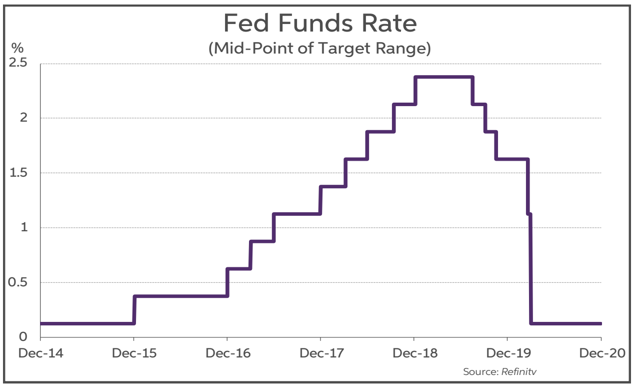
Fed Watch

AIB Treasury Economic Research Unit

17th December 2020

Fed alters QE guidance, linking it to economic recovery

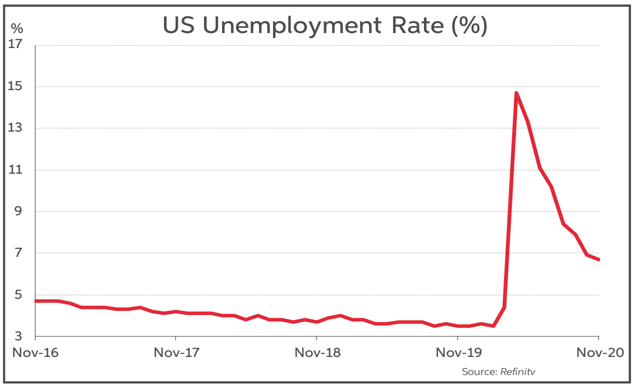
The final US Federal Reserve policy setting meeting for 2020 concluded last night in line with expectations. The Federal Open Market Committee (FOMC) kept the fed funds rate in its target range of 0.00-0.25%. It also continues to operate an open-ended asset purchase programme. There had been some speculation in the lead up to the meeting, that given the recent uptrend in longer term US Treasury yields, the Fed may alter the composition of QE through increasing the weighted average maturity of its purchases. However, the Fed made no changes in this regard, and will continue to purchase $80bn in Treasuries and $40bn in mortgage backed securities per month. Although, the Fed indicated a willingness to loosen policy further if required.



The Fed did alter its forward guidance in relation to its asset purchases. In the only change to its meeting statement, it added that its QE would continue until "substantial further progress" has been made towards its "maximum employment and price stability objectives". In other words, the Fed is now linking any tapering of its purchases to a marked improvement in the economy. The FOMC also stated that the asset purchases would help foster accommodative financial conditions.

This implies that its QE programme could continue for an even longer period of time. However, the Fed did not provide any specifics on what conditions would warrant tapering to QE. In his prepared remarks during the post-meeting press conference, Fed Chair Powell stated that the guidance is "outcome based" and is tied to progress toward reaching our employment and inflation goals. When questioned on what this meant, Chair Powell did not go into any further detail, other than noting that "our guidance for interest rates and asset purchases will keep monetary policy accommodative until our maximum credit and price stability goals are achieved".

The update to the Fed's view on the likely path of future interest rates (i.e. the dot plot) was broadly similar to its September version. The median projection was for no change in the fed funds rate through to end 2023. All 17 FOMC members expect that the current level of interest rates will be warranted until the end of 2021. Only one FOMC member believes that a rate hike will be required in 2022. Meanwhile, 12 members (it was 13 in September) expect rates to remain on hold through to the end of 2023.



In terms of market expectations, futures contracts show that the first rate hike is not priced in until mid 2023, with the fed funds rate rising by 12.5bps to 0.25%. The futures market does not envisage rates rising to 0.5% until the second half of 2024.

Meanwhile, in terms of the economic outlook, the Fed revised slightly higher its GDP forecasts to take account of the fact that the recovery has progressed more quickly than it had previously anticipated. The Fed is projecting GDP to be –2.4% y/y (was –3.7%) in Q4 2020. It is now anticipating growth of 4.2% y/y by the end of 2021 (was 4%), and 3.2% y/y by end 2022 (from 3%). For Q4 2023, it is forecasting growth of 2.4% y/y (previously 2.5%).

Despite these modest upgrades, Chair Powell was keen to emphasise that economic activity remains well below its pre-pandemic level and the path ahead remains highly uncertain. He also commented that all FOMC members continue to be of the view that the level of uncertainty regarding the outlook remains "elevated", although he did state that fewer participants see the balance of risks as weighted to the downside than in September. **Overall, it is clear from the December Fed meeting that the central bank expects to be maintaining an ultra accommodative monetary policy stance for quite some time.**

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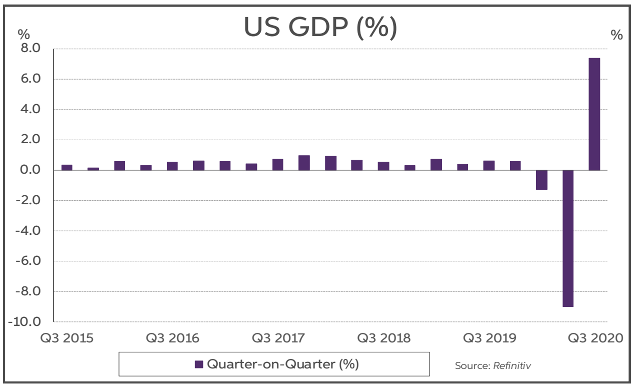
Economic rebound loses steam in Q4

US GDP rebounded by a record 33.1% annualised growth rate in Q3, following an unprecedented contraction of 31.9% in Q2 and a 5% fall in Q1 2020. The economy in Q3 was still about 3.5% smaller than in Q4 '19. The underlying breakdown showed a robust rebound in consumer spending, which rose by 40.7%, adding 25.3 percentage points (p.p) to GDP. Fixed investment added 5 p.p., while government expenditure subtracted 0.7 p.p. Net exports subtracted 3.1 p.p. from growth, although, this was offset by a 6.6 p.p. rise in inventories.

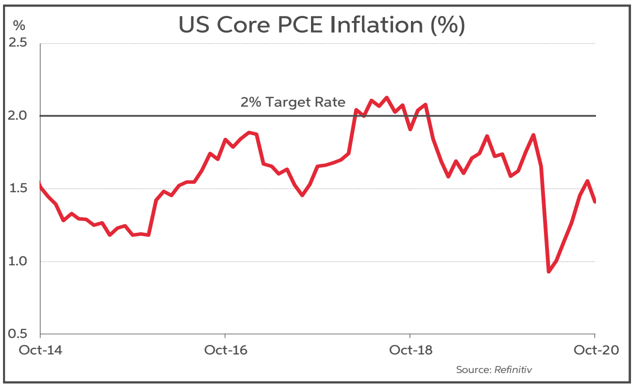


Survey data suggest that the recovery continued in Q4. Both the manufacturing and service PMIs have printed in expansion territory each month. Thus, the manufacturing PMI has averaged at 55.5, while the services PMI averaged 56.9. Likewise, the manufacturing and non-manufacturing ISMs have printed strongly, with both indices remaining in expansion mode in November, at 57.5 and 55.9 respectively. Meanwhile, the University of Michigan measure of consumer sentiment averaged 80 in Q4, matching its September reading. However, the Conference Board measure has moved lower, to 96.1 in November, from 101.9 in September.

The available hard data also suggest that the recovery has continued, albeit at a slower pace than in Q3. Industrial production continued to recover, rising by 1.1% in October and 0.4% in November. However, this still leaves output 4.9% below its pre-Covid level, with manufacturing output performing slightly better, at 3.7% below its level before the pandemic hit. Retail sales increased by 0.3%, in October, although they moved lower in November as the sharp rise in Covid cases dampened consumer spending.

The labour market recovery is losing momentum. Payrolls increased by 245k in November, much less than the 460k forecast. This means that payrolls still stand 9.8m below their February total. The unemployment rate has fallen to 6.7% in November from a high of 14.7% in April, although, this masks the fact that there are now some 4.5m fewer people in the labour force. Worryingly, initial jobless claims have remained at elevated levels, and have recently spiked higher.

In terms of inflation, the core-PCE rate fell to 1.4% yoy in October from 1.6%. Core CPI inflation was unchanged in November at 1.6%. Both measures highlight that price growth remains subdued. This view is shared by the Fed, which reiterated that weak demand and earlier declines in oil prices have been holding down inflation. The Fed's latest projections see inflation remaining subdued, with core-PCE expected to remain below the 2% inflation target until 2023.



Overall then, while data so far in Q4 suggest the recovery has been maintained, there are signs it has lost momentum and remains uneven. Meantime, record breaking Covid-19 cases, hospitalisations and deaths in December suggest that the virus is not under control as we head into 2021. This will continue to weigh on the recovery in the near term.

However, there are also reasons for optimism. The rebound in activity in Q3 was much stronger than expected. The Fed has also reiterated that loose monetary policy will remain in place as long as inflation remains under control. The availability of highly effective vaccines as 2021 progresses should also boost activity and should allow for the release of forced and precautionary savings. A fiscal package looks like it may finally arrive before Christmas, worth $900bn, providing further support to the economy. The incoming Biden administration will likely look to add to this in the new year. A weaker dollar next year may also raise the competitiveness of US manufacturers abroad. The Fed's latest summary of economic projections envisage that GDP will be -2.4% y/y in Q4 2020, which is much smaller decline than was initially anticipated. Further ahead, the Fed has revised its projections for 2021-23 slightly upwards. GDP growth is now expected to be 4.2% y/y by Q4 '21, 3.2% y/y by Q4 '22, and by the end of 2023, growth is forecast to be running at 2.4% y/y.

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