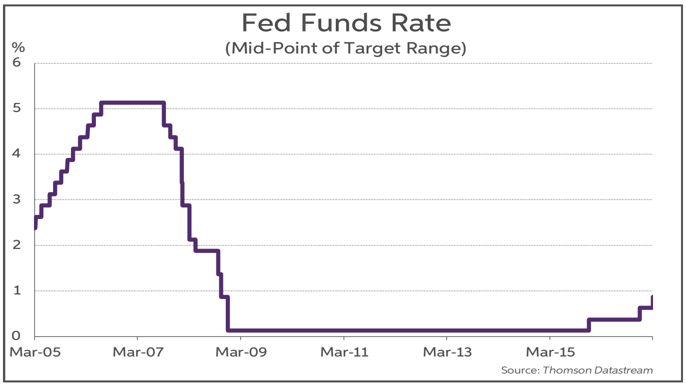
# Fed Watch

AIB Treasury Economic Research Unit

16th March 2017

# Fed hikes and maintains its 2017/18 rate projections

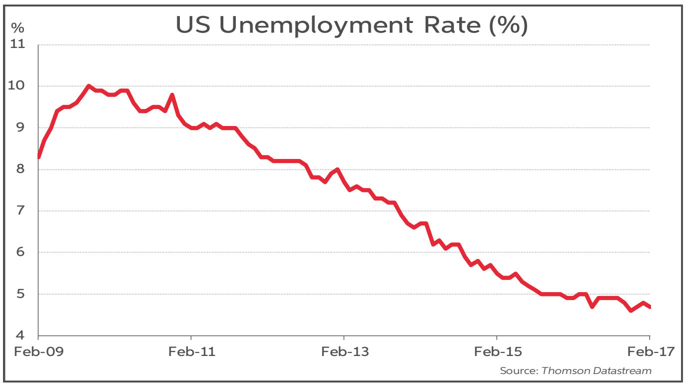
**As expected, the March meeting of the US Federal Reserve concluded with the Central Bank increasing the target range for the federal funds rate by 25bps to 0.75-1.0%.** This represents only the third rate increase from the Fed in the last decade, but it is the second hike in the past three months. The decision was not unanimous, with one member (Neel Kashkari) voting to keep rates unchanged.




**The meeting statement outlined the economic case that underpinned the Fed's decision.** It stated that "economic activity continued to expand at a moderate pace and that inflation was "moving closer to the Committee's 2 percent longer run objective". The Fed also upgraded its characterisation of business investment, noting that it "appears to have firmed somewhat". It also stated that job gains remain solid.

**In her post meeting press conference, Fed Chair Janet Yellen elaborated further on the rationale behind the Fed's policy change.** She said the decision to hike was "appropriate in light of the economy's solid progress toward our goals of maximum employment and price stability". She also commented that the "decision reflects our view that waiting too long to scale back some accommodation" might result in having to "raise rates rapidly sometime down the road" and the disruption/risks this could cause to financial markets and the economy. In terms of the outlook, Chair Yellen stated that the Fed continues to "expect that the economy will expand at a moderate pace over the next few years". Therefore, its economic forecasts were little changed from those in December, with the economy expected to average around 2% growth per annum over the next 2-3 years.

Given that the rate hike had been well signalled in advance by recent hawkish Fed comments, a key point of interest for markets was the updated set of FOMC interest rate projections. **Despite some speculation that it might do so, the Fed refrained from making any significant changes to its projections.** The median projection for end-2017 remains at 1.38% and at 2.17% for end-2018, consistent with three rate hikes per annum over this period. The FOMC did slightly revise higher its 2019 projection, from 2.88% to 3%.




The **central bank is still guiding a more aggressive pace of rate increases than the market is expecting in 2018-19.** Current futures pricing indicate that the market is looking for rates to rise to around 2.25% by end-2019, with the market factoring in two increases for next year and just one in 2019 after three hikes in 2018.

**However, there is scope for the Fed's projections to be revised even higher later in the year** should President Trump unveil a major fiscal stimulus programme. There is still scant detail in terms of specifics, meaning the Fed has not been able to fully factor in the impact of these plans into its forecasts. Overall, the March FOMC meeting showed that the **Fed is willing to follow through on its interest rate projections, something which it failed to do in 2016**. The next rate hike is expected over the summer months, possibly as early as June. Of course, the extent of further rate increases remains data dependent. **Market reaction to the Fed meeting suggests some surprise that its near term interest rate guidance was not revised higher.** The dollar weakened slightly, with EUR/USD regaining the $1.07 level, while US stocks and bonds rallied.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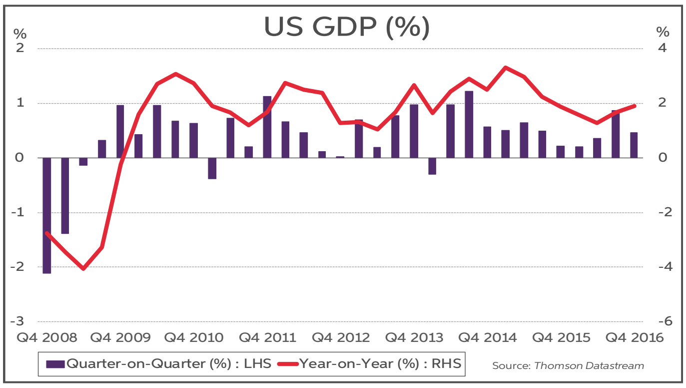
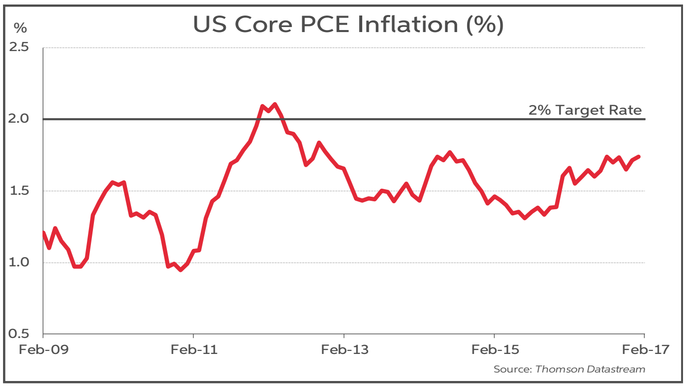
# Solid growth, tighter labour market




**The pace of annualised growth in the US slowed in Q4, from 3.5% to 1.9%. Although, this 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 2.6% in Q4, from 2.1%. It rose by 2.4% in Q2. Thus, the underlying growth rate in the US has been very stable recently.

**Leading indicators of activity have picked up in the first quarter of 2017.** For example, the non-manufacturing ISM rose further in February, hitting a 16-month high of 57.6, while the manufacturing index hit a 30-month high of 57.7 in the same month. Although, the rise in the Composite PMI has been less pronounced. It averaged 54.9 in January/February, only a slight improvement on Q4's 54.5 average.

In terms of the 'hard' data, the 'control' measure of retail sales, which is seen as a good proxy for the goods consumption component of GDP, rose by a strong 1.2% in Jan/Feb, after increasing by 0.9% in Q4. Although, **real personal consumption declined by 0.3% in January.** Meantime, **industrial production also declined by 0.3% in January,** though this followed on from December's strong 0.6% rise. The data were impacted by warmer than usual weather in January, which weighed on the 'utilities' sector. US temperatures stayed warm in February. Overall, US GDP growth could remain below 2% in Q1.




**Meanwhile, the labour market has been generally firmer in Q1.** Non-farm payrolls grew by an average of 237k in Jan/Feb, a marked improvement on Q4's average monthly increase of 148k. The unemployment rate edged back down to 4.7% in February. Labour market surveys (i.e. Conference Board, NFIB) point to a tightening jobs market and the potential for a further decline in the unemployment rate.

**There are some signs that US wage growth is increasing.** While year-on-year growth in the 'wages' component of the Employment Cost Index, the Fed's preferred earnings measure, slowed to 2.3% in Q4, from 2.4%, timelier weekly earnings data for February show growth rose to 2.8%. The oft-cited Atlanta Fed wage measure came in at 3.2% in January.

**Meantime, headline CPI inflation remains on an upward trend, rising to 2.5% in January, its highest level since March 2012.** It has been boosted by higher oil prices. Although, the Fed's preferred measure of price pressures, core-PCE inflation, has held in a 1.6-1.7% range since the start of last year, remaining below its 2% target. The most recent Fed projections show that it does not expect inflation to reach its target until 2018.

**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 has estimated that his proposals could boost GDP by around 1% in total. The continued improvement in the labour market will be helpful to the key consumer side of the economy. **However, the economy still faces 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. Nonetheless, the most recent IMF forecasts show that it expects the US economy to record good growth of 2.3% this year, before increasing by 2.5% in 2018.



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