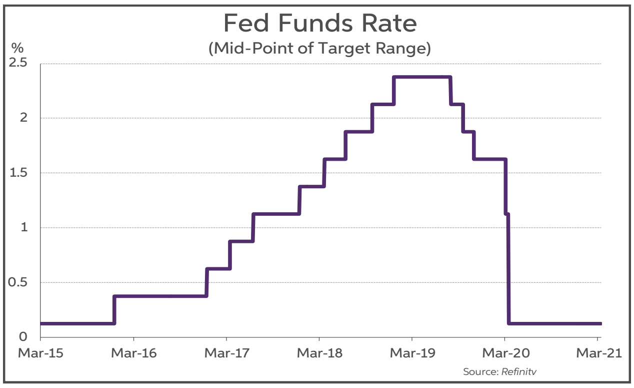
Fed Watch

AIB Treasury Economic Research Unit

18th March 2021

Fed emphasises its dovish side, market unconvinced

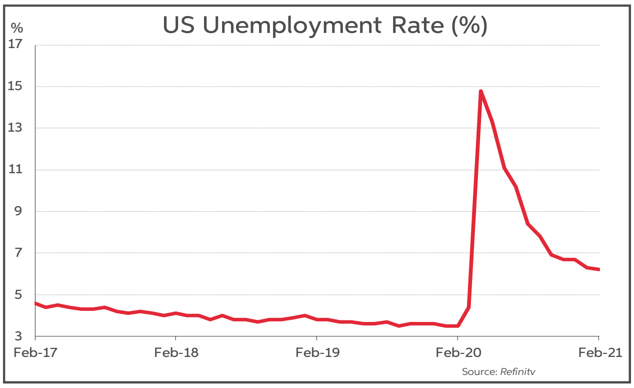
The March meeting of the US Federal Reserve concluded as expected with no change to monetary policy. The central bank kept the funds rate in its target range of 0.00-0.25% as well as continuing to implement an open-ended asset purchase programme. There was unanimity within the FOMC on its decision to leave policy unchanged. Meanwhile, there was only minor amendments to the meeting statement to reflect the better than expected macro data recently.



Given the recent move higher in US Treasury yields amid market expectations for a strong economic rebound, the main point of focus from the meeting outcome was centred on the Fed's updated macro and interest rate projections. In terms of its macro forecasts, the Fed revised significantly higher its growth expectation for this year. It is now anticipating GDP growth of 6.5% y/y by the end of the year. This compares to its previous forecast of 4.2% in December. Its growth forecasts for end 2022 and end 2023 showed only minor changes at 3.3%y/y (was 3.2%) and 2.2%y/y (was 2.4%) respectively. In terms of its outlook for the labour market, the median projection of FOMC participants was for the unemployment rate to fall to 4.5% (was 5.0%) by the end of this year and to move down to 3.5% (was 3.7%) by the end of 2023.

Meanwhile, it now expects inflation to rise to 2.4% (was 1.8%) by the end of this year, declining back to 2% by the end of 2022 and edging back above 2% by end-2023. However, Fed Chair Powell commented that the rise above its 2% target this year would be "transitory" and would "not meet" the condition of its desired inflation outcome**.** Indeed, he explicitly stated that the economy is a "long way" from its employment and inflation goals", and it is "likely to take some time" for "substantial further progress to be made".

The update to the Fed's view on the likely path of future interest rates (i.e. dot plot) was similar to December, in that the median projection was for no change to the fed funds rate through to the end of 2023. All 18 FOMC members anticipate that the current level of interest rates will be warranted until the end of 2021. There were some additional members though, projecting rate hikes in subsequent years compared to December. Four FOMC members (from one) now believe a rate hike will be required next year. Meanwhile, 7 members (was 5) expect rate hikes by the end of 2023.



However, in the press conference, Chair Powell emphasised to not read too much into the changes in the dot plot. He also stated in response to numerous questions on whether it was time for the Fed to think about tapering its QE programme, that now is not the time, and that the Fed would give ample advance notice for tapering to allow markets to gradually adjust.

Despite Fed Chair Powell stressing the dovish credentials of the Fed, futures contracts continue to show that the market is expecting the first rate hike in the second half of 2022, with the fed funds rate ending the year at 0.25%. The futures market anticipate rates rising to 0.5% by end 2023. This represents a significant shift in market expectations compared to the time of the Fed's last meeting in January, when futures contracts were indicating the first rate hike around mid-2023 and rates not getting to 0.5% until the first half of 2024.

In terms of market reaction, US Treasury yields, which had been trading higher (to 1.68%) in the lead up to the meetings conclusion, fell back slightly in the immediate aftermath. However, in overnight action, the recent sell-off in US bonds continued, with the 10 year Treasury yield rising to its highest level since January'20 at above 1.7%. Meanwhile, there was some volatility in the dollar. EUR/USD rose to $1.199 last night, before the dollar regained some momentum this morning, moving back below the midpoint of $1.19-1.20.

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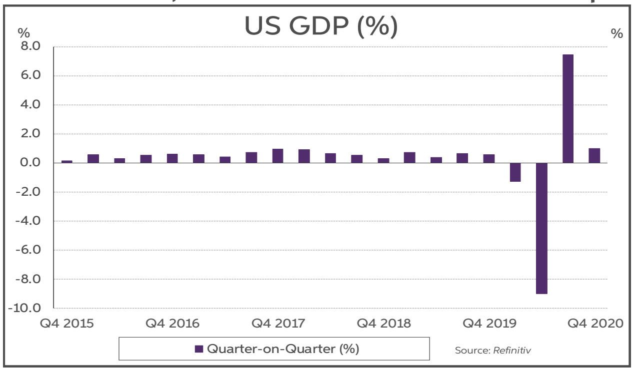
US GDP forecasts revised higher

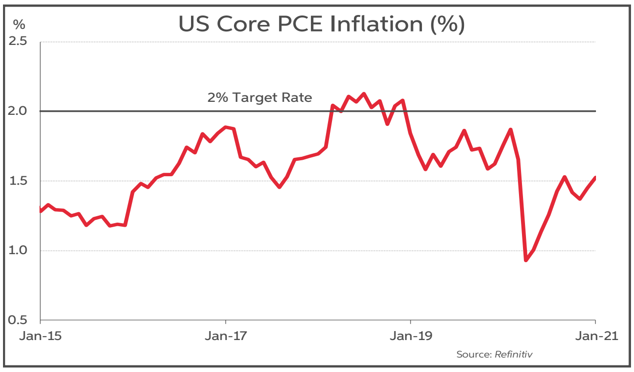
The US economy grew by an annualised growth rate of 4.1% in Q4, as momentum slowed due to a rapid resurgence in Covid-19 cases. Consumer spending rose by 2.4%, adding 1.6 percentage points (p.p.) to the total. Fixed investment increased by 19.1%, buoyed by a strong housing market, contributing 3.1 p.p.. Meanwhile, government expenditure trimmed 0.2 p.p. off GDP. Net trade subtracted 1.5 p.p. from growth as imports outpaced exports in Q4, although this was largely offset by a rise in inventories (1.1 p.p.). Overall, less stringent containment measures than elsewhere, a strong fiscal response and loose financial conditions meant that the US economy contracted by just 3.5% in 2020, much less than was initially feared.



Survey data indicate that the economy has regained momentum in Q1. Both the manufacturing and non-manufacturing ISMs have averaged above their Q4 levels in Jan/Feb, highlighting that the economic recovery has picked up pace in early 2021. The services PMI rose to 59.8 in February, its highest level since July 2014, driven by an increase in new orders. The manufacturing PMI also printed well into expansion mode at 58.6 in February. Meanwhile, the latest Conference Board (Feb) and Michigan (Mar) measures of consumer confidence have moved higher, as the vaccine rollout picks up pace, and fiscal transfers under the American Recovery Plan start to be sent to households.

In terms of 'hard data', retail sales fell by 3% in February as winter storms depressed economic activity in many states. The decline was also from an elevated level, as they increased by 7.6% in January following a surge in spending induced by stimulus payments. Thus, retail sales in February were 6.3% higher than a year ago, before the pandemic hit. The storms hindered industrial production also. Output declined by 2.2% in February, with manufacturing falling by 3.1% as semiconductor shortages led to a sharp fall in auto production.

Meanwhile, the labour market recovery is starting to pick up pace again, after stalling over the winter as states continue to re-open. Payrolls rose by 379K in February, with most of the increase coming in the leisure and hospitality sector (+355k). The jobless rate edged lower to 6.2%. Nonetheless, the labour market recovery still has a long way to run, with payrolls some 9.5m below their pre-pandemic levels. Indeed, the underemployment rate remains elevated at 11.1% in February, highlighting the high level of slack that remains in the labour market.



Regarding inflation, energy prices are pushing the headline CPI rate higher. In February, headline CPI inflation rose to 1.7% from 1.4%, but core CPI slipped to 1.3% from 1.4% as underlying price pressures remained subdued. Core-PCE inflation also remained subdued, at 1.5% in January. However, inflation is expected to rise over the course of the year, as pent up demand and excess savings are released once the economy has fully reopened. Suppliers have also started to pass on higher costs to customers - the latest PPI reading rose to 2.8%, and the services PMI survey highlighted that input costs showed the largest monthly gain since 2009. However, given the large amount of economic slack that remains, the pick-up in inflation is expected to prove to be transitory.

Over the course of this year, the US economy is expected to rebound strongly, following a sharp contraction in GDP in 2020. The rollout of highly effective vaccines has picked up pace since the turn of the year, allowing the economy to regain momentum. The latest fiscal stimulus package worth $1.9trn, with the majority due to be spent in 2021, will provide a further boost to growth. The Fed has also reiterated that loose monetary policy will stay in place as long as inflation remains under control. The Fed's latest economic projections envisage that GDP growth will be 6.5% y/y by Q4 '21. **Meanwhile, the OECD has recently revised upwards its forecast for US GDP from 3.3% to 6.5% in 2021, reflecting the stronger than expected recovery since mid-2020, the fast paced rollout of vaccines, and in particular the very large Biden fiscal stimulus.**

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