Fed Watch

AIB Treasury Economic Research Unit

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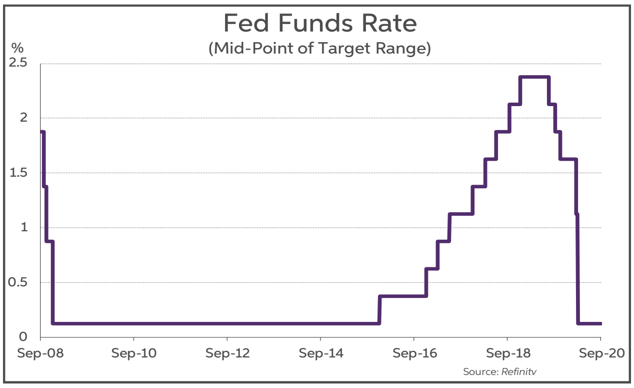
Fed confirms rates lower for longer

The Federal Open Market Committee (FOMC) meeting for September concluded, as expected, yesterday evening with no changes made to its interest rates or QE policy. The fed funds rate was kept in its target range of 0.00-0.25%, and it continues to operate an open ended programme of asset purchases.

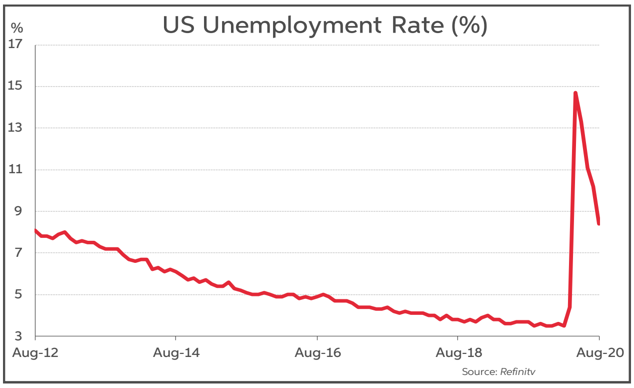


However, the Fed did update its forward guidance to reflect the recent significant changes to its policy framework whereby it has now adopted an average inflation targeting approach. The Fed has a dual mandate of maintaining stable prices while maximising employment. Going forward, it will now put greater emphasis on achieving its employment objective by allowing inflation move moderately above 2% for some time.

The meeting statement now incorporates this new framework into its forward guidance by outlining that it expects to maintain the fed funds rate at its current level until labour market conditions have reached levels consistent with its "assessment of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time". The Fed was careful to maintain flexibility in its meeting statement, as was Fed Chair Powell in the press conference by not quantifying or providing specifics about what "moderately exceeding 2% for some time" means. There were two dissenters to the updated guidance. Robert Kaplan preferred to retain "greater policy rate flexibility", while Neel Kashkari wanted the FOMC to not raise rates until "core inflation has reached 2% on a sustained basis".

The changes to the statement bring its policy guidance in line with the recent framework update, that rates are going to be maintained at their current very low levels for an even longer period of time, even if a robust recovery takes hold in the US economy and inflation rises somewhat above the 2% target. Indeed, interest rates could remain very low even when the economy has returned to full employment, provided inflation stays well behaved.

In this regard, we got an update into the FOMC's view on the likely path of future interest rates with the release of the updated "dot plot" of interest rate projections. All 17 members believe that that the current level of interest rates will be warranted until the end of 2021. The median projection for end 2022 is also for unchanged rates. Meanwhile, 13 participants also expect rates to remain on hold through to the end of 2023.



In terms of market expectations, futures contracts suggest that the first rate hike is not being priced in till late 2023, with the fed funds rate rising by 12.5bps to 0.25%. The market does not envisage rates rising to 0.5% until early 2025.

We also got the latest macro forecasts from the Fed last night. Compared to the June forecasts, GDP for 2020 is expected to fall by less than previously anticipated, due to better than expected incoming macro data. The Fed is now forecasting GDP to be down by 3.7% y/y in Q4'20 (was –6.5%). However, growth projections for end 2021 and end 2022 were revised lower to 4% (from 5.0%) and 3% (from 3.5%) respectively. Given the better near term growth expectations, the Fed also revised lower its unemployment rate, projecting it to now average 7.6% in Q4'20 (previous forecast was 9.3%), 5.5% in Q4'21 (from 6.5%) and 4.6% in Q4'22(from 5.5%)

Overall, the September FOMC meeting further solidifies the view that US interest rates will remain at their current low levels for even longer. The Fed is now more upbeat in its economic assessment though, and the market reaction to the meeting saw the dollar making some gains and bond yields moved higher.

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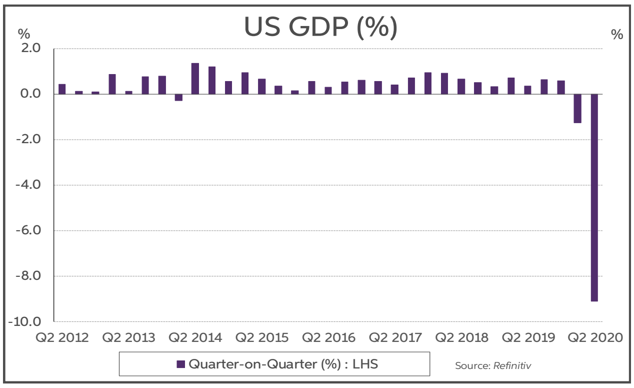
Rebound losing some steam

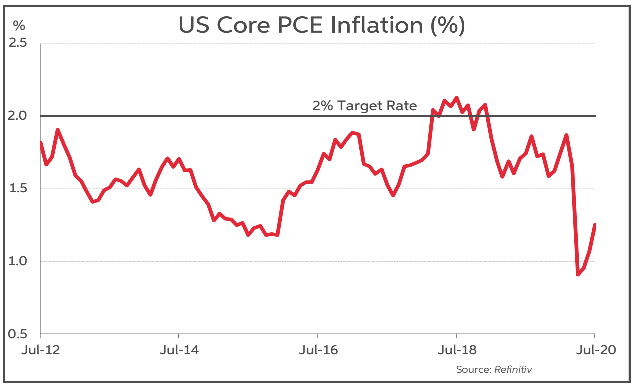
US GDP contracted by an unprecedented 31.7% in annualised terms in Q2 following a 5% drop in the opening quarter of the year. This left the year-on-year rate at –9.1%. The steep decline reflects the fact that the most severe "stay-at-home" orders were issued in March and April. While states began to open up in May and June, some were still hampered by ongoing restrictions. **Consumption, the largest component of US GDP, collapsed by 34.1% in the quarter.** This was led by a fall in spending on services, which fell by 43.1%. Business investment also contracted by 28.9%.



The hard data point to a marked rebound in growth in Q3, though it is losing some momentum as the quarter progresses. Headline retail sales rebounded strongly in June by 7.5%, and have since expanded by 1.2% in July, and 0.6% in August. Industrial production has also bounced back, although momentum has slowed here also, as output only increased by 0.4% in August, having grown by 5.4% and 3.0% in June and July.

Survey data though show the economy remains in expansionary mode. The composite PMI increased to 54.6 in August after reaching the key 50 mark a month earlier. Looking at the components separately, the manufacturing PMI rose to 53.6 in August, while the services PMI reached 54.8. The manufacturing and non-manufacturing ISM's have also remained strongly expansionary. On the demand side, the Conference Board measures of consumer confidence slipped backwards in August, although the University of Michigan measure moved higher. The housing sector has also performed strongly, with July's housing starts number just below 1.5m. NAHB homebuilder sentiment for August and September continued to move higher also.

Turning to the labour market, the unemployment rate fell to 8.4% in August, having peaked at 14.7% in April. Payrolls increased by 1.37m in August, boosted by delayed hiring by the government for the upcoming US census. However, payrolls still remain 11.5m lower than their pre-Covid peak. Continuing pandemic unemployment assistance claims reached a record 14.6m for the week ending the 22nd of August, the last week for which there is available data. All this suggests that labour market conditions remain soft, with the rebound in employment now slowing down.



Core-PCE, the Fed's preferred measure of inflation, rose to 1.3% in July from 1.1% in June, well below the Fed's 2% average inflation target. Core CPI for August, a more timely measure of inflation edged up to 1.7% from 1.6%. Both measures highlight that weak demand due to the Covid-19 crisis continues to act as a headwind for price growth. The Fed's updated projections see inflation remaining subdued, with core-PCE expected to remain below 2% until 2023.

In the short term, the outlook for the US economy remains clouded with uncertainty. Many sectors of the economy will not be able to run at full capacity until a vaccine is found. Wildfires in California and other states, will likely act as headwinds to the US economy. Congresses inability to date to pass a further stimulus package, and the withdrawal of enhanced jobless benefits will also result in a slower recovery. The Presidential election, is another source of uncertainty.

The latest economic projections by the Fed show GDP contracting by 3.7% YoY in Q4'20, a smaller decline than was originally expected. Looking further ahead, the Fed has revised downwards its projections for GDP in 2021 -22, but output is now expected to regain its pre-Covid level by the end of 2021. While substantial easing measures implemented by the Fed remain in place, the recovery still very much depends on continuing fiscal support. With Congress likely to remain in logjam until after the election, this may not arrive for some time. Meanwhile, continuing restrictions to control the spread of the virus remain a major headwind for the economy. The risks, then, for the economy remain to the downside.

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