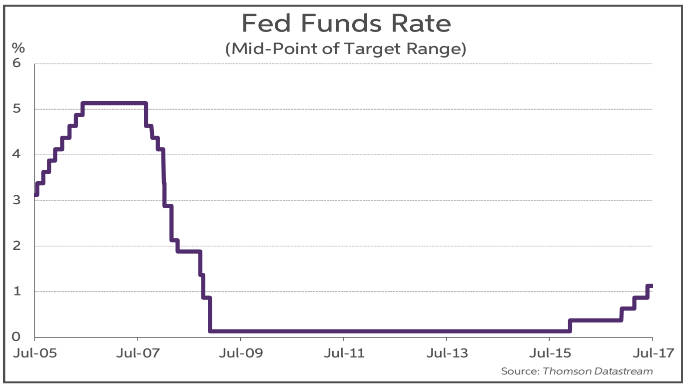
Fed Watch

AIB Treasury Economic Research Unit

27th July 2017

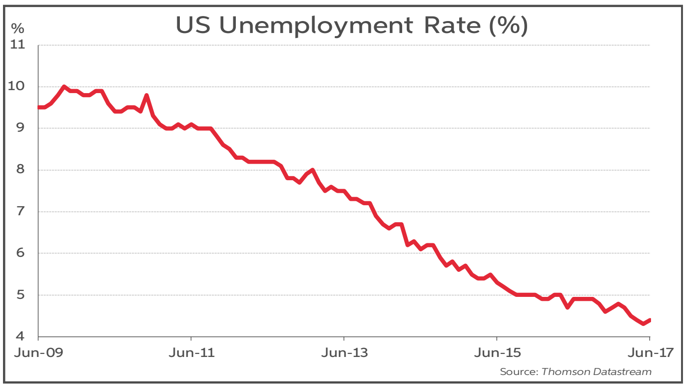
Fed remains on a tightening path

The July meeting of the US Federal Reserve concluded as expected with no changes to monetary policy. The Central Bank maintained the target range for the federal funds rate at 1-1.25%. The decision to leave rates unchanged was unanimous. **With no press conference or updated staff projections, the meeting statement was the centre of attention.** The text of the statement contained no major surprises and only minimal changes. Its description of the economy's performance was very similar to the June version, commenting that the "labour market has continued to strengthen and that economic activity has been rising moderately".



There was a change to the Fed's characterisation of the current inflationary environment. The Fed acknowledged the recent softness in inflation, observing that "overall inflation and measures excluding food and energy have declined and are running below 2% percent". **However, it must be noted that the Fed did not alter its inflation outlook,** stating that "inflation on a 12-month basis is expected to remain somewhat below 2% in the near term but to stabilize around the Committee's 2 percent objective over the medium term".

In terms of the economic outlook, the Fed continues to hold the view that the near term risks for the US economy are "roughly balanced". It expects the economy to grow at a "moderate pace", and that "labour market conditions will strengthen somewhat further".



The most recent set of interest rate projections ('dots') from the Fed were released at the June FOMC. There was very little change to these compared to the March edition**.** The median projections for end-2017 and end-2018 were unchanged, at 1.38% and 2.13% respectively, consistent with three hikes per annum over the period. The FOMC did slightly revise lower its end 2019 projection from 3% to 2.9%.

The market remains sceptical about the extent of rate hikes from the Fed over the next 2-3 years. Indeed, futures contracts continue to indicate that the market is expecting a less aggressive path of rate hikes than the Fed is guiding. Current pricing suggest that the market is looking for rates to rise to around 1.75% by end -2019. This infers that the market is factoring in only around three additional rate hikes over this period.

Overall, the July meeting statement shows that the Fed remains comfortable with, and intends to continue on its tightening path. The FOMC left its characterisation of the economic outlook unchanged, while also stating that it "expects to begin implementing its balance sheet normalization program relatively soon". This implies that an announcement on the unwinding of QE could happen in September. This means, that if the economy evolves as per Fed expectations over the coming months, its final projected rate hike for 2017 may occur in December, something which the market has not fully priced in.

In terms of market reaction, the dollar has been weaker in the aftermath, adding to its recent softer tone, with dollar watchers appearing to focus in on the Fed's change to its description of the current inflation backdrop. In level terms, this was evident in EUR/USD pushing up into $1.17 territory, trading as high as $1.178, its highest level since January 2015. Dollar weakness was also evident in GBP/USD back above $1.31 and USD/JPY down at ¥111.

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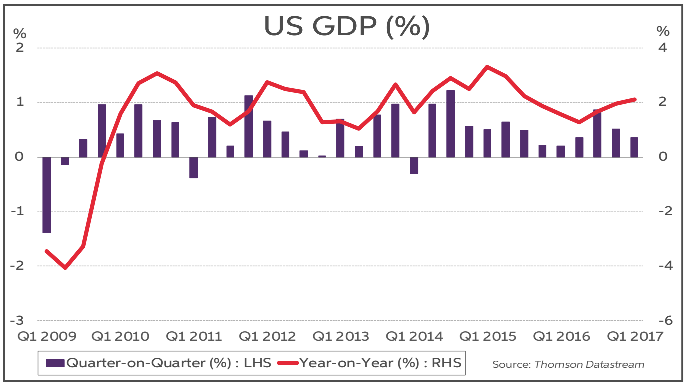
Signs economy has picked up in recent months

US annualised growth slowed further in Q1 to 1.4%. This primarily reflected a slowdown in consumer spending and a decline in inventories. However, **there appears to be an issue with the seasonal adjustment of the Q1 GDP figures,** which has given an overly negative view of growth in the first quarter for the last number of years. Temporary factors such as the later timing of Easter and delayed tax refunds also had negative impacts on first quarter growth.



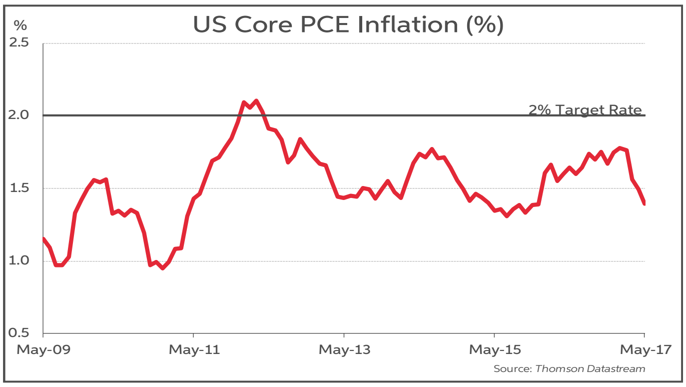
Leading indicators for Q2 have generally suggested that growth saw some modest improvement in the quarter. The manufacturing ISM index averaged a solid 55.8 in the quarter, though this is down from 57 in Q4. However, the far more significant non-manufacturing index (roughly 80% of US economy) picked up from Q1's 56.4 to 57.3 in Q2. Meantime, the Markit composite PMI averaged 53.7 in Q1, just ahead of the 53.4 seen in Q1.

Meanwhile, **hard data have reinforced the view that the US economy has picked up following a sluggish start to the year.** For example, real personal consumption grew by 0.7% in April/May versus Q1, in which it rose by just 0.3%. Meantime, industrial production grew by 1.2% in the second quarter, from just 0.4% in Q1. There was also a modest improvement in the trade deficit (good and services) in April/May.

Recent labour market data have also been encouraging. Non-farm payrolls averaged +194k in Q2, an improvement on Q1's 166k average. Year-on-year growth in household employment picked up to 1.3%, from 1%. This, combined with a decline in the size of the labour force, helped to keep downward pressure on the unemployment rate. It fell to a 16-year low of 4.3% in May, edging back up slightly to 4.4% in June.

Despite a tightening in the labour market, **US average hourly earnings growth has generally remained stuck in the 2.5-2.8% range that it has occupied since Q2 2016.** It came in at 2.5% in June. Although, the Atlanta Fed's national wage tracker, which controls for compositional changes in the jobs market, rose by 3.2% in Q2. The NFIB 'jobs hard to fill' index averaged 32.3 in Q2, its highest level since Q4 2000. The Conference Board labour market differential (jobs 'plentiful' minus jobs 'hard to get') rose to a 16-year high in June. These indicators suggest that we could see wages start to experience more sustained upward pressure.

At the same time, **CPI inflation has softened in recent months.** Headline inflation slowed from its recent high of 2.8% in February to 1.6% in June, while core slowed from 2.3% to 1.7%, reflecting a broad based easing in price pressures. Meantime, the Fed's preferred measure, core-PCE inflation, slowed from 1.8% in February to 1.4% in May, moving away from its 2% target.



Overall, the outlook for the US economy remains generally positive. The data suggest the economy has regained momentum after the slowdown in GDP growth in Q1. Continued improvement in the labour market will help the key consumer side of the economy. There is, however, a huge amount of uncertainty surrounding **President Trump's proposed expansionary fiscal policies. If implemented, they should provide a boost to the economy.** However, recent political developments suggest that Congress will be unwilling to support all of his proposals. Meantime, it also remains to be seen if the improvement in US business investment seen in Q1 will prove to be sustained. **The IMF revised down its US GDP forecasts earlier this week, from 2.3% to 2.1% for this year and from 2.5% to 2.1% next year, based on its assessment that the extent of expansionary fiscal policy will be less than previously envisaged.**

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