to the key consumer side of the economy. Investment in the energy sector should continue to pick up. **However, the economy does still face some headwinds,** such as a slowdown in emerging markets (especially China), the stronger dollar and some uncertainty over the direction of the US political/fiscal policy. The weakness in business investment is also a concern. The Fed's latest economic projections show that it expects US GDP growth of 1.8% this year and 2% in 2017.