Fed Watch

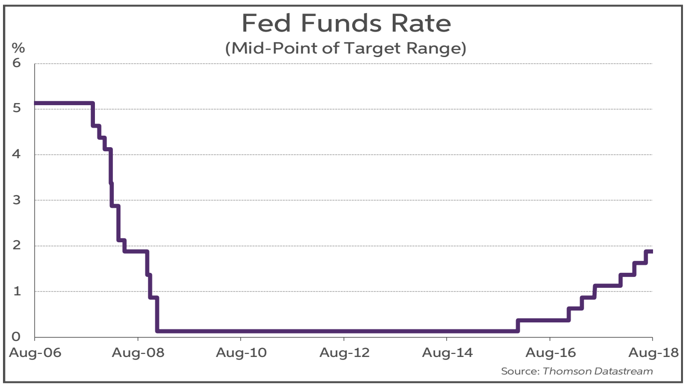
AIB Treasury Economic Research Unit

2nd August 2018

Fed remains on course to hike in September

The latest meeting of Federal Reserve Open Market Committee (FOMC) concluded as expected with no changes to its monetary policy. At its previous meeting in June, the Fed hiked rates by 25bps, with the target range for the key fed funds rate raised to 1.75-2.0%. The committee was unanimous in its decision last night to keep rates at their current target range. The market is expecting the Fed will hike again in September.

There was no press conference or updated macro projections to accompany the Fed's latest policy setting meeting. **Therefore the main focus was on the meeting statement.**



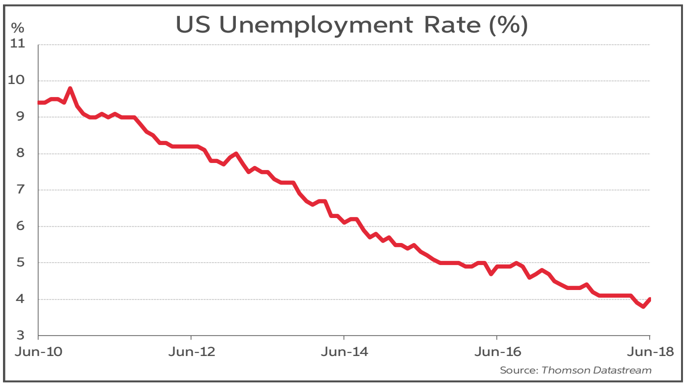
There were only modest changes to the text. However, **the amendments that were made in the FOMC statement were hawkish in tone.** The Fed upgraded its characterisation of the US economy's performance from "solid" to " strong". It continues to describe the risks to the economic outlook as being "roughly balanced".

This narrative is in keeping with its most recent economic growth forecasts, which were released back in June. The Fed expects US GDP to grow by 2.8% this year, 2.4% in 2019 and 2% in 2020 (Q4 over Q4). Meanwhile, the unemployment rate is forecast to fall to 3.5%, with core-PCE inflation picking up to 2% and headline inflation rising above this level.

This upbeat assessment of the economy's performance and outlook was also evident in the Fed's most recent update (at the June FOMC) to its interest rate projections. The Central Bank increased its guidance for 2018 from three to four 25bps rate hikes. This would bring the Fed funds rates up to a target range of 2.25-2.50% by end year. Its projections for 2019 see rates rising to 3.125%. Its end-2020 projection remained unchanged at 3.375%. As mentioned above, the market is pricing in a September hike and is almost fully pricing in another rate hike by year end, as per the Fed's guidance.

However, despite some recent firming in rate expectations, the market continues to anticipate a less aggressive pace of tightening from the Fed over the medium-term. Futures contracts suggest the market is expecting rates to reach a peak in the second half of 2019, ending the year at 2.75%. **By contrast, the Fed is envisaging taking rates up to near 3.4% by end 2020**.

Our assessment is that the US economy is likely to continue to grow strongly over the next year. This, combined with a pick-up in inflationary pressures, will result in the market having to re-evaluate its view on rates. This is likely to see the market pricing in a greater degree of policy tightening than it currently envisages. We anticipate that the Fed funds rate will rise above 3% by the end of 2020.



Overall, the latest Fed meeting statement served to further validate market expectations of a September rate hike. As a result, there was minimal reaction from the dollar and other markets. US Treasury yields have moved higher in recent days, with the 10-year yield back up at the 3% mark. However, this is in the context of a general move higher in global bond yields following the recent policy tweaks from the BoJ, and some firming of rate hike expectations. Aside from the release of the meeting minutes (August 22nd), the next major Fed event for markets to digest will be the annual Jackson Hole Economic Symposium (August 23-25th). The market will look to this for further insight on the Fed's rate outlook over the next couple of years.

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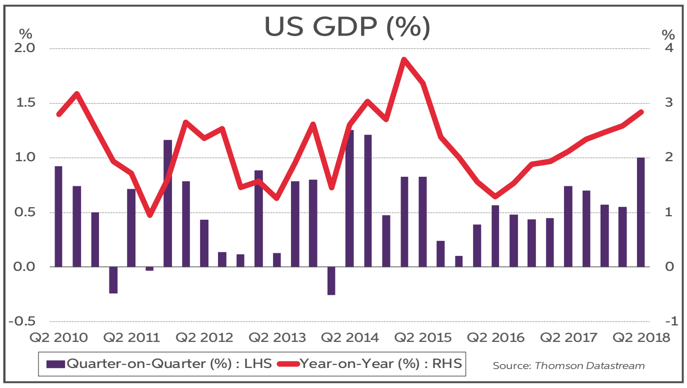
US economy still growing strongly

US annualised growth accelerated to 4.1% in Q2, from 2.2% in Q1. This represents the economy's best performance since Q3 2014. In year-on-year terms, growth picked up to 2.8% in Q2, a three year high.

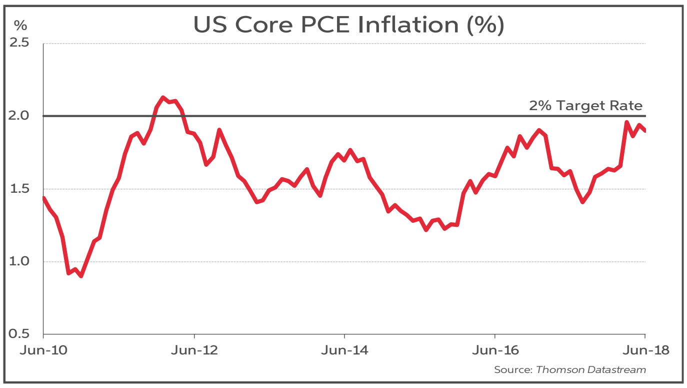


The underlying data show that the firmer pace of growth was broad based, with consumer spending making the most significant contribution. Personal consumption added 2.7 percentage points (p.p.) to GDP in Q2, compared to just 0.4 p.p. in Q1. Spending is being boosted by lower taxes in the US, as well as the robust jobs market. Business investment continued to increase strongly. It provided a 1p.p. fillip to GDP. Meantime, net exports added 1.1 p.p., driven by a jump in goods exports. This reflects soybean producers 'front loading' exports to China to beat Chinese tariffs on US agricultural produce which came into effect in July. However, this was largely 'netted off' in the GDP figures as farmers ran down inventories of soybeans to meet demand. Inventories deducted 1 p.p from growth in Q1.

Labour market data remained strong in Q2. Non-farm payrolls recorded an average monthly increase of 203k in the quarter. This was only slightly below the Q1 monthly average of 218k. Solid employment growth and a fall in the participation rate saw the unemployment rate decline to an 18-year low of just 3.8% in May, before an increase in the size of the labour force saw it rebound to 4% in June.

Despite the very low level of unemployment, there has been little change in US wage growth. Year-on-year growth in average hourly earnings remains in the 2.3-2.8% range it has occupied since Q3 2015, coming in at 2.7% in June. **The Fed's preferred Employment Cost Index based measure of wage growth edged up to 2.8% in Q2,** from 2.7% in Q1. Leading indicators suggest we could see earnings growth accelerate in the second half of the year. The NFIB's 'jobs hard-to-fill' and 'few or no qualified applicants' indices rose to all-time highs in June, suggesting employers may have to offer more generous remuneration to attract workers.

Meantime, **the Fed's preferred inflation measure, core-PCE prices, held at 1.9% throughout Q2.** There are indications, though, that price pressures are building, meaning that underlying inflation could rise above the Fed's 2% target in the coming months.



Survey data for July indicate that the US economy continued to grow at a robust pace at the start of Q3. The Composite PMI came in at 55.9, just above Q2's 55.5 average. Meanwhile, the manufacturing ISM was 58.1 in July, versus the 58.7 average seen in Q1.

Overall, the near-term outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption should remain robust. The raft of tax cuts passed by Congress at the end of last year should continue to boost activity well into 2019. **The IMF is forecasting that US GDP will rise by 2.9% this year and 2.7% in 2019.** Growth will likely slow in 2020 as the impact from the fiscal stimulus fades.

There are also some risks to the economy. **The fiscal stimulus will likely boost demand for imports, further widening the US trade deficit.** It will also increase the size of the budget deficit and, thus, add to upward pressure on US Treasury yields, increasing borrowing costs. So too will the Fed's steady removal of monetary policy accommodation. The Trump Administration's protectionist trade policies are likely to drive up the cost of imports, increasing inflation and thus, weighing on consumer spending. **Overall though, growth should remain strong this year and next.**