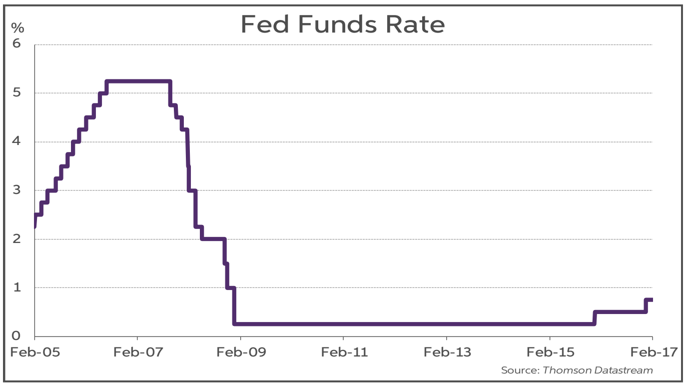
Fed Watch

AIB Treasury Economic Research Unit

2nd February 2017

No clear signal on timing of next rate hike

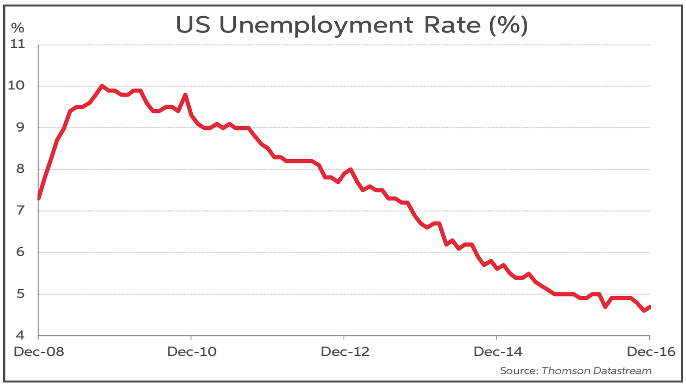
The first US Federal Reserve meeting of 2017 concluded as expected, with no changes to monetary policy. The target range for the federal funds rate was maintained at 0.5-0.75%. This was very much in line with market expectations, as the Fed had as recently as December hiked interest rates for only the second time in the last ten years. The decision to leave rates unchanged was unanimous.



With no press conference or updated projections, the focus for markets was on the meeting statement. The text of the statement contained no major surprises. Indeed, the Fed's characterisation of the economy was very similar to the description outlined in the December statement. It noted that economic activity continues to "expand at a moderate pace" and that job gains "remained solid", while the unemployment rate "stayed near its recent low". The Fed also continued to comment that "business investment remained soft". Although, the Central Bank did include a new sentence in the statement, commenting that "measures of consumer and business sentiment have improved of late".

In terms of the economic outlook, the Fed continues to be of the view that the near term risks for the US economy are "roughly balanced". It expects that the pace of economic growth will remain "moderate" against a backdrop of modest adjustment in the stance of monetary policy.

The most recent set of projections on the likely path of interest rates were released at the December FOMC meeting. These projections represented a slightly faster pace of rate increases than was outlined in the September version. They showed that the median projection for end-2017 was 1.38% which would represent three 25bps rate hikes this year. The FOMC anticipates rates rising to 2.17% by end-2018 and to 2.88% by end-2019



These projections illustrate that the Fed is guiding a more aggressive pace of rate increases than the market is expecting. Current futures pricing indicates that the market is looking for two 25bps rate hikes in both 2017 and 2018 and just one in 2019. The Fed's projections are consistent with three 25bps increases per annum over this period.

Overall, the Fed continues to display a clear tightening bias. There was nothing in the February meeting statement to suggest the Fed will alter its expected path of rate increases, but it avoided giving any indication on the likely timing of its next rate move. The US economic outlook still remains uncertain given the lack of detail from the Trump administration on its proposed fiscal stimulus. While, there was no mention of fiscal policy in the statement, the minutes from the December meeting alluded to this. Indeed, the Fed Chair, Janet Yellen, recently commented on how the "potential changes in fiscal policy" could affect the economic outlook and therefore the appropriate pace of tightening, however "the size, timing, and composition of such changes remain uncertain".

Therefore, the Fed is awaiting further details on the new fiscal policy initiatives to analyse what impact they will have on US growth and inflation. Fed Chair Yellen's upcoming semi-annual testimony to Congress (Feb 14th & 15th) as well as the meeting minutes (Feb 22nd) will be looked to for further insight into the Fed's thinking on these issues, as well as for indications as to when it may hike rates again.

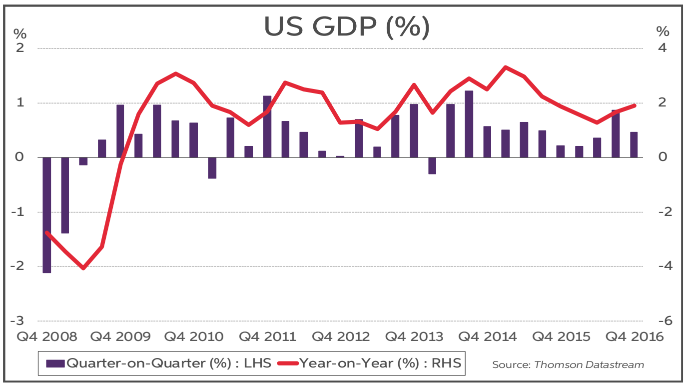
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Steady, solid underlying US growth

The pace of annualised growth in the US slowed in Q4, from 3.5% to 1.9%. Although, this is largely reflects a reversal of Q3's sharp improvement in the trade balance (mostly due to a one-off spike in soybean exports). Indeed, final sales to domestic purchasers (GDP minus net trade and changes in inventories), which offers a clearer view of the domestic economy, rose to 2.5% in Q4, from 2.1%. It rose by 2.4% in Q2. Thus, the underlying growth rate in the US has been very stable at a solid 2.1-2.5% recently.

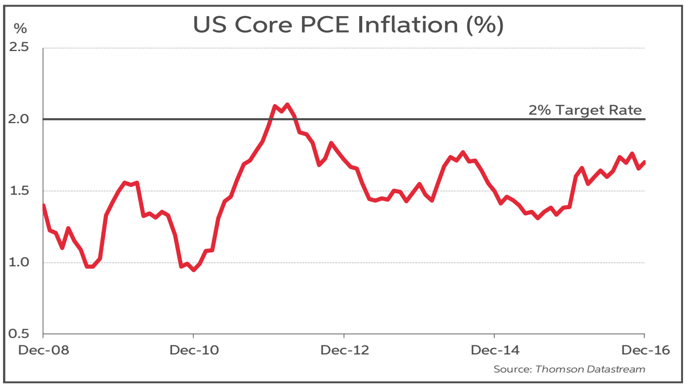


Consumer spending continued to increase at a strong pace in Q4, adding 1.7 percentage points (p.p.) to GDP. Private investment made a third consecutive positive contribution (0.3 p.p.). Inventories also continued to rebound following a period of contraction, adding 1 p.p. in the quarter. Government spending provided a modest boost (0.2 p.p.).

Meanwhile, the US labour market recorded a slower pace of growth in Q4. Non-farm payrolls rose by 495k, slower than 636k recorded in Q3. Year-on-year growth in employment came in at 1.4% in December, versus 2% in September. Nevertheless, the unemployment rate finish the period at 4.7%, compared to 4.9% at the end of Q3. In terms of survey data, the Conference Board labour market differential and the NFIB 'jobs hard to fill' component also point to a tightening labour market and the potential for a further decline in the unemployment rate.

Despite this, the pace of wage growth has remained moderate. **Year-on-year growth in the 'wages' component of the Employment Cost Index, the Fed's preferred earnings measure, slowed slightly to 2.3% in Q4, from 2.4%.** Although, weekly earnings growth did rise to 2.9% in December.

Meantime, headline CPI inflation remains on an upward trend, rising to 2.1% in December, its highest level since June 2014. It has been boosted by higher oil prices. Although, the Fed's preferred measure of price pressures, core-PCE inflation, held in a 1.6-1.7% range throughout 2016, remaining below its 2% target. The most recent Fed projections show that it does not expect inflation to reach its target until Q4 2018. Although, some growing price pressures could see the level reached sooner than that.



Survey data for January have been positive. The Markit composite PMI rose to 55.4, its highest level since November 2015. Meantime, both the Michigan and Conference Board measures of consumer confidence remained at strong levels.

Overall, the outlook for the US economy remains positive. President Trump's proposed expansionary fiscal policies should provide a boost over the medium-term. The OECD recently estimated that his proposals could boost GDP by around 0.4 percentage points in 2017 and 0.8 p.p. in 2018, seeing growth of 2.3% and 3% in the respective years. The labour market continues to improve, will be helpful to the key consumer side of the economy. **However, the economy does still face some headwinds.** These include the stronger dollar, the potential for fiscal stimulus to lead to a more rapid pace of monetary policy tightening and some political uncertainty, with the new President retaining his protectionist approach to trade. Relatively subdued business investment also remains a concern.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com