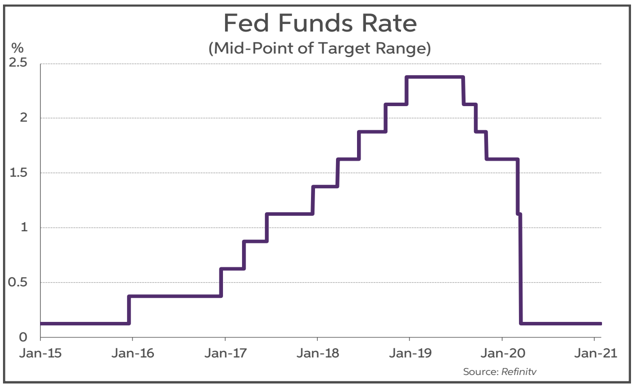
Fed Watch

AIB Treasury Economic Research Unit

28th January 2021

Fed content with current policy stance

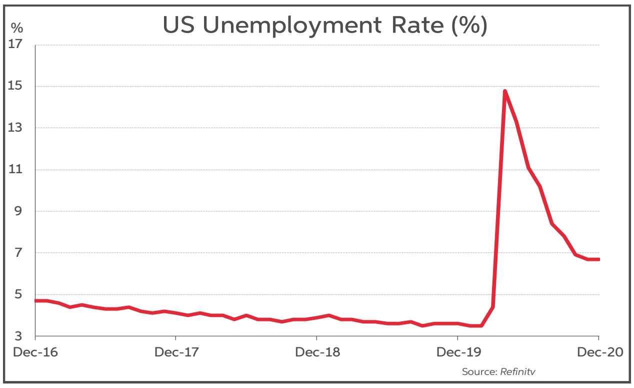
The first policy setting meeting of the US Federal Reserve for 2021 was uneventful with no changes made to monetary policy. This was in line with market expectations. The fed kept the funds rate in its target range of 0.00-0.25% and also continues to operate an open-ended asset purchase programme. There was unanimity within the FOMC on its decision to leave policy unaltered. **At its last meeting in December, the Fed did alter its forward guidance.** This was to align it with its new policy framework whereby it is stating that it will continue QE until significant progress has been made towards its "maximum employment and price stability objectives".



The meeting statement for January did contain some changes to the Fed's description of the economic backdrop to take account of the recent developments. It noted that the pace of the economic recovery had moderated in recent months, in terms of both activity and employment, while also acknowledging that this weakness has been, "concentrated in sectors most adversely impacted by the pandemic." The text also made reference for the first time to "progress on vaccinations" as being a key determinant on the path that the economy takes.

In terms of the economic outlook, in his remarks during the press conference, Fed Chair Powell espoused a cautiously optimistic view, while not downplaying the near term risks. He took comfort from the resilience the economy has shown since the summer. He noted the key role that widespread vaccinations would have on enabling a return to more normal economic activities. He also stated that fiscal policy would help to limit the lasting damage on the economy from the pandemic. **The Fed published its most recent forecasts at its previous meeting in December.** This update saw it revise slightly higher its GDP forecasts to take account of the fact that the recovery has progressed more quickly than it had previously anticipated. The Fed is anticipating growth of 4.2% y/y by the end of 2021 (was 4%), and 3.2% y/y by end 2022 (from 3%). For Q4 2023, it is forecasting growth of 2.4% y/y (previously 2.5%).

The most recent guidance from the Fed on its view of the likely path of future interest rates (i.e. the dot plot) was also released at its December meeting. The median projection was for no change in the fed funds rate through to end 2023. All 17 FOMC members expect that the current level of interest rates will be warranted until the end of 2021. Only one FOMC member believes that a rate hike will be required in 2022. Meanwhile, 12 members expect rates to remain on hold through to the end of 2023.



Futures contracts suggest that the market is expecting the first rate hike to occur around the middle of 2023. This would see the fed funds rate rising by 12.5bps to 0.25%. The futures market does not envisage rates rising to 0.5% until the first half of 2024.

In summary, the US Fed is content with the current usage and positioning of its various policy tools. There was nothing from the January meeting statement or press conference to suggest any changes to the Fed's expectation of maintaining an ultra accommodative monetary policy stance for quite some time. In the lead up the meeting, there had been some speculation in the market around the prospect of tapering of the Fed's QE. However, when questioned on the issue in the press conference, Fed Chair Powell stated that such talk is premature, and that the Fed wants to see substantial further progress towards its policy goals before it would consider modifying its guidance on asset purchases. **These comments suggest that tapering is some way off.** Given the lack of new developments from the Fed's January meeting, it had little impact on markets.

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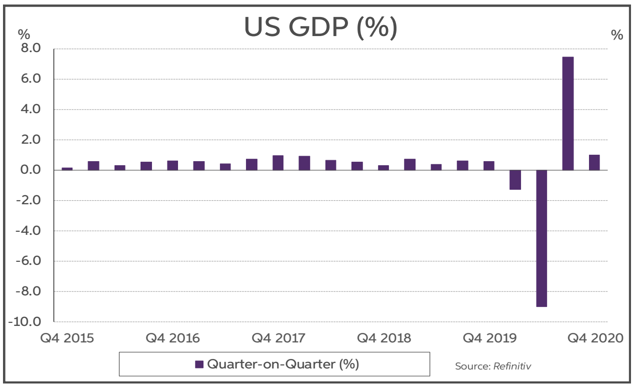
Economic rebound continued in Q4

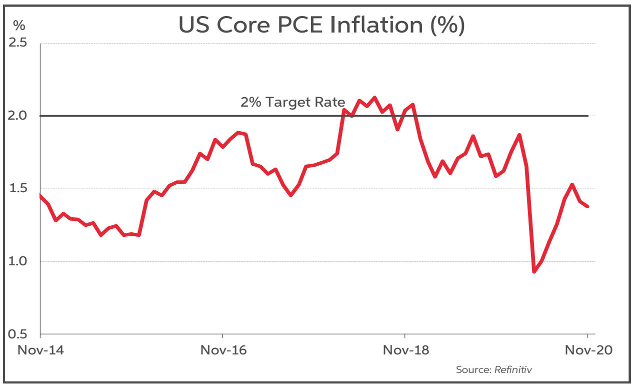
US GDP grew by an annualised growth rate of 4% in Q4, after a record 33.1% rebound in Q3. However, this in turn followed on from an unprecedented contraction of 31.9% in Q2, after a 5% fall in GDP in Q1. This all means that the US economy contracted by 3.5% in 2020, much less than was initially feared. However, the adverse impact of the pandemic has not been evenly distributed, with the service sector suffering more than the manufacturing. The labour market has also suffered a severe shock as a result of the pandemic.



With regard to the underlying breakdown, consumer spending rose by 2.5%, adding 1.7 percentage points (p.p) to GDP in Q4. Fixed investment increased by 18.4%, and added 3 p.p., while government expenditure subtracted 0.2 p.p. External trade subtracted 1.5 p.p. from growth, despite exports rising by 22% in Q4. However, this was partially offset by a 1.0 p.p. rise in inventories.

Meanwhile, the labour market recovery has stagnated. Payrolls fell in December for the first time since April. Although, the decline was much smaller than in the spring at 145k. Payrolls now stand at close to 9m below their pre-pandemic level, indicating that the recovery in the labour market still has a long way to go. The unemployment rate remained unchanged at 6.7% in December, having fallen from a peak of 14.7% in April. However, the downward trend in the unemployment rate masks the fact that there are now some 4.5m fewer people in the labour force, and at 6.7% the unemployment rate is almost double its 3.5% pre-pandemic rate.

In terms of price developments, CPI inflation has been subdued and relatively stable during the second half of 2020. Core CPI inflation has printed at either 1.6% or 1.7% YoY since July, while the headline rate has only been slightly more volatile, between 1-1.4% over the same period. The core-PCE deflator, the Fed's preferred measure of inflation has also been subdued, and was at 1.4% in November. Weak demand for services, and earlier declines in oil prices have been holding inflation down, although, these effects should reverse over the course of 2021, as the economic recovery gathers momentum. However, the Fed's latest projections see inflation staying subdued, with core-PCE expected to remain below the 2% inflation target until 2023.



The limited amount of available data for January have been mixed. The flash reading of both the services and manufacturing PMI moved higher than their December levels. They were also above their Q4 averages, with the services PMI at 57.5 vs. 56.9, while the manufacturing PMI was at 59.1 vs. 55.5. However, on the demand side, both the University of Michigan and Conference Board measures of consumer sentiment were below their average levels in Q4.

To surmise, the US economy experienced a deep shock in the first half of 2020 but rebounded strongly in the second half of the year. However, there are signs that the recovery is losing momentum, with the stagnation in the labour market of particular concern. It is by now clear that the jobs market will not recover fully until the pandemic is under control. Meanwhile, although, the number of new Covid-19 cases is falling again, it remains at a high level. The accompanying restrictions will continue to weigh on the recovery in the near term.

However, there are reasons for optimism. Highly effective vaccines have begun to be rolled out, which should allow for activity to pick up steam as savings are run down, once the economy reopens fully. The Fed has also reiterated that loose monetary policy will stay in place as long as inflation remains under control. A substantial third fiscal package worth up to $1.9trn is also on the cards, perhaps for March. The weakening of the dollar since last summer may also raise the competitiveness of US manufacturers abroad. The Fed's latest summary of economic projections envisage that GDP growth will be 4.2% y/y by Q4 '21. **Meanwhile, the IMF has recently revised upwards its forecast for US GDP this year, from 3.1% to 5.1%, reflecting the stronger than expected recovery since mid-2020, and the increased likelihood of a big fiscal stimulus package in 2021.**