Fed Watch

AIB Treasury Economic Research Unit

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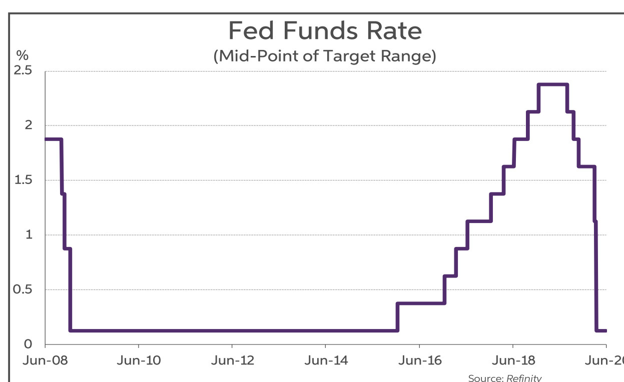
No changes from Fed, but ready to do more if needed

The June meeting of the Federal Reserve Open Market Committee (FOMC) concluded last night in line with market expectations for no change to policy. The decision to leave policy unaltered was unanimous. Since March, the Fed has introduced an extensive package of monetary stimulus measures in an effort to mitigate the economic fallout from the Covid-19 crisis.

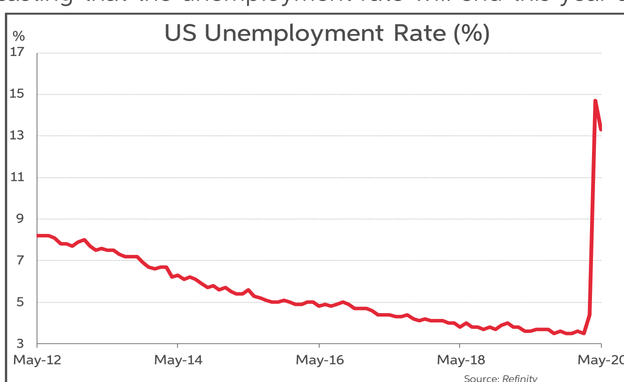


These measures have included cutting the fed funds rate by a total of 150bps to a target range of 0.00-0.25%. The Fed also restarted its QE programme, initially by $700bn and then subsequently expanding it to unlimited purchases. Additionally, the Fed has undertaken measures to support the flow of credit to all sectors of the economy as well as re-implementing fresh US dollar liquidity swap lines with a raft of other central banks to ease pressures on dollar funding.

The meeting statement showed very little change from its April version. The Fed continued to state that the on-going public health crisis will weigh heavily on economic activity, the labour market and inflation in the near term. It also emphasised this crisis "poses considerable risks" to the outlook for the US economy over the medium term. In one amendment though, the Fed did comment that it would purchase Treasury securities and Mortgage-backed securities "at least at the current pace", leaving open the possibility and the flexibility to increase the pace of asset purchases if it deems it necessary.

Fed Chair Powell, noted the "great uncertainty about the future". He said that the decline in US Q2 GDP is "likely to be most severe on record". He did though acknowledge that some recent indicators suggest a stabilisation or "even a modest rebound" for certain sectors of the economy. While also referencing the recent upside surprise in May payroll data, he put this in the context that there are still around 20 million net job losses since February. Chair Powell also stated the extent of the downturn and the pace of the recovery will to a large degree depend on the "success in containing the virus" and "policy actions taken at all levels of government".

The updated macro forecasts provided further insight into the Fed's own assessment of the impact of the Covid-19 pandemic on the US economy. It is expecting a decline in GDP of 6.5% year-on-year in Q4'20, followed by growth of 5% y/y in Q4'21 and 3.5% in Q4'22. It is forecasting that the unemployment rate will end this year at 9.3%, falling to 6.5% by end-2021 and at 5.5% by end-2022. Given the elevated unemployment levels, the Fed sees inflation remaining below its 2% target over the next 3 years.



Against this backdrop, the Fed does not envisage hiking interest rates until at least 2023 at the earliest. The June interest rate projections showed that all 17 FOMC members believe the current level of rates will be needed until at least the end of 2021. Meanwhile, 15 of the 17, expect no rate increases in 2022. **In terms of market expectations, fed futures would appear to be looking for a 12.5bps rate hike to 0.25% by around mid-2023.** Further out, the 3-month contracts are pointing to the Fed rate rising to 0.5% in the second half of 2024.

Overall, the Fed June update shows that while the central bank is content with its current policy initiatives, in Chair Powell's words, they are "prepared to adjust our plans as appropriate to support our goals". This could involve an increase in the pace of monthly asset purchases as well as potentially implementing 'yield curve control' (i.e. buy longer term bonds to keep longer term rates below a certain target), which was discussed at this month's meeting. Given the lack of policy changes, there was no major reaction from the dollar to the meeting outcome. However, the downbeat assessment of the economic outlook from the Fed has contributed to some risk aversion on markets.

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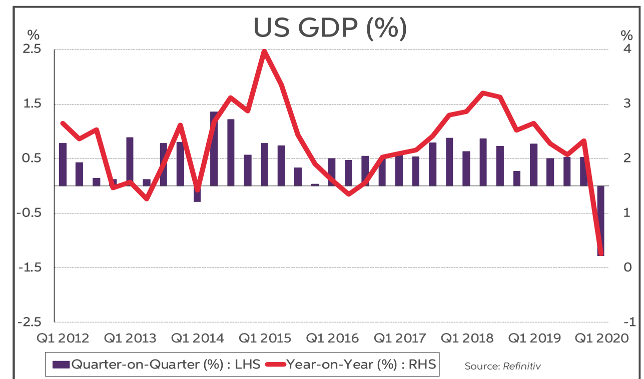
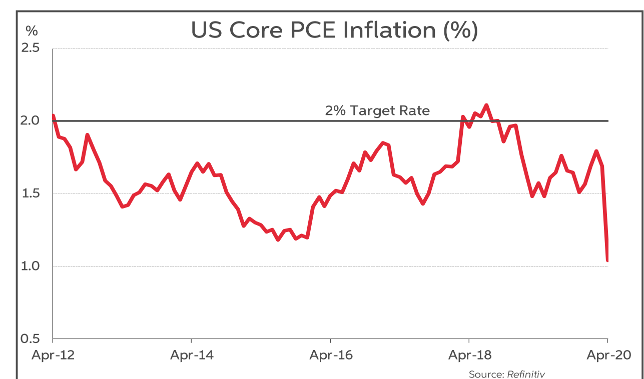
US economy contracts sharply on Covid-19 impact

US GDP contracted by 5.0% in annualised terms in the opening quarter of 2020 as the Covid-19 crisis brought an end to the economy's longest expansion on record. Consumption plummeted by 6.8% on an annualised basis as retail outlets closed and unemployment spiked higher. Notably, consumer spending on services plunged by 9.7%. At the same time, business investment fell by 2.4%, contracting for a fourth consecutive quarter. Exports also sank, declining by 8.7%. However, net trade made a positive contribution to growth as imports also fell sharply. Meantime, government spending rose by a modest 0.8%.



The available data for Q2 suggest that the US economy is on track for its worst ever quarterly performance. This reflects the more stringent restrictions imposed throughout the whole of April and that remain in place in many states. Consumption declined by a record 13.6% on a month-on-month basis in April off an already depressed March level. Industrial activity also collapsed in the month, with output falling by 11.2%. There are, however, some grounds for optimism with incoming survey data for May suggesting the downturn may have bottomed out. The composite PMI moved off its record of 27.0 in April to 37.0, driven by improvements in both the manufacturing and service sector sub-indices. Similarly, the manufacturing ISM, as well as its non-manufacturing counterpart, in May increased to 43.1 and 44.0, respectively, from 41.5 and 41.8 in April. On the household side, the Michigan measure of consumer sentiment has also begun to stabilize.

In terms of the labour market, non-farm payrolls unexpectedly increased by 2.8m (f'cast for –7.5m) in May, having collapsed by 20.5m in April. The payroll figures indicate some signs of improvement in the jobs markets as re-hiring took place amid a reopening in certain states. Although, it should be noted that employment remains at its lowest level since 2011. Meanwhile, the unemployment rate fell to 13.3% in May. However, officials warned that classification issues probably underestimate the actual rise in unemployment.



Weak demand, due to the impact from the Covid crisis, saw the Fed's preferred measure of inflation, core-PCE, decelerate to an over 9-year low of 1% in April. The core rate of CPI was put at 1.2% in May, its lowest since March 2011. Meanwhile, headline CPI inflation slowed to just 0.1% in May amid weakness in energy prices.

Looking ahead, the short term outlook for the US economy, as is the case for many other advanced economies, is very challenging. A historic drop in GDP is a certainty in Q2 as the Covid-19 lockdown saw activity ground to a virtual halt in April and restrictions are only gradually being unwound. Consumer spending likely reached its nadir in April but ongoing social distancing measures and elevated joblessness will weigh heavily on household expenditure over the coming months. Although, May's payroll data does offer some encouragement. Heightened uncertainty, weak demand and issues with supply chains will also create a challenging backdrop for investment. Significant government stimulus programmes will provide some support to activity. **The substantial easing measures being implemented by the Fed since March will also help to mitigate some of the economic fallout.**

The economic projections published by the OECD recently show a 7.3% contraction being forecast for the US economy in 2020. This would represent the economy's worst performance since 1946 when it shrank by 12%. The downside risks to this forecast are substantial. As mentioned above, the economy has begun to re-open, but restrictions may need to be reintroduced if the virus takes hold again. More generally, the possibility of a second, smaller wave to the virus later this year cannot be discounted. On the assumption that such outcomes are avoided, the OECD is forecasting growth of 4.1% next year.

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