Fed Watch

AIB Treasury Economic Research Unit

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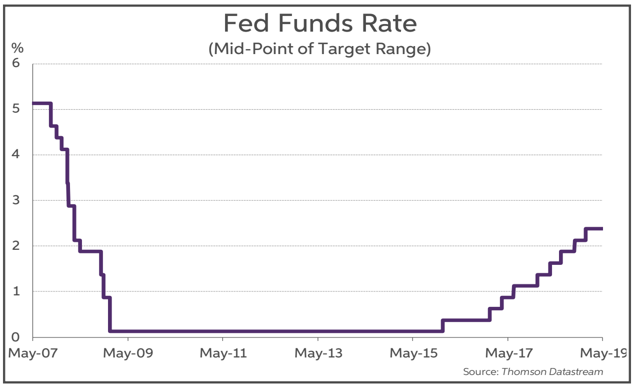
Fed continues to espouse patience

To no great surprise, the May meeting of the Federal Reserve Open Market Committee (FOMC) saw the target range for the key fed funds rate maintained at 2.25-2.50%. The decision to leave policy unchanged was unanimous.

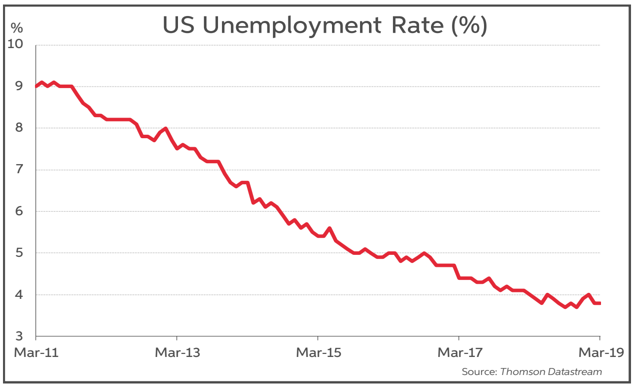
The meeting statement and subsequent press conference provided an update on the Fed's view of the US economy's performance and outlook. The statement noted that labour market conditions remained "strong" and that the rate of growth in economic activity was "solid". However, the Fed did acknowledge that household spending and business investment slowed in the first quarter.



In the press conference, Fed Chair Powell's comments were somewhat more upbeat than the tone from the meeting statement. In relation to the recent fall back in core inflation, Chair Powell commented that the Fed "suspects that some transitory factors may be at work" and their view remains that inflation will return over time to its 2% target. Meanwhile, he also stated that some of the concerns the Fed had regarding risks (incl. weaker growth in China and Europe, disruptive Brexit) to the economic outlook at the start of the year appear to have "moderated somewhat".

Back at the time of its March policy meeting, the Fed revised lower its economic forecasts, albeit marginally. It expects GDP to grow by a still solid 2.1% at end 2019 (was 2.3%) and 1.9% at end 2020 (was 2.0%). Meanwhile, it continues to anticipate inflation remaining around the 2% level.

The most recent guidance from the Fed on their monetary policy outlook was also updated back in March. The so-called 'dot plot' of interest rate projections indicated that the central bank does not anticipate hiking interest rates this year. Meanwhile, for 2020, the Fed's projections incorporate just one rate hike. Therefore, the central bank now sees rates peaking at 2.625%, compared to 3.125% in its December 2018 projections.



The market expectations on the direction of US interest rates remains out of sync with the Fed's projections. Future contracts are not pricing in any further rate hikes and believe that rates have already reached their peak.

In contrast to the Fed, which is projecting a rate hike in 2020, the market is anticipating a rate cut around the first quarter of 2020. The market is also pricing in a second rate cut by mid-2021.

Overall, the May FOMC meeting shows that the Fed continues to maintain a very cautious approach to the monetary policy outlook. Fed Chair Powell stated that recent developments and the macro outlook are "consistent with continued patience in assessing further adjustments in monetary policy". This means that we are unlikely to see any rate changes from the Fed in the near term.

However, the US economy has started the year on a solid footing. Indeed, while first quarter annualised GDP growth of 3.2% was boosted by what are expected to be temporary factors (i.e. inventories, net trade), a raft of other macro indicators, including healthy monthly payroll growth, offer encouragement regarding the prospects for the remainder of 2019. **Therefore, if the economy maintains a solid pace of growth and inflationary pressures rise, a rate hike from the Fed cannot be ruled out later this year.**

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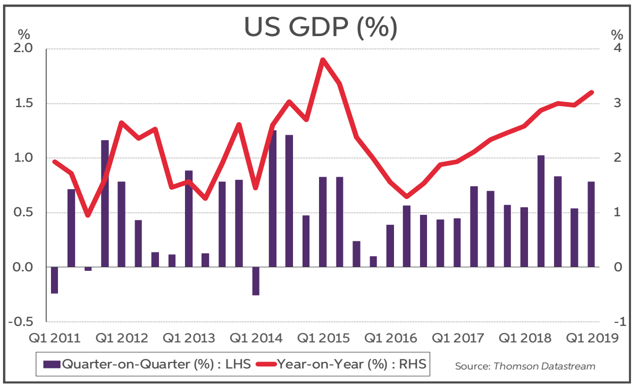
US GDP growth accelerates in Q1

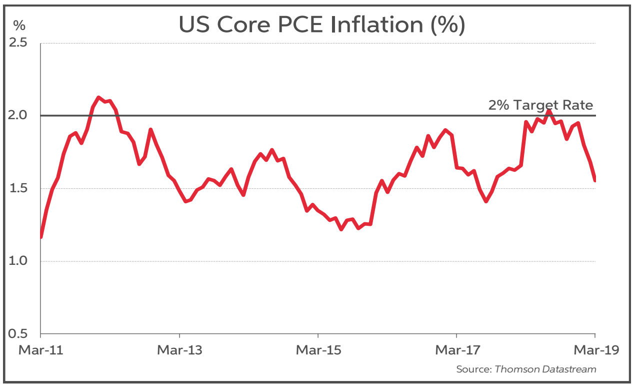
US annualised growth picked up to a strong 3.2% in Q1, from 2.2% in the closing quarter of 2018. The underlying data showed that the improvement was driven by an increased contribution from net trade (+1.0 percentage points) and changes in private inventories (+0.7p.p.). Indeed, despite the positive headline figure, domestic demand (consumption, government spending and fixed investment) was weaker in the quarter. Altogether, it added 1.5 percentage points (p.p.) to the quarterly total, down from 2.1 p.p. in Q4.



The slowdown in domestic demand is reflected in other hard data released in the quarter. For instance, the control measure of retail sales (ex-gas, autos and building materials) edged down by 0.2% in the quarter. Although, the most recent figures (March) were more encouraging. Meanwhile, on the output side of the economy, industrial production volumes were little changed on Q4 levels.

In contrast, labour market data remained solid in Q1. The average monthly growth rate of non-farm payrolls eased to 180k in the quarter, down from 233k in Q4, but still represents a healthy pace of job creation. Meanwhile, at 3.8%, the unemployment rate remains at a multi-decade low level. Overall, the lack of slack in the labour market helped the year-on-year growth rate of average hourly earnings hold in a tight 3.2-3.4% range in the quarter. Furthermore, leading indicators of wage pressures, such as the NFIB 'jobs hard to fill' index which reached a joint record high in March, suggest that earnings growth may accelerate.

However, rising wages have not yet translated into higher inflation. The Fed's preferred measure of price pressures, core-PCE, moderated in the first quarter of the year, from 2.0% in December to 1.6% year-on-year in March. At the same time, higher energy prices, helped the headline CPI rate pick up to 1.9% in the same month.



The limited survey data available for April have been somewhat disappointing. The flash composite PMI dipped to 52.8 in April, its lowest reading since September 2016, largely due to a steep drop in the services index. Consumer confidence data have been more encouraging, with both the Conference Board and University of Michigan measures at levels consistent with a solid level of household expenditure.

Overall, the near-term outlook for the US economy remains positive. While the boost from tax cuts at the beginning of last year is fading, a strong labour market continues to support the key consumer sector of the economy (c. 70% GDP). Reports of progress in relation to US/China trade talks also offer encouragement. Meantime, with rates relatively low and the Fed remaining cautious, monetary policy should carry on supporting growth. **The recent IMF forecast is for solid US GDP growth of 2.3% in 2019. After the strong Q1 data, GDP growth could be closer to 2.75% this year.**

However, in the medium term there are some risks facing the US economy. The growing twin deficits are a source of worry**.** The lagged effect from the Fed's rate hikes could act as a headwind to activity. The slowdown in the global economy is another headwind, while on-going uncertainty related to the Trump administration's protectionist trade policies also remains a risk factor. **Overall, while growth is expected to remain strong in 2019, the US economy could slow over the medium term, especially as this will become the longest US economic expansion on record next month.**

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