Fed Watch

AIB Treasury Economic Research Unit

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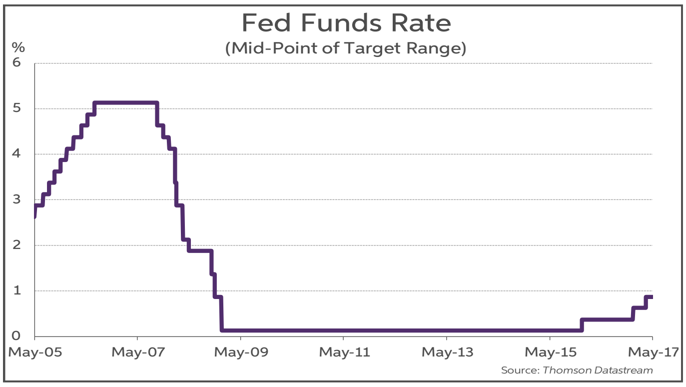
Fed keeping its options open for a June hike

The May meeting of the US Federal Reserve concluded in line with market expectations with no changes to monetary policy. The Central Bank maintained the target range for the federal funds at 0.75-1.0%. The decision to leave rates unchanged was unanimous.

Given that there was no press conference or updated macro projections, the focus was on the meeting statement. The text of the statement contained no major surprises. The Fed did acknowledge weakness in economic growth in the first quarter. Although, it downplayed this to a large extent, commenting that it "**views the slowing in growth during the first quarter as likely to be transitory".**

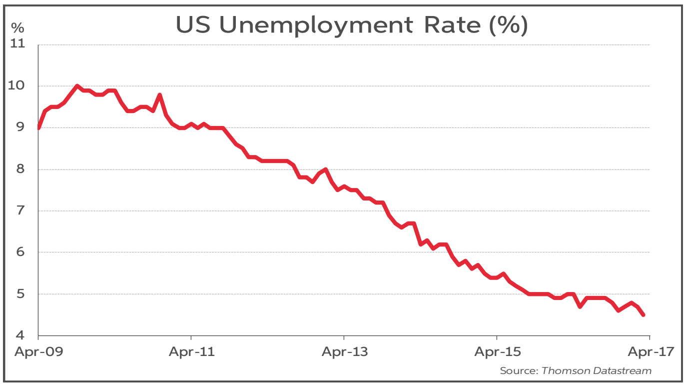


It noted that while consumer spending increased "only modestly", the "**fundamentals underpinning the continued growth of consumption remained solid**". The Fed also stated that inflation "has been running close to the Committee's 2 percent longer run objective".

In terms of the economic outlook, the Fed remains of the view that the near term risks for the US economy are "roughly balanced". It continues to expect the economy to expand at a "moderate pace", with further strengthening in the labour market and inflation stabilising near "2 percent over the medium term" against a backdrop of "gradual" tightening in monetary policy.

The most recent set of projections on the likely path of interest rates were released at the March FOMC. Despite some speculation in the lead up to that meeting, the Fed refrained from making any significant changes to its projections. In fact, the median projection for end-2017 remained at 1.38% and at 2.17% for end-2018, consistent with three rate hikes per annum over this period. The only change was that the FOMC revised slightly higher its 2019 projection, from 2.88% to 3%.

The Fed is still guiding a more aggressive pace of rate increases than the market is expecting. Current futures pricing indicates that the market is looking for rates to rise to just under 2% by end-2019. Thus, the market is factoring in only four more 25bps hikes between now and end-2019, compared to eight to nine by the Fed.



Overall, the May FOMC meeting showed that the Fed is keeping its options open regarding the timing of its next rate hike. The fact that it indicated that it was looking through the slowdown in Q1 and focusing on the solid fundamentals underpinning the economy means that **a rate hike at its next meeting in June is a strong possibility**. Therefore, very close attention will be paid to FOMC member speeches, especially Chair Janet Yellen (speaking this Friday), over the coming weeks for signs that the Fed could hike in June.

It is also important to bear in mind that policy tightening from the Fed could also arise from the Central Bank starting to gradually reduce down the size of its balance sheet, something which may occur towards the end of this year. Thus, we could see a further rate hike in September, with the unwinding of QE beginning in December.

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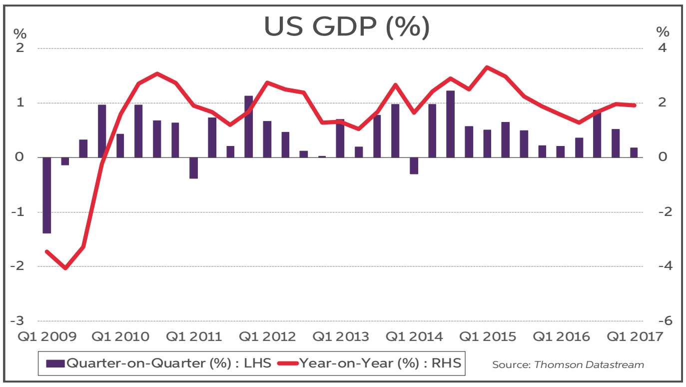
Slowdown in growth expected to prove temporary

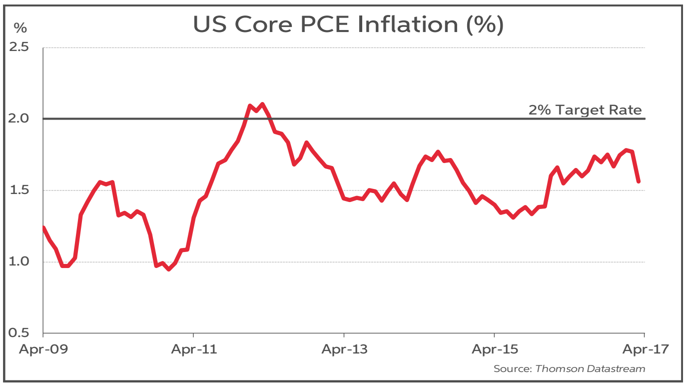
US annualised growth slowed further in Q1, from an already soft 2.1% to just 0.7%, its weakest performance since Q1 2014. However, **there appears to be an issue with the seasonal adjustment of the figures,** which has given an overly negative view of growth in the first quarter for the last number of years. Although, temporary factors such as unseasonably warm weather in the US at the start of the year, the later timing of Easter and delayed tax refunds did have negative impacts on GDP in Q1.



The underlying Q1 GDP figures suggest that a marked weakening in consumption was the primary cause of the overall slowdown. It added just 0.2 percentage points to annualised growth in the quarter, compared to 2.4 p.p. in Q4 2016. A sharp decline in motor sales as well as weak spending on services, including on utilities (impacted by unseasonably mild weather) were important drags on household spending. Net exports were broadly flat in the first quarter, while inventories deducted 0.9 p.p. Although, an improvement in business investment (+1.1 p.p. from +0.1 p.p.) was a positive development. A key part of this performance was a rebound in investment in oil extraction.

Despite the marked slowdown in growth in Q1, the labour market firmed. Non-farm payrolls grew by an average of 178k in the quarter, an improvement on Q4's average monthly increase of 148k. The unemployment rate edged back down to 4.5% in March, its lowest level in 10 years.

Meantime, **US wage growth also improved slightly during Q1.** Year-on-year growth in the 'wages' component of the Employment Cost Index, the Fed's preferred earnings measure, edged up to 2.4%, from 2.3%. Average hourly earnings remained solid with growth of 2.7%, the same as in Q4. The oft-cited Atlanta Fed national wage tracker rose to 3.4% in March, from 3.2%.



At the same time, **headline CPI inflation increased during Q1, averaging 2.5%** compared to 1.8% in Q4. This largely reflects higher oil prices. The Fed's preferred measure of price pressures, core-PCE inflation, remained at 1.7% year-on-year for a third consecutive quarter in Q1, remaining below its 2% target.

Timelier leading indicators of activity for April have been mixed. The Markit manufacturing PMI slowed further (52.8 vs Q1 avg 54.2), suggesting the sector started Q2 on a slightly weaker footing. Likewise, the services sector PMI edged down to 53.1, below its Q1 average of 54.1. The non-manufacturing and manufacturing ISM indices, which have tended to overstate the performance of the US economy of late, both remained at strong levels in April.

Overall, the outlook for the US economy remains positive. The economy is expected to regain momentum after the slowdown in GDP growth in Q1. The continued improvement in the labour market will be helpful to the key consumer side of the economy. **President Trump's proposed expansionary fiscal policies should provide a boost over the medium-term,** though it seems unlikely that Congress will be willing to support all of his proposals. **However, the economy still faces some headwinds.** These include the stronger dollar, the potential for any fiscal stimulus to lead to a more rapid pace of monetary policy tightening and some political uncertainty, with the new President retaining protectionist views on trade. It also remains to be seen if the improvement in business investment seen in Q1 will prove to be sustained. **Nonetheless, the most recent IMF forecasts show that it expects US growth of 2.3% in 2017 and 2.5% in 2018.**

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