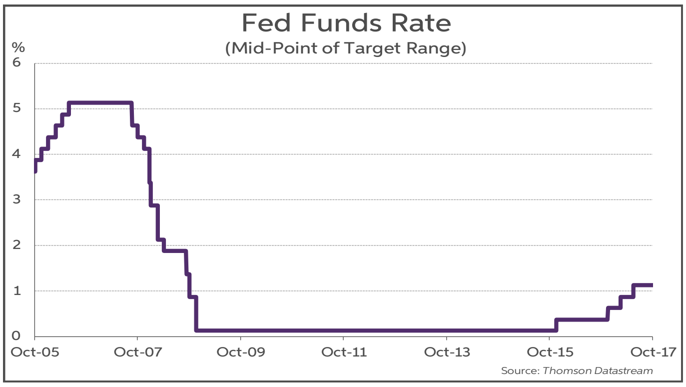
Fed Watch

AIB Treasury Economic Research Unit

2nd November 2017

December rate hike remains on the cards

The November meeting of the Federal Reserve concluded in line with market expectations for no changes to monetary policy. The Central Bank maintained the target range for the fed funds rate at 1-1.25%. At its previous meeting back in September, the Fed announced that it would begin the process of balance sheet reduction (i.e. quantitative tightening) and this has been underway since October. The decision to leave rates unchanged, was unanimous.

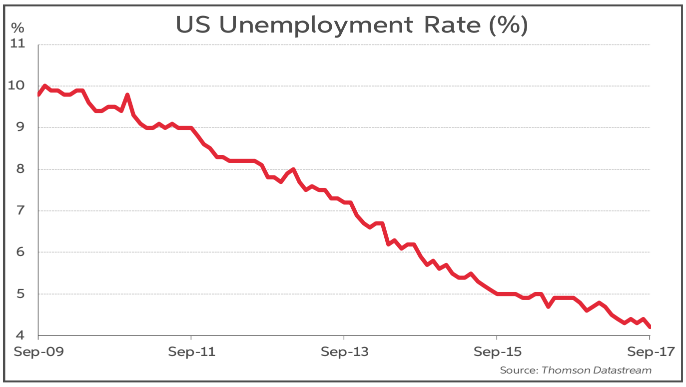


With no press conference or updated staff projections, the main focus was on the meeting statement. The text contained only modest changes compared to the September version.

The Fed upgraded its characterisation of the economy's performance. It stated that "economic activity has been rising at a solid rate despite hurricane-related disruptions" a change from its previous description of activity increasing "moderately". In its description of the labour market, while it acknowledged that the "hurricanes caused a drop in payroll employment in September", at the same time it noted that the "unemployment rate declined further". Overall, it remained of the view that the jobs data since its last meeting indicate that the "labour market has continued to strengthen".

Meanwhile, in its assessment of the inflationary backdrop, the Fed commented that headline inflation was boosted by higher gasoline prices in the aftermath of the hurricanes. Although, the Fed also noted that inflation for items "other than food and energy remained soft". Indeed, the Fed continues to anticipate that inflation will "remain somewhat below" its 2% target in the near-term, and start to stabilise closer to its objective over the medium-term.

The most recent set of interest rate projections from the Fed were released at the September FOMC. There was very little change in these compared to the June edition. The FOMC is still indicating that it will hike one more time this year. The median projection for end-2018 was unchanged at 2.125%, consistent with three 25bps hikes next year. It did slightly revise lower its end-2019 projection, expecting rates to finish the year at around 2.75% (versus 2.9% indicated in June). Meanwhile, it is envisaging rates edging up to 2.875% in 2020.



In terms of market expectations, it has become more hawkish on the rate outlook over the past month or so, with the gap between the market and the Fed narrowing. Although, based on futures contracts, it is still anticipating a less aggressive path of rate hikes than the Fed is guiding over the next 2-3 years. While the December rate hike is fully priced in, current pricing suggests that the market is looking for rates to rise to around 2% by end-2019 compared to the aforementioned Fed projection of 2.75%.

Overall, the Fed meeting statement did little to alter market expectations that the Fed will hike interest rates by 25bps at its next meeting (12th/13th December) as per its guidance. Looking ahead to next year and beyond (when the Fed is expected to be under a new Chairperson), if the incoming data continue to point to solid growth and financial market conditions remain appropriate, it will increase the chances of the Fed following through on its indicated rate hike trajectory. The Fed may also have more details over the coming months on President Trump's fiscal stimulus programme, which it can factor into its future policy decisions. Of course, inflation is a key consideration for the Fed. If it remains subdued, then the FOMC may not tighten policy as much as it has indicated. We would not be surprised if the fed funds rate rose to 2.375% by end 2019.

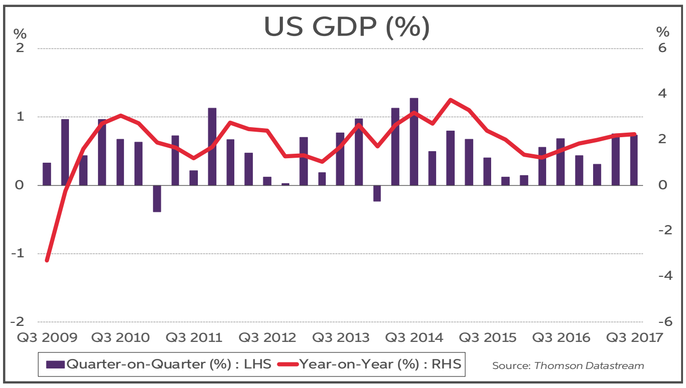
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

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

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

US economy remains on a solid footing

US annualised growth was broadly stable at 3% in Q3, following 3.1% in Q2. The stronger than expected rise in Q3 GDP indicates that the negative impact from the hurricanes was less severe than had perhaps been feared.

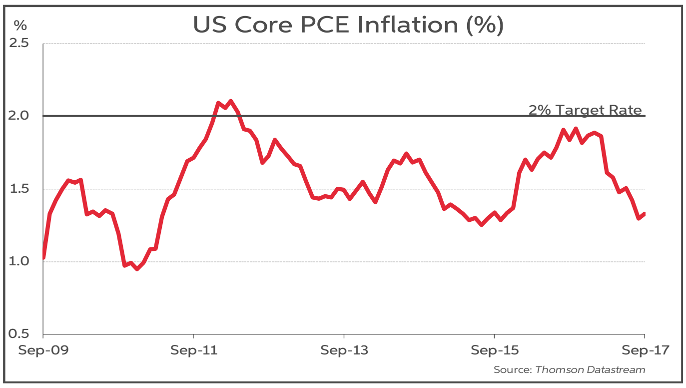


However, the headline GDP figure was flattered by a large increase in inventories, which boosted growth by 0.7 percentage points (p.p). Indeed, domestic demand slowed from an annualised rate of 2.7% to 1.8% in the third quarter. Consumer spending was solid, though, adding 1.6 p.p. in the quarter, after Q2's strong 2.2 p.p. contribution. Consumption was supported by a jump in car sales in Q3. Business investment added 0.5 p.p. compared to 0.8 p.p. in Q2. Net trade contributed 0.4 p.p., its best performance since Q4 2013. The impact from Government spending remained negligible.

Labour market data were more clearly impacted by weather related distortions in the third quarter. Non-farm payrolls grew by an average of 91k in the quarter, which included a 33k decline in September. The US unemployment rate fell to a 16-year low of 4.2% in September, even as the participation rate rose from 62.9% to a 3½-year high of 63.1% and the labour force increased by 575k. This suggests that, weather related distortions aside, the US labour market remains on a very strong footing.

Meantime, **recent data have tentatively suggested that wage growth is accelerating. Average hourly earnings rose from 2.7% to 2.9% on a year-on-year basis in September,** though this may partly reflect compositional issues, as lower paid workers were more likely to be displaced by the hurricanes. The 'wages & salaries' component of the Employment Cost Index, **the Fed's preferred measure of earnings growth, edged up to 2.5% year-on-year in Q3, from 2.3% in Q2.** At the same time, the oft-cited Atlanta Fed national wage tracker, which seeks to control for compositional effects, rose from 3.2% to 3.6% in Q3. Meantime, leading indicators such as the Conference Board 'labour market differential (jobs plentiful minus hard to get) or the NFIB jobs 'hard to fill' index are both up around their highest levels in over a decade, suggesting wages could continue to rise as employers increasingly compete for workers.

At the same time, **headline CPI inflation has resumed its upward trajectory, rising to 2.2% in September** compared to 1.6% at the end of Q2. This primarily reflects higher energy costs, as fuel prices rose. In contrast, the Fed's preferred measure of price pressures, core-PCE inflation (excludes fuel costs), has been on an overall downward trend in recent months, slipping from 1.9% in February to 1.3% in August/ September, well below its 2% target.



Overall, the outlook for the economy remains generally positive. Data suggest the economy is growing at a solid pace. The strong improvement in the labour market is helping the key consumer side of the economy. Meanwhile, recent political developments suggest that some of President Trump's fiscal policies could be implemented in the coming year.

The IMF recently revised up its US GDP growth forecasts from 2.1% to 2.2% and 2.1% to 2.3% for 2017 and 2018, respectively. However, risks to the outlook remain. A tight labour market may see wages rise more quickly than expected, potentially forcing the Fed to tighten policy more strongly. Meantime, the timing and size of President Trump's fiscal stimulus remain uncertain.