Fed Watch

AIB Treasury Economic Research Unit

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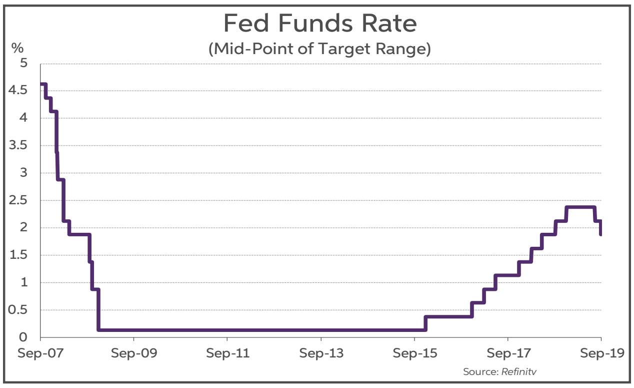
Fed cuts rates again, but very divided on future moves

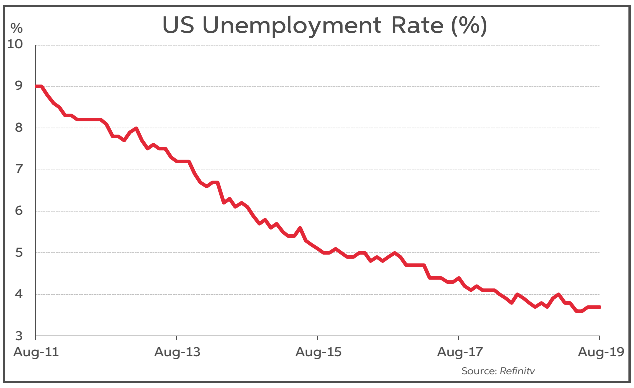
As was widely anticipated, the September meeting of the Federal Reserve Open Market Committee (FOMC) saw the central bank cut interest rates by 25bps for the second time in less than two months. The target range for the key fed funds rate was lowered to 1.75-2.0%. As in July, the decision to lower interest rates was not unanimous, with two members voting for no change and another voting for a 50bps cut.

The FOMC statement indicated that the decision to cut rates was taken in the light of the implications of global developments for the economic outlook in the US, as well as continuing muted inflationary pressures. Fed Chairman Powell also stated in his press conference that the rate cut is intended to "provide insurance" against ongoing risks, including weak global growth and trade policy uncertainty. However, with the 25bps cut already fully priced in, the main focus for the market was on the indications the Fed would provide about any further rate cuts.



In this regard, **there are wide divisions on the FOMC about where rates go next in the US. The median forecast from the 'dot-plot' of FOMC members projections is no further change to rates** in 2019 or 2020, with the funds rate staying at 1.875%. However, only five of the 17 FOMC members think rates will stay unchanged in Q4 2019, while five seem to expect rates to rise and seven think rates will be cut again. **It is interesting to note that no FOMC member believes that rates will be cut by any more than 25bps to 1.625% in the next couple of years.**

The reason for the Fed's cautious approach on rates can be seen in its assessment of the US economy. Chair Powell said the outlook for the US economy remains favourable. He noted that the main downside risks are coming from abroad. The Fed published its latest set to macro forecasts last night also and these showed only marginal changes from its June projections. The Feds still sees the US economy growing at a solid pace of close to 2% in 2020 and 2021. Core inflation, meanwhile, is seen rising to its 2% target in the next couple of years.



The market in recent weeks has pared back its expectations regarding Fed rate cuts, as it has done for other central banks too. **It now sees the Fed cutting rates to around 1.2% rather than 1% previously. This is still well below the FOMC 'dot-plot' of rate projections** where the most optimistic forecasts are for rates to fall to 1.625% and the median is for no rate cut at all.

Nonetheless, the Fed was careful to keep its options open regarding the interest rate outlook. It has not ruled out greater rate cuts. Chair Powell stated that if the economy does turn down, then a more extensive sequence of rate cuts could be appropriate. He added that **the Fed is not on a pre-set course and its rate decisions are going to be "highly data dependent".** Its best judgement, though, is that the situation it faces is best addressed with "moderate adjustments" to rates. In this regard, it will be monitoring incoming macro data and the evolving risk picture, linked in part to global trade tensions. Indeed, to some extent, the more that President Trump keeps trade tensions with China on the boil, the greater the likelihood that the Fed could deliver the further rate cuts that he has been calling for, given the risks that trade tensions pose for the US economy.

The September meeting may have disappointed those expecting a more dovish policy outlook. Overall though, **the reaction in markets was muted to what is being described as a hawkish rate cut.** Stocks ticked upwards, there was a small rise in bond yields and the dollar was little changed. It may be that markets are taking the Fed rate projections with a grain of salt, and believe that it will cut rates significantly further in the next twelve months.

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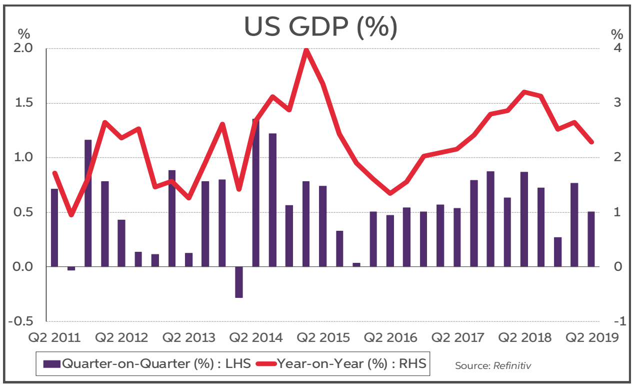
US economy slows, but growth still solid

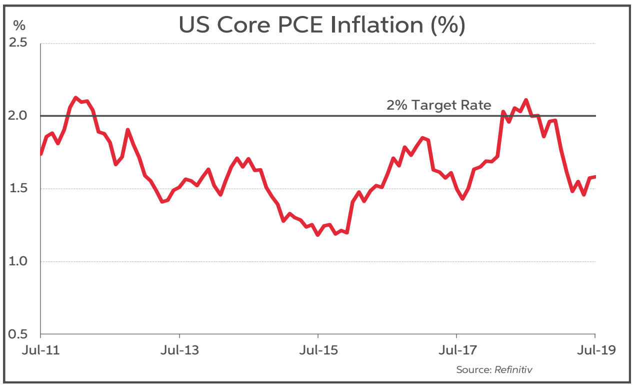


US annualised GDP growth eased to 2.0% in Q2, from 3.1% in the opening quarter of the year. Growth was very uneven in Q2 and was driven by strong consumer spending, which contributed 3.1 percentage points (p.p) to the quarterly total. Fiscal policy also remained expansionary, with government spending adding 0.8 p.p.. However, changes in inventories, net trade and fixed investment all acted as drags, subtracting 0.9, 0.7 and 0.2 p.p. respectively.

Survey data suggest that the US economy may have lost further momentum in Q3. The deterioration in the global economic outlook has hit the manufacturing sector hard in the US. This is reflected in the ISM for the sector dropping below the key 50 level that separates growth from contraction in August, while the PMI is just above this threshold. In contrast, services have held up reasonably well, though the pace of activity has eased in the sector this year. The services PMI averaged 51.9 in July/August, while the non-manufacturing ISM came in at 55.1 in the same period. These are broadly similar to Q2's levels. Meanwhile, on the demand side of the economy, the University of Michigan measure of consumer sentiment averaged 93.4 in Q3, down sharply from 98.5 in Q2.

The available 'hard' data have been generally positive to date in Q3. Retail sales have risen by a robust 1.4% on Q2 levels in July/August, though expenditure was boosted in July by the impact of the Amazon Prime sales event. Consumer spending then, continues to underpin growth in the US. On the output side of the economy, industrial output was up by 0.3% in July/August on Q2 levels.

Meantime, the labour market remains in good shape. Although, growth in non-farm payrolls has been trending lower this year as economic activity eases and the US moves to full employment - the average monthly gain has fallen to 158k in the year-to-date, from 223k in 2018. August's figure was low at 130k, with private payrolls expanding by just 96k. However, the unemployment rate remains at just 3.7%, close to 50-year lows. Despite the tightness of the labour market, wage inflation, while solid, has not accelerated and has been hovering just above the 3% level in recent months.



On the inflation front, the Fed's preferred measure of inflation, core-PCE, has been weighed down by a number of technical factors this year, holding below the central bank's 2% target. In July, core-PCE was recorded at 1.6%. In contrast, core CPI data point to an acceleration in price pressures, with inflation picking up to 2.4% in August. Lower oil prices, though, saw headline CPI hold below 2% in the same month.

To surmise, growth in the US economy is slowing, but remains solid enough nonetheless. This largely reflects the impact of the more uncertain global economic environment, including US-China trade tensions. Separately, late cycle dynamics are also playing a role, with the current economic expansion now the longest on record. These factors have weighed on business confidence, and in turn fixed investment. However, a healthy labour market should continue to support the key consumer side of the economy (c. 70% GDP). At the same time, the Fed's willingness to "act as appropriate" to ensure that the US expansion continues, suggests that monetary policy will remain supportive of growth. Additionally, government spending is expected to continue rising in the immediate future. Last night's Fed projections for GDP growth of close to 2% over the next three years are in-line with the IMF's most recent forecasts and point to a continuing solid economic performance.

Over the medium term, there are risks facing the US economy. Of particular concern is slower global economic growth and a rising fiscal deficit. Separately, the inversion of the yield curve is seen by some commentators as signalling slower growth ahead, if not outright recession. Thus, economic data will need close watching.

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