Fed Watch

AIB Treasury Economic Research Unit

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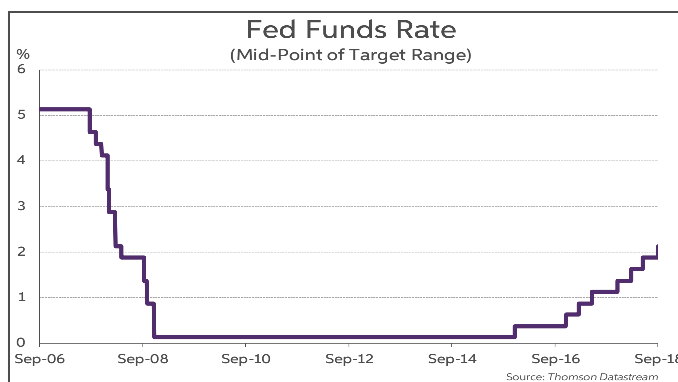
Fed hikes again, more rate increases in the pipeline

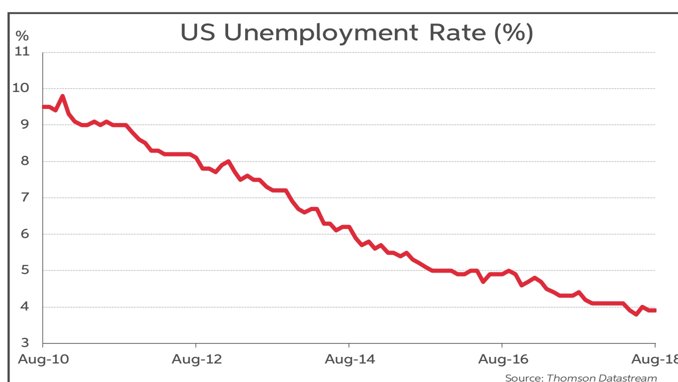
As expected, the September meeting of the Federal Reserve Open Market Committee (FOMC) saw rates hiked by 25bps, with the target range for the key fed funds rate raised to 2.0-2.25%. This represented the third rate hike this year and is the seventh rate increase in the last eight quarters. Thus, the Fed is on a very steady rate hiking path. The decision at yesterday's meeting was unanimous, with the Fed continuing to indicate that rates will rise again in December.

The meeting statement outlined the rationale for the latest rate hike. The most commonly used word in the statement to describe the economy's performance was 'strong'. It noted that job gains have been strong and economic activity has been rising at a strong rate. Household spending and business investment are described as having grown strongly. As a result, **the Fed upgraded its GDP growth forecast for this year from 2.8% to 3.1%.**



The economy is forecast to grow by 2.5% in 2019, 2.0% in 2020 and 1.8% in 2021. The jobless rate is expected to drop to 3.5% next year and remain there in 2020, while inflation is projected to be stable at 2.1% over the next three years. In the post meeting press conference, Fed Chair Powell commented that he does not see inflation surprising to the upside.

For many, the key change in the FOMC statement was dropping the reference that "monetary policy remains accommodative". This is not that surprising as, with inflation at 2%, this latest rate hike marks the end of negative real official interest rates. **Policy has now moved in to more neutral territory.** The Fed, though, did lift its assessment of the long run level for the funds rate from 2.9% to 3.0%.



The Fed assessment of the likely future path of interest rates remains unchanged. After hiking again in December, it expects to deliver four further rate increases over 2019/20 before rates level off at around 3.4%. Three of the hikes are projected for next year, with the final rate increase seen as occurring in 2020.

The market continues to expect a less aggressive pace of rate tightening from the Fed. Futures contracts show that the market is pricing in just two further rate hikes next year, taking official rates up to near 2.9%, with rates levelling off thereafter. This is **50bps points below what the Fed is projecting.**

We believe that continuing strong growth by the US economy over the next year, combined with rising inflationary pressures, will force the market to re-evaluate its outlook on rates. Indeed, the market has been forced to move its view on rates more closely into line with the Fed over the past year. At the end of 2017, the market belief was that rates would top out at around 2%. We anticipate that the Fed funds rate will rise to 3.125% next year. Whether we get further tightening in 2020 is likely to depend on the extent to which the US economy slows as the boost to growth from the fiscal stimulus fades and higher rates impact on activity.

The market reaction to the Fed meeting outcome saw the dollar get a small boost overnight, possibly on the upgrade to this year's growth forecast. Meanwhile, the yield curve flattened as yields at the long-end fell on the reassurance by Fed Chair Powell that he does not expect inflation to surprise to the upside. Bond yields will come under renewed upward pressure, though, if the market has to move to discount more than 50bps of rate tightening in 2019/20, as the Fed is projecting.

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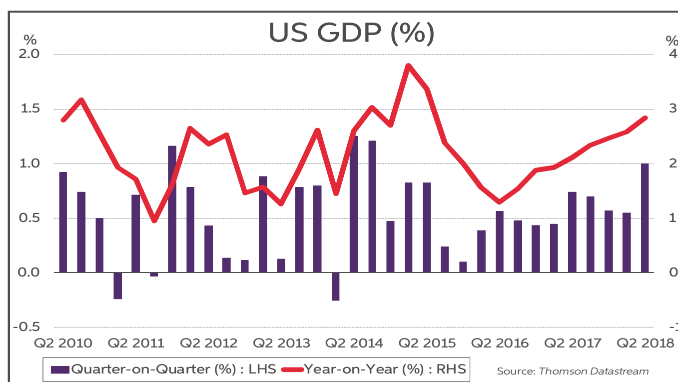
Growth remains strong in the US

US annualised growth accelerated to 4.2% in Q2, from 2.2% in Q1. This represented the economy's best quarterly performance since Q3 2015. In year-on-year terms, growth picked up to 2.8% in Q2, a three year high.

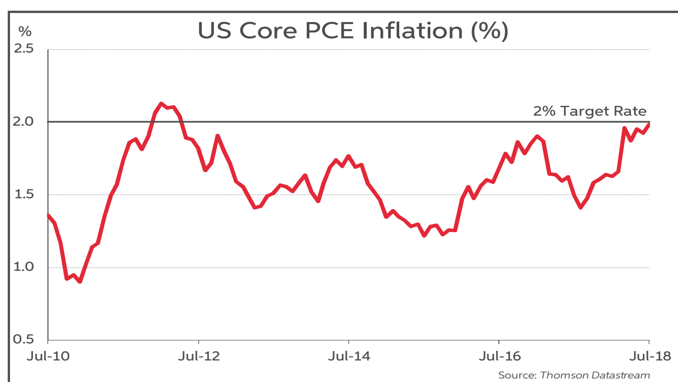


In terms of the third quarter, survey data for the period suggest that the economy is continuing to grow solidly, albeit at a slightly slower pace. The Markit Composite PMI averaged 54.6 in Q3 compared to 55.9 in the second quarter. Similarly, the non-manufacturing ISM (c. 80% of GDP) fell back to 57.1 in July/August from 58.2 in Q2. The manufacturing index points to a continued acceleration of growth in that sector, having averaged 59.7 in July/August against 58.7 in Q2. However, this measure has tended to overstate growth recently.

The limited hard data available for Q3 also point to a slight easing in the pace of economic growth. On the consumer side of the economy, the 'control' retail sales measure (ex-gas, autos and building materials) recorded an average growth rate of 1.4% in July/August against 1.8% in Q2. Meanwhile, personal consumption has continued its upward trend, rising by 0.2% in July. However, this represents a slight dip on the three consecutive monthly increases of 0.3% through Q2. Elsewhere, industrial production grew by just 0.7% in July/August compared to Q2's 1.3% increase. Overall, the data suggest the economy grew at 3% or above in Q3.

Labour market data have remained strong in Q3. The average monthly growth rate of non-farm payrolls fell to 174k in July/August, down from Q2's strong monthly average of 217k. However, the unemployment rate continued to hold at 3.9%. 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. Furthermore, this trend looks set to continue, with leading indicators of wage pressures such as the NFIB 'jobs hard to fill index' rising to historically high levels in July/August. Elsewhere, the Fed's preferred measure of compensation growth, the 'wages & salaries' component of the Employment Cost Index, edged up slightly to 2.8% in Q2.

Headline CPI inflation has remained close to the 3% level in July and August. Meanwhile, the Fed's preferred measure of price pressures, core -PCE inflation (exclusive of energy costs), has been running at, or very close to, its 2% target rate since March.



The near-term outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption should remain robust, while equity markets are at record highs. Monetary policy is tightening, although interest rates remain low and rate hikes are taking place at a gradual pace. At the same time, the raft of tax cuts and spending increases passed by Congress should continue to boost activity well into 2019. **The recent IMF forecasts are for strong US GDP growth of 2.9% in 2018 and 2.7% in 2019.**

However, in the medium term there are some risks facing the US economy. The marked loosening of fiscal policy will result in a big rise in the budget deficit and possibly the balance of payments deficits as well. It also risks overheating the economy, with the unemployment rate now below 4% and wage growth beginning to edge up. **The US economy could slow quite sharply once the fiscal stimulus fades and higher interest rates begin to impact on activity.** The Fed sees GDP growth slowing to 1.8% by 2021, but it could weaken more than this, especially if inflation rises, forcing the Fed to tighten policy by more than is generally expected.

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