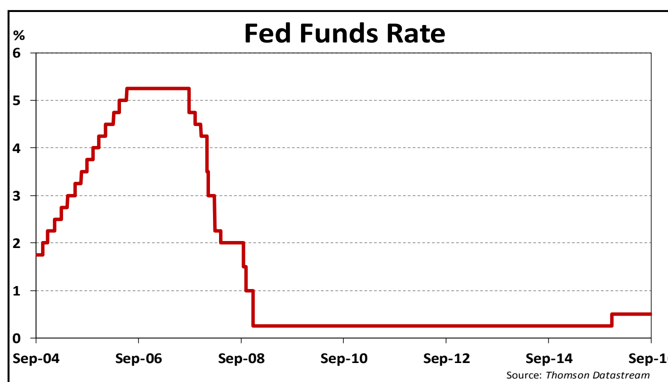
Fed Watch
23rd September 2016
AIB Treasury Economic Research Unit

Fed signals rate hike before year end

As had been expected, the Fed's September meeting concluded with no changes to monetary policy, with the fed funds rate remaining at 0.375%. However, the decision to leave policy on hold was not unanimous, with three of the ten FOMC members voting for an immediate 25bps rate hike. This compares to July's 9-1 split, with members Eric Rosengren and Loretta Mester joining Esther George in voting for an increase.

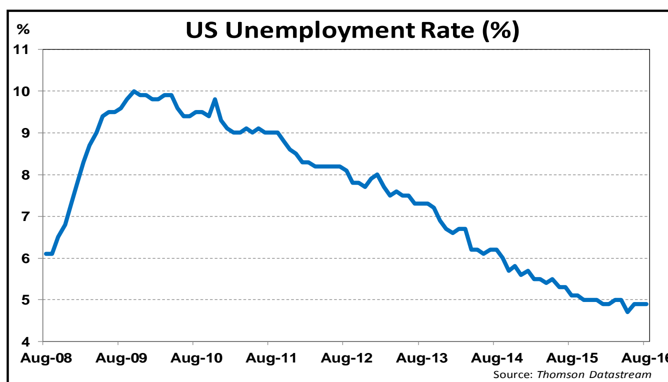
The tone of the meeting statement was more hawkish than in July. The FOMC noted that the labour market had "continued to strengthen" and that growth had "picked up from the modest pace" seen in H1. Another important change to the statement was the assessment that "risks to the economic outlook appear roughly balanced". This represents a reintroduction of language not seen since just before the Fed hiked rates in December last year.



In terms of the view on the economic outlook, the Fed has revised down its growth forecast for this year to 1.8%, from 2%, taking account of weaker than expected US growth in H1. GDP forecasts for 2017 and 2018 were left at 2%. The outlook for inflation and unemployment were also broadly unchanged.

In the post-meeting press conference, Fed Chair Yellen stated that the FOMC "judged that the case for an increase has strengthened, but decided for the time being to wait for further evidence of continued progress" towards its policy objectives. Overall, the tone of the various Fed updates show that the Fed is emphasising its willingness to tighten policy sooner rather than later.

This view is supported by the Fed's latest set of interest rate projections, the so-called 'dots'. They show that **14 of the 17 members of the Fed expect to see policy tightening before the end of the year, with the median view being for one 25bps hike in the fed funds rate to 0.625%.** This does represent a more cautious view compared to June, though, which had pencilled in two hikes before the end of 2016.



The projections for 2017 and 2018 also show a less aggressive pace of rate increases. They now indicate two 25bps rat hikes in 2017 compared to the expectation of three hikes back in June, while the Fed still expects three hikes in 2018. The FOMC projections now indicate that rates will reach 1.875% by end 2018, versus previous expectations that they would finish the period at 2.375%. Despite the Fed's slower projected rate of tightening, markets continue to expect an even more gradual pace of increases. Futures contracts suggest they are pricing in just two rate hikes by end 2018, bringing the fed funds rate to just 0.875%.

In summary, the Fed's September meeting provided stronger signals of a rate hike in the US this year. As always, though, this will remain data dependant. Fed Chair Yellen stated that the FOMC is "generally pleased" with the economy's performance, though it wants "to wait for further evidence of continued progress" towards its policy objectives before hiking. **Overall then, we retain the view that the Fed will hike interest rates before the end of the year.** This is most likely to happen in December given the timing of the November meeting just before the US Presidential election. Thereafter, rates are likely to rise only gradually.

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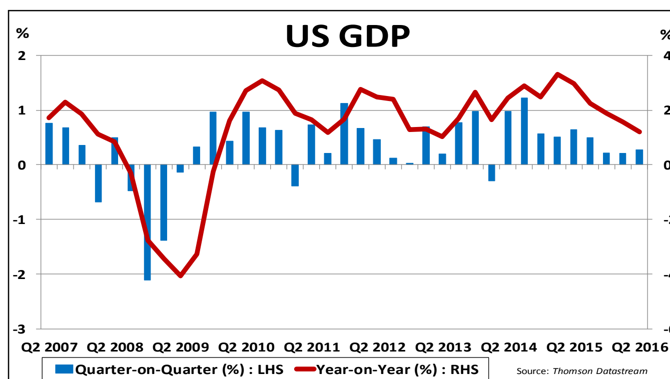
Signs are that growth has remained modest

The US economy slowed in the first half of 2016. The economy grew by just 1.1% on an annualised basis in Q2, following 0.8% growth in Q1. The underlying data show that while consumer spending improved in the second quarter, the drag from investment increased, which was largely down to a further fall in inventories, though a third consecutive decline in business investment was also unhelpful.

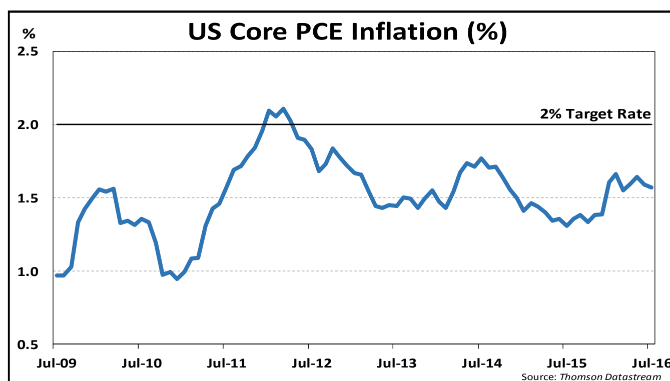


Survey indicators of activity have suggested that growth remained subdued in Q3. The non-manufacturing ISM index slowed to 51.4 in August, its lowest level since February 2010. There is some indication that this may have been as a result of weaker growth in consumption. The manufacturing ISM moved back below the expansion indicating 50 mark in August for the first time since February, as the sector continues to struggle. However, the Markit composite PMI averaged 51.5 in July/ August which is not markedly different from Q2's 51.2 average.

Hard data have also been somewhat mixed in Q3. The 'control' measure of retail sales (a proxy for spending on goods in GDP) rose by just 0.2% in July/August versus Q2, in which it rose by a strong 1.7%. This would suggest that perhaps the key consumer side of the economy may not have had as much momentum in Q3 as previously envisaged. Although, personal consumption did rise by a healthy 0.3% month -on-month in July. Meantime, industrial production rose by 0.7% in July/August compared to Q2, in which it fell slightly.

Meanwhile, the labour market has picked up after some weakness in Q2. The key non-farm payrolls rose by an average of 213k in July/August, following Q2's 110k average. Meantime, the unemployment rate held at 4.9% for a third consecutive month in August. This partly reflects a net 997k increase in the size of the labour force during this period.

The signs of 'tightness' in the jobs market look to be having some upward impact on wage growth. The wages & salaries sub-component of the Employment Cost Index, the Fed's preferred measure of earnings, rose to 2.5% year-on-year in Q2, from 2%. Meantime, survey data have pointed to further tightening in the labour market, indicating wages may continue to edge higher in the coming months.



On the inflation front, the CPI measure rose to 1.1% in August, while the core measure (excludes food and energy), rose to 2.3%. It has been boosted by price increases in the services sector, particularly medical and housing costs. However, the core-PCE prices, **the Fed's preferred measure of inflation held around 1.6% in July, still below its 2% target rate.**

Overall, growth in the economy should pick up in the second half of the year. Low energy prices are providing some support to spending, while the labour market remains strong. Both of these should help to support the consumer side of the economy. There are also signs that investment in the energy sector may start to pick-up again.

However, the economy does still face some headwinds, such as a slowdown in emerging markets, the stronger dollar, a tighter labour market and uncertainty over November's US elections. The decline in business investment is also a concern. **The Fed's updated projections show that it expects US growth of 1.8% in 2016 and 2% in 2017.**

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