Fed Watch

AIB Treasury Economic Research Unit

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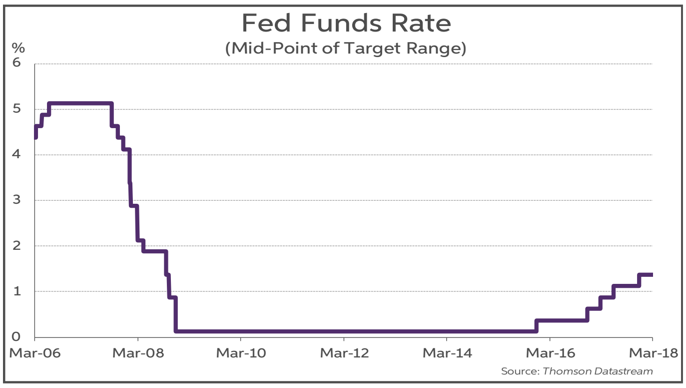
Fed to continue on rate hiking path

The March Federal Reserve monetary policy (FOMC) meeting saw rates hiked by 25bps as expected, with the target range for the key fed funds rate raised to 1.5-1.75%. The decision to raise rates by 25bps was unanimous. It represented the sixth 25bps rate hike in this cycle. **The Fed maintained its guidance that two further 25bps increases were likely over the remainder of the year,** which would take the fed funds rate up to a 2.0-2.25% range by end 2018.

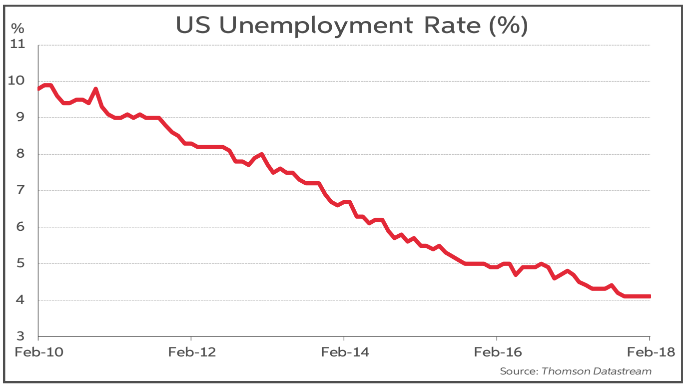
There had been speculation that the Fed might signal that one additional rate hike was likely in 2018, giving four in total this year. It came very close to doing so, with only one more FOMC member needed to flip to four hikes in 2018 for the median projection to move.



The Fed, though, did raise the projected number of rate hikes in 2019 from two to three. It now sees rates increasing to 3.375% by end 2020 compared to 3.06% previously. Thus, it expects to deliver seven further 25bps rate hikes over the next couple of years.

Markets have more than fully priced in two further 25bps rate hikes for this year. However they are at odds with the Fed in terms of the likely path of interest rates in 2019 and 2020. They expect just two rate hikes over these two years, taking the fed funds up to a 2.5-2.75% range by end 2020, whereas the Fed is projecting five rate hikes that would bring official rates up to a 3.25-3.5% range**.**

How this difference gets resolved will have a crucial bearing on financial markets in the next couple of years. **Significant further upward pressure on US bond yields can be expected if the Fed sticks to its projected rate hike path,** with spill-over effects likely on stock markets. In particular, support for ten year Treasuries at the 3% yield level can be expected to give way, with a further marked flattening of the yield curve also.



The reasoning behind the Fed's belief that there is a significant way to go in the rate tightening process can be traced to its upbeat assessment of the prospects for the US economy. The new Fed Chairman, Jay Powell, has been making optimistic noises about the US economy recently as activity picks up both at home and abroad and US fiscal policy turns even more expansionary.

Yesterday's meeting saw the Fed upgrade its forecasts for the US economy, with stronger growth, higher inflation and lower unemployment now being predicted. The Fed now expects US GDP to grow by 2.8% this year, 2.4% in 2019 and 2% in 2020 (Q4 over Q4). The unemployment rate is predicted to drop to circa 3.5%, with core PCE inflation picking up to 2% and headline inflation rising above this level.

Market reaction to the Fed meeting was muted enough, with just limited movements in both bond and stock markets. There was, no doubt, some relief that the Fed did not raise its rate projection for 2018. The dollar did weaken, but this largely reflected growing concerns about a possible trade war between the US and China.

Bond markets have become quite range bound in recent weeks after the sharp upward move in yields at the start of the year. Ten year Treasury yields have been confined to a 2.8-2.95% range since early February. We expect this range to hold in the near term. However, ten year yields can be expected to rise above the crucial 3% support level later this year if markets begin to price in additional rate tightening for either 2018 or 2019-2020.

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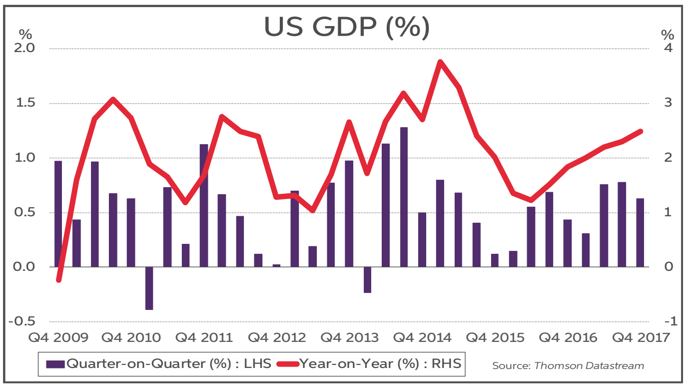
Growth forecast to remain strong in the US

US annualised growth slowed to 2.5% in Q4, from 3.2% in Q3. The economy did grow by 2.3% in 2017 though, an improvement on 2016's soft 1.5% rate. The underlying data showed that much of the slowdown in Q4 was due to a strong drag from net trade. Indeed, final sales to domestic purchasers (GDP ex. trade and inventories) rose by 4.3% in Q4, its strongest rate since Q3 2014, showing that despite slower headline growth, underlying economic activity strengthened, including strong performances from consumer spending and business investment.

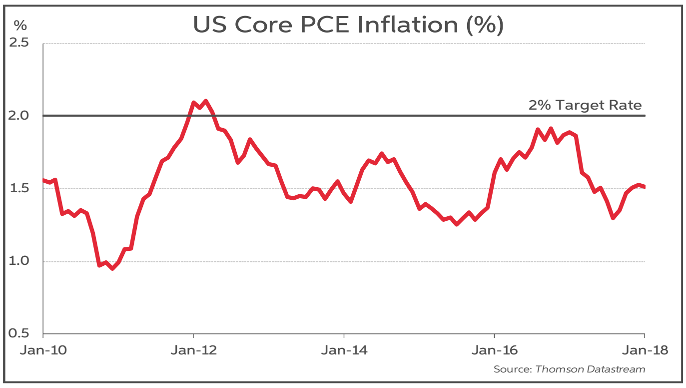


Survey data on the economy have been upbeat in the first quarter of 2018. The manufacturing ISM averaged 60 in January/February, compared to 58.7 in Q4 2017. The key non-manufacturing index (c.80% of GDP) also improved, recording 59.7 in Jan/Feb compared to Q4's 57.7. The Markit composite PMI, which has tended to be a better leading indicator of growth, has pointed to a more modest improvement (54.9 vs. 54.4).

However, hard data for Q1 2018 have been less buoyant. For example, industrial production grew by 0.7% in Jan/Feb versus Q4 2017, in which it grew by a very strong 1.7%. Some of the slowdown reflects the warmer than usual weather in the first quarter, dragging on the utilities sector. On the consumer side of the economy, the 'control' retail sales measure (ex-gas, autos and building materials), which is seen as a good proxy for the goods component of consumer spending in the GDP data, rose by just 0.2% in Jan/Feb versus 1.9% in Q4'17. Indeed, overall consumer spending recorded a modest decline in January after surging ahead in Q4 2017.

Labour market data, though, have been very strong in Q1. Employment grew by 242k in February, a third consecutive 200k+ increase. At the same time, year-on-year growth in the labour force has increased, rising to a 15-month high of 1.2% in February as participation rises with more people being enticed back into the buoyant jobs market. This has seen the unemployment rate hold at a 17-year low of 4.1%. **Despite this, wage growth has remained modest.** Annual growth in average hourly earnings has been confined to a 2.3-2.8% range since Q3 2015, coming in at 2.6% in February. The Fed's preferred measure of compensation growth, the 'wages & salaries' component of the Employment Cost Index remained at 2.5% in Q4.

Headline CPI inflation has settled at just above 2% in recent months. Core inflation (ex. food and energy) has been stuck in a tight 1.7-1.8% range since May. The Fed's preferred measure of price pressures, core-PCE inflation held at 1.5% in January, still well below the Fed's 2% target level.



Overall, the outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption should remain robust. The global economy has strengthened while the dollar has declined over the past year, which will help US exports. Meantime, despite the rate hikes, the Fed's monetary policy remains accommodative. At the same time, the raft of tax cuts passed by the US Congress at the end of last year should provide a fillip to growth in the next couple of years. **The IMF estimates that the fiscal stimulus will provide a cumulative 1.2% boost to growth by end 2020.** The IMF is now expecting growth in 2018 of 2.7% (was 2.3% previously) and 2.5% in 2019 (was 1.9%). The Fed has also upgraded its growth forecasts to similar levels. Although the medium term risks for the economy may be rising, strong growth looks set to continue in 2018-19, which would make this the longest US economic expansion on record.

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