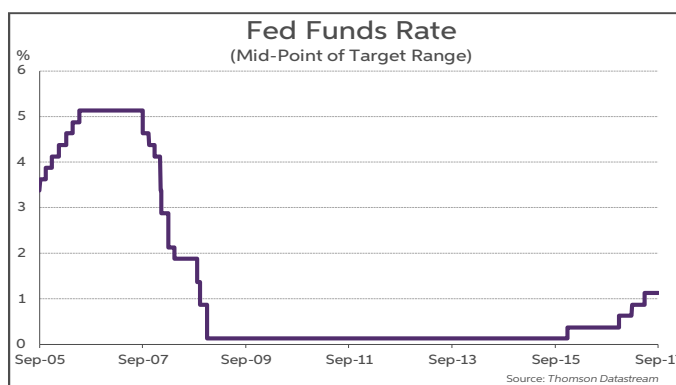


## Fed remains hawkish on interest rates

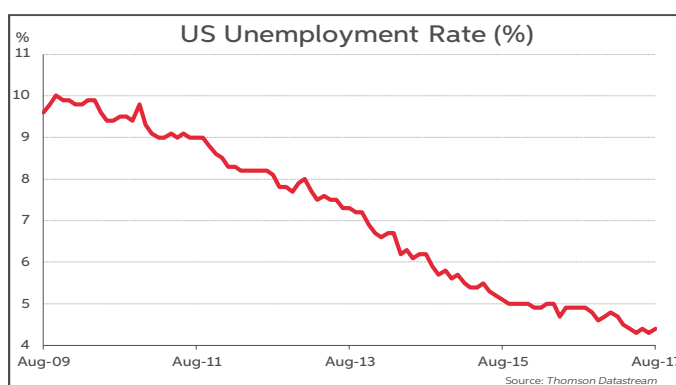
The Federal Reserve announced following yesterday's meeting that it would begin the process of balance sheet reduction, or 'quantitative tapering' (QT), next month. At the same time, it decided to leave the target range for the fed funds rate unchanged at 1-1.25%. Both of these policy decisions were in line with market expectations.

The balance sheet 'normalisation' announcement had been well flagged to markets by the Fed. Up until this point, the Fed has been reinvesting funds as bonds it held matured, keeping the size of its balance sheet constant at \$4.5 trillion. **From October the Fed will allow its balance sheet to decline in size by up to \$10bn per month.** This upper limit, or 'cap', is scheduled to be increased over time, rising to \$50bn within 12 months. **Fed Chair Yellen stated in her post-meeting press conference that the Fed does "not plan on making adjustments to [its] balance sheet normalization program".** Although, "the Committee would be prepared to resume reinvestments" in the event of "a material deterioration in the economic outlook".



**Yesterday's meeting also provided an updated suite of FOMC economic projections.** On growth, the Committee noted that "economic activity has been rising moderately". They also said, in relation to the recent extreme weather conditions in parts of the US, that "past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term". The GDP growth forecast for this year was revised up slightly to 2.4% from 2.2%. The growth projection for 2018 remained at 2.1%, while the 2019 forecast was revised up slightly to 2% (was 1.9%). The Fed also provided a forecast for 2020 for the first time, with GDP expected to rise by 1.8%. Meanwhile, **not surprisingly given the subdued inflation data in recent months, core PCE inflation is expected to average 1.5% in 2017 (was 1.7%), 1.9% in 2018 (2%), before holding around its 2% target rate in 2019 and 2020.**

**On the issue of interest rates, the Fed's latest projections were little changed compared to June. The FOMC is still suggesting that we will see one more hike this year.** It continues to expect three more hike in 2018, bringing rates to 2.125%. It has revised down its outlook slightly for 2019, expecting rates to finish the year at 2.75%, as opposed to the 3% indicated back in June. It is projecting rates to edge up to 2.875% in 2020.



**The market remains sceptical about the extent of rate hikes from the Fed over the next 2-3 years. Futures contracts continue to indicate that the market is expecting a less aggressive path of rate hikes than the Fed is guiding.**

The next rate hike is not being fully priced in until March 2018, while rates are only seen rising to around 1.75% by end 2019.

**Overall, the Fed meeting was more hawkish than some market participants may have been expecting.** By sticking to its guns with regard to a rate hike this year, whilst teeing markets up for a steady pace of increases in the fed funds rate in the coming years, the Fed is highlighting its hawkish resolve. This provided some support to the dollar and saw some further upside pressure on US bond yields.

**If the Fed follows through with its indicated policy tightening programme, and the US data continue to point to solid growth, then sooner or later markets may have to move towards the FOMC's way of thinking.** Given the scale of the margin between the Fed's view on rates and that of markets, such a shift in perceptions could see the dollar find the support it has lacked for most of this year, bond yields could rise further, while elevated US stock markets may see a downward correction.

## US economy remains solid

US annualised growth picked up to 3% in Q2, its best performance since Q1'15. This largely reflects a stronger performance by consumer spending, which added 2.3 percentage points (p.p.). The sector was aided by a rebound in motor vehicle and clothing sales after declines in Q1. The contribution from inventories was flat, after they deducted 1.5 p.p. in Q1. Business investment remained solid (+0.85 p.p.), while net exports were also positive (+0.2 p.p.).

**Indicators for Q3 have generally suggested that the economy may slow somewhat compared to Q2, while still growing at a solid pace.**

The Markit composite PMI averaged 55.1 in July/August, an improvement on Q2's 53.2 performance. The ISM indices have remained at strong levels. Although, the non-manufacturing ISM (roughly 80% of US economy) averaged 54.6 in July/August compared to 57.3 in Q2. The manufacturing ISM did improve though, averaging 57.6 versus 55.8 in the first quarter.

**Hard data measures have suggested continued, though more moderate, growth.** For example, the control measures of retail sales (seen as a good proxy for goods consumption in GDP) grew by 0.3% in July/Aug, compared to the more robust 1% pick-up seen in Q2. Real personal consumption recorded a modest 0.2% rise in July, following on from +0.8% in Q2. Meantime, industrial production grew by just 0.1% in July/Aug compared to Q2's strong 1.4% increase.

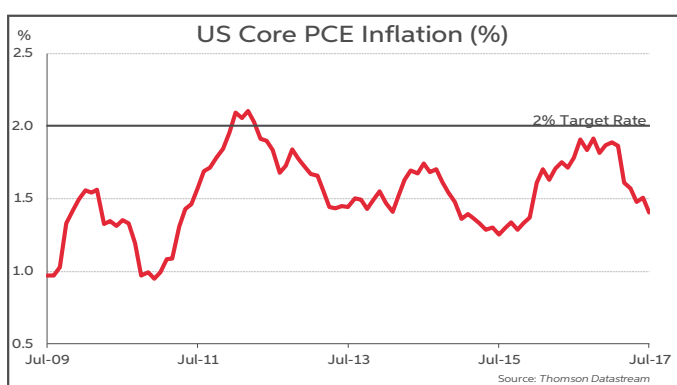
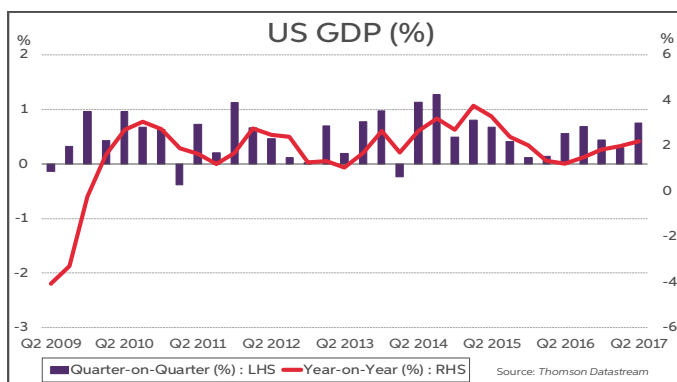
Meanwhile, **labour market data have remained encouraging overall.** Non-farm payrolls averaged +173k in July/Aug, close to Q2's 187k average. The unemployment rate edged back up to 4.4% in August, from July's 16-year low of 4.3%. This is partly explained by a rise in the labour force.

Despite a tighter labour market, **US average hourly earnings growth has been stuck at 2.5% since April.** Although, the Atlanta Fed's national wage tracker, which controls for compositional changes in the jobs market, rose by 3.4% in the three months to August. The NFIB 'jobs hard to fill' index remains strong, at levels not seen since end 2000. The Conference Board labour market differential (jobs 'plentiful' minus jobs 'hard to get') rose to a 16-year high in August. These indicators suggest that we could see wages start to experience more sustained upward pressure as employers compete for workers.

CPI inflation remains well below its highs from the start of the year. Headline inflation edged up to 1.9% in August, from 1.7%. Core inflation (ex-food & energy) has remained at 1.7% since May. Meantime, **the Fed's preferred measure of price pressures, core-PCE inflation, has continued to slow, edging down to 1.4% in July, further below the 2% target rate.**

**Overall, the outlook for the US economy remains generally positive.** The data suggest the economy is growing at a solid pace. 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, Congress is unlikely to be willing to support all of his proposals. **The IMF recently revised down its US GDP forecasts 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.** Meantime, it also remains to be seen if the improvement in US business investment seen in H1 will prove to be sustained.



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