Fed Watch

AIB Treasury Economic Research Unit

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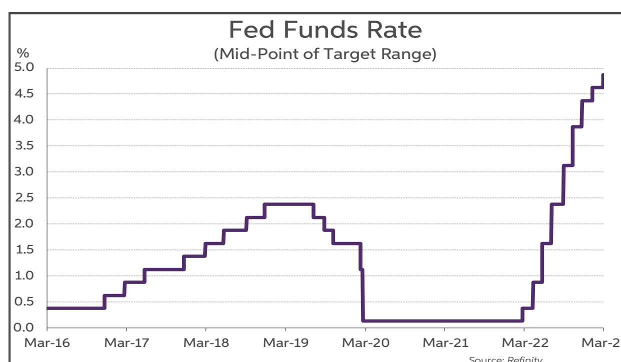
Fed hikes by further 25bps, but rates near peak

As largely expected, the Fed announced a further 25bps hike in rates yesterday. This brings the target range for the Fed funds rate up to 4.75-5.0%. The Fed has now enacted 475bps worth of rate increases since it commenced tightening policy a year ago. **The decision to raise rates by 25bps was unanimous.** Talk of a larger 50bps move abated with the emergence of frailties in parts of the US banking system in the past fortnight, but the easing of the associated turbulence in financial markets in the last couple of days left the door open for the FOMC to deliver a 25bps increase.



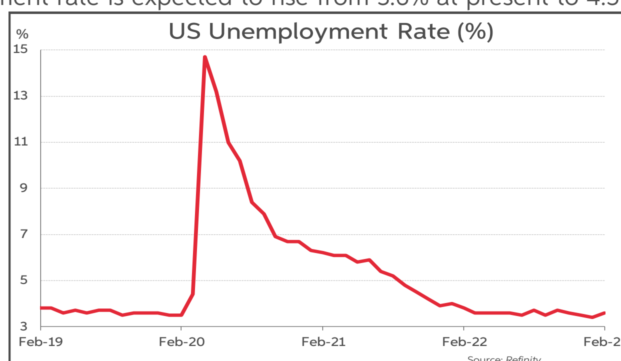
The signs of weakness in parts of the banking system and recent exceptional volatility on markets has made the Fed's task of bringing inflation under control, while at the same time preserving financial and economic stability, all the more difficult. **The post FOMC meeting statement indicated that some additional tightening of policy *may* be appropriate** to attain a monetary stance that is sufficiently restrictive to return inflation to its 2% target over time. This is a marked softening from the tone of the previous meeting statement, that ongoing rate increases ***will*** be appropriate.

The events of the past fortnight are clearly a fresh headwind for activity and should help dampen inflation. Indeed, the **Fed commented that "recent developments are likely to result in tighter credit conditions for households and businesses and weigh on economic activity, hiring, and inflation".** This has been reflected in **a marked softening in market rate expectations in the past fortnight amidst considerable volatility in futures contracts.** Markets had been expecting that US rates could be hiked by as much as 100bps to a high of 5.75% earlier this month. They then moved to start pricing in early rate cuts. **Markets now doubt that rates will be increased any further, with 75bps in cuts being priced in for the second half of the year, starting as soon as July.**

The latest set of official interest rate projections, or dot-plot, were published by the Fed after its meeting. These show that it **anticipates hiking rates by a further 25bps in May to a 5.0-5.25% range and then keeping them on hold over the balance of the year.** It is notable that 17 of the 19 FOMC members see rates above 5% at end year and none are anticipating a rate cut in 2023 in marked contrast to the market. This suggests that there is a strong bias to keep policy tight this year. Further out, the median dot-plot shows that the Fed expects rate cuts of 100bps in both 2024 and 2025, with the funds rate falling to 4.1% by end 2024 and, 3.1% at end 2025.

There was little change in the Fed's latest set of macro forecasts from three months ago. The projections are for the headline and core PCE rates to fall to 3.3% and 3.6%, respectively, by Q4 2023, and be still above target at 2.5% by end 2024, before falling to 2.1% in Q4 2025. Meanwhile, in terms of activity, the Fed see GDP growth at 0.4% y/y in Q4 2023, 1.2% in Q4 2024 and 1.9% in Q4 2025. The unemployment rate is expected to rise from 3.6% at present to 4.5% by end year, and to 4.6% in 2024 and 2025.

The meeting statement, though, acknowledged that the extent of the effects on the economy of the recent stresses in the banking system are uncertain. Chair Powell commented that the expected tightening in credit conditions "could easily have a significant macroeconomic effect and we would factor that into our policies". The markets clearly believe it will, as they are pricing in rate cuts from the summer onwards.



However, **a final rate hike at the May FOMC meeting could still be on the cards.** The dot-plot would suggest that there is a very strong bias within the FOMC to raise rates again, especially if the data remain strong. The impact of a tightening of credit conditions is unlikely to be apparent in the data by then. Thus, provided the stresses in the banking sector remain contained, a final rate hike looks likely in May. **A much bigger question is whether rates are cut in the second half of the year. The FOMC seems dead set against it, but tightening credit conditions could well change its mind**. After all, it may just be a question of timing as the Fed sees significant rate cuts in the pipeline for 2024 and 2025.

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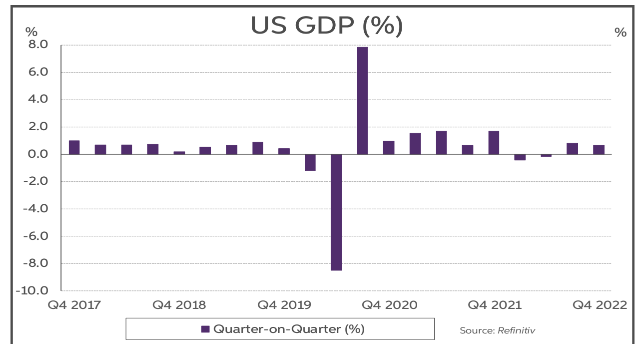
US economy enjoys a good start to 2023, but risks rising

The US economy grew by an annualised growth rate of 2.7% in Q4 of last year, down slightly from 3.2% in Q3. Consumer spending continued to grow solidly in Q4, rising by 1.4% in annualised terms. Business investment also continued to expand, but there was yet another very sharp fall in residential investment, which contracted by 26% annualised. Meanwhile, Government expenditure added 0.6 p.p. to growth. Net trade bolstered GDP by 0.5 p.p., although, this was largely due to a fall in imports. Furthermore, inventory building boosted GDP by a hefty 1.5 p.p. Overall then, **the underlying details indicate activity was not as strong as suggested by the headline GDP growth figure**. Indeed, real final domestic sales rose by just 0.7% annualised. **For the full year, the US economy grew by 2.1% in 2022, down from 5.9% in 2021.**

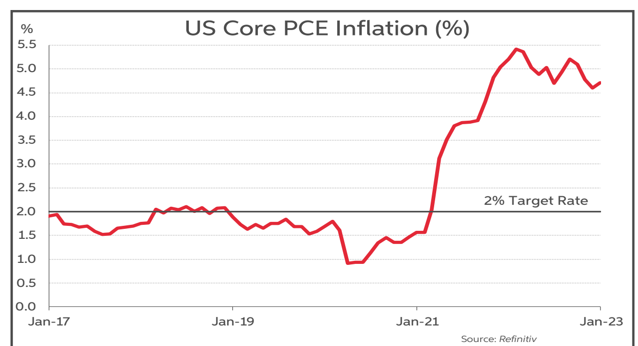


Survey data have been somewhat mixed since the start of 2023. Services are outperforming manufacturing, with the services PMI rising to 50.5 in February, moving into expansion mode for the first time since June of last year. The manufacturing index remains in contractionary territory, although, it has been trending higher, rising to 46.9 and 47.3 in January and February, respectively. Similarly, the non-manufacturing ISM has printed above 55.0 in January and February, while the manufacturing ISM remained firmly below 50, at 47.4 and 47.7. Consumer confidence remains restrained, with the Michigan and Conference Board measures still at weak levels. The NAHB Homebuilder sentiment index, though, has moved higher in the first three months of 2023, albeit from a low level.

Meanwhile, retail sales surged by 3.2% in January, before falling by 0.4% in February, as car sales and fuel consumption declined sharply in the month. The control group measure, a key core-retail sales indicator, jumped by 2.3% in January and rose by 0.5% in February. However, unusually warm weather at the start of 2023 is likely boosting consumer demand. Industrial production rebounded by 0.3% in January, before flat-lining in February, having fallen throughout Q4. Elsewhere, activity in the housing sector looks to have bottomed out, and is now beginning to recover, with building permits, housing starts and existing home sales rising very sharply in February. Overall, the data are consistent with the US economy regaining momentum at the start of 2023.

Likewise, the pace of job creation has gathered steam so far in Q1. Payrolls rose by 504k in January and 311k in February, up from an average of 284k in Q4. The unemployment rate remains very low also, standing at 3.6% in February. Thus, conditions in the labour market remain very tight. However, the pace of earnings growth has slowed recently. Average earnings rose by 0.2% in February, down from 0.3% in January, and 0.4% per month in Q4. In year-on-year terms, average earnings were up 4.6% in February, down from a peak of 5.9% last March.

Regarding inflation, the headline rate is in marked decline. It fell to 6.0% in February, down from 6.4% in January, and well below its peak of 9.1% in June. Food prices continue to rise strongly though, up 10.2% y/y in February. **Core CPI has been edging lower** since peaking at 6.6% in September, declining to 5.5% in February. However, **core-PCE inflation rose to 4.7% in January**, ending a three-month run of declines. It is expected to move back only slowly towards the 2% target level over the next couple of years. The latest Fed projections, published yesterday, are for core-PCE inflation to ease to 3.6% by Q4 this year, 2.6% in Q4 2024, and to 2.1% in Q4 2025.



To surmise, the US economy grew more slowly than anticipated last year, as inflation surged and monetary policy was tightened significantly. However, **data so far in 2023 have tended to print on the strong-side, indicating the economy has regained some steam. Looking ahead though, recent concerns regarding the US banking system will likely led to tighter credit conditions, which will weigh on economic activity**. Monetary policy is likely to remain restrictive for an extended period of time also. At the same time, the looming battle over raising the debt ceiling may result in a Government shut-down, which could also weigh on GDP. Thus, the US economy is set to grow more slowly this year, although, recent growth forecasts for 2023 have been revised higher. **The OECD sees GDP growth averaging 1.5% in 2023, up from 0.5% previously.** Meanwhile the Fed expects growth to slow to 0.4% y/y by Q4 2023, pointing to an average growth rate above 1% this year. The risks are to the downside for these forecasts.

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