Fed Watch

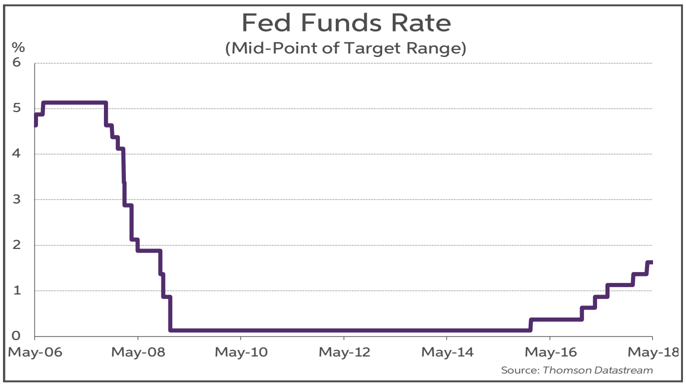
AIB Treasury Economic Research Unit

3rd May 2018

Next Fed rate hike set for June, with more to follow

The May Federal Reserve monetary policy (FOMC) meeting concluded as expected, with no changes to rates. Thus, the target range for the key fed funds rate was kept at 1.5-1.75%, having being hiked by 25bps at the previous FOMC meeting in March. At that meeting, 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. **The market has fully discounted that the next rate hike will come at the June FOMC meeting.**

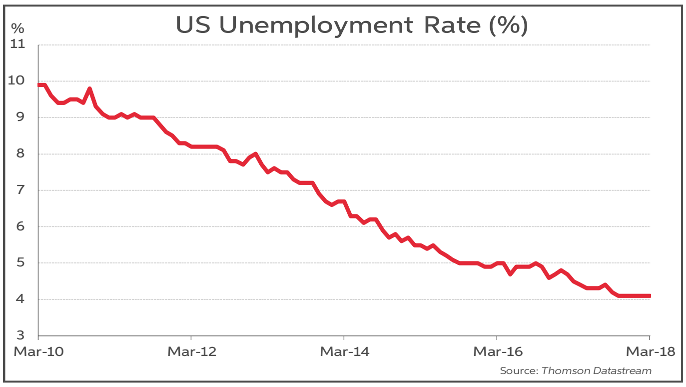
There is growing speculation that the Fed will actually deliver two rate hikes rather than one in the second half of 2018, giving four in total for the year. The market has moved in recent weeks to start to price in such a possibility. Fed futures contracts are currently pricing in about a 50% chance of a fourth rate hike in 2018.



The Fed does not provide any updated macro-economic and interest rate projections at its May meetings. Thus, **market attention was focused on the FOMC's post-meeting policy statement for any new policy insights.** However, there was little change, although the Fed did note that inflation has moved close to 2%, while stating that this target is symmetric. This suggests that Fed policy won't be greatly impacted if inflation moves slightly above 2%.

While a lot of attention has been focused on the number of rate hikes in 2018, **the main source of uncertainty is in regard to the path of interest rates in 2019 and 2020. The market is completely at odds with the Fed's view in this regard.**

The market is only pricing in between one and two rate hikes in total over the 2019-2020 period. This would take the mid-point of the fed funds target range up to around 2.65% by end 2020. **By contrast, the Fed is projecting five rate hikes for 2019-2020.** This would bring the mid-point for the target range for official rates up near 3.4%, which is 75bps above the level expected by the market.



How this difference gets resolved will have a crucial bearing on financial markets in the next year. **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 flattening of the yield curve also.

The reason for the Fed's belief that there is a significant way to go in the rate tightening process is its upbeat assessment of the outlook for the US economy. The Fed expects US GDP to grow by 2.8% this year, 2.4% in 2019 and 2% in 2020 (Q4 over Q4), no doubt helped by the recent loosening of fiscal policy. The unemployment rate is predicted to drop to 3.5%, with core PCE inflation picking up to 2% and headline inflation rising above this level.

By contrast, it would seem that the market believes that US growth will slow to less than 2% over the next couple of years, as the impact of the fiscal stimulus wanes and higher interest rates start to weigh on the pace of activity**. The market obviously also expects inflation to remain subdued**.

In our view, **the market may have not discounted enough Fed tightening in 2019 in particular,** as we don't see the US economy slowing much anytime soon, given the looseness of both fiscal and monetary policy. We also see wage pressures starting to build given the very tight labour market. Thus, **we expect rate tightening to be maintained at a significant pace in 2019 in particular, with official rates getting to 3% or above in this cycle.**

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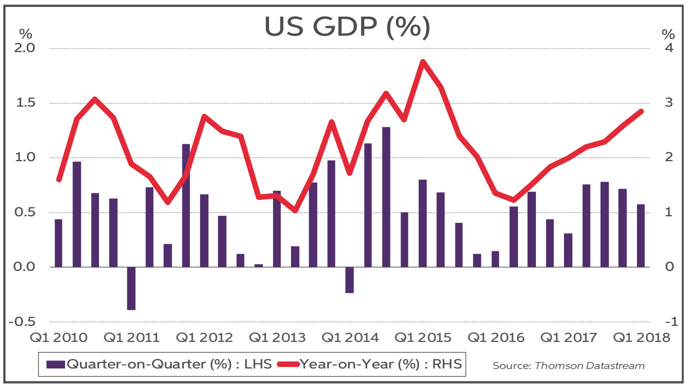
Annual growth rate rises to near 3%

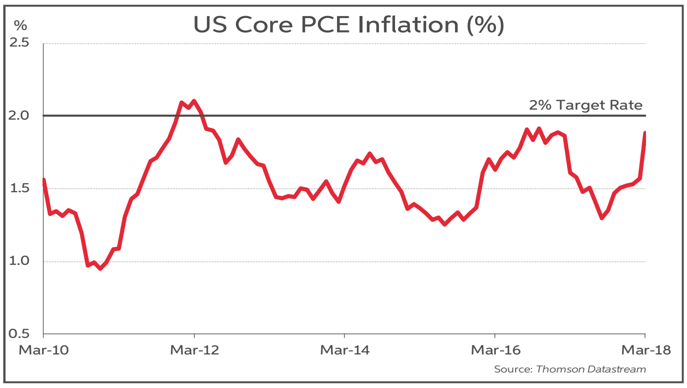


US annualised growth slowed somewhat to 2.3% in Q1, from 2.9% in Q4 2017. Overall though, the economy has grown at a steady pace of between 2.3-3.2% for the past four quarters. Meanwhile, the year-on-year growth rate in Q1 picked up to 2.9%, its strongest level since Q2 2015.

The main factor behind the more modest pace of growth in Q1 was slower consumer spending. The sector recorded very strong growth of 4% (annualised) in Q4 2017, so some slowdown in Q1 was always likely. Consumers had to up their spending in Q4 to replace goods, such as cars, which were damaged or destroyed in some extreme weather in the quarter. **Personal consumption added only 0.7 percentage points (p.p.) to Q1 GDP, compared to 2.8 in Q4.** In terms of the other main GDP components, net trade proved a modest support to growth, adding 0.2 p.p., while government spending (+0.2 p.p.) and business investment (+0.8 p.p.) were also positive. Overall then, the Q1 data show that the US economy continued to grow at a healthy rate.

Labour market data remained solid in Q1. Non-farm payrolls recorded average monthly growth of 202k in the quarter, though this was slightly below Q4 2017's 221k average. A larger average monthly increase in the size of the labour force (389k) meant that the unemployment rate held at 4.1% throughout Q1. Overall, the indications are that the US jobs market remains in robust health.

However, **wage growth has remained modest.** Year-on-year growth in average hourly earnings has held in the 2.3-2.8% range it has occupied since Q3 2015, coming in at 2.7% in March. The Fed's preferred measure of compensation growth, the 'wages & salaries' component of the Employment Cost Index edged up slightly to 2.7% in Q1, from 2.6% in Q4 2017. Leading indicators of wage pressures, such as the NFIB 'jobs hard to fill' index, suggest that wage growth may accelerate. The index averaged 34.3 in Q1, its strongest quarterly rate since records began in 1975. Competition between employers for workers may soon start to drive up wages.



Meantime, **the Fed's preferred inflation rate measure, core-PCE prices, rose to 1.9% in March,** a one year high. There are indications that price pressures are still building, meaning that inflation could rise above the Fed's 2% target in the coming months.

Survey data for April suggest the economy has continued to grow at a solid pace. The ISM manufacturing index came in at 57.3, a high level. The Markit Composite PMI at 54.8 was in line with Q1's 54.7 average. April consumer confidence data also remained very strong.

Overall, the outlook for the economy remains positive. Business and consumer surveys suggest investment and consumption should remain robust. Meantime, despite recent interest rate rises, US monetary policy remains accommodative. At the same time, the raft of tax cuts passed by Congress at the end of last year should provide a fillip to growth in the next couple of years. **The recent IMF forecasts are for strong US GDP growth of 2.9% in 2018 and 2.7% in 2019.**

Although, there are also some risks to the economy. **The fiscal stimulus will likely boost demand for imports, further widening the US trade deficit.** It will also increase the size of the budget deficit and, thus, add to upward pressure on US Treasury yields, increasing borrowing costs. On-going uncertainty related to the Trump Administration's protectionist trade policies also remain a risk factor.