Fed Watch
AIB Treasury Economic Research Unit

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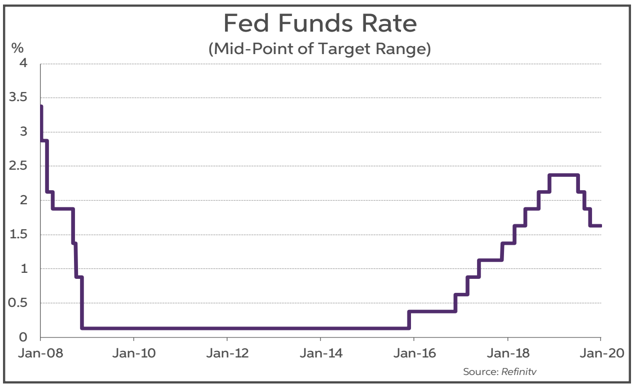
Fed on hold, but markets expect more rate cuts

The first meeting of the Federal Reserve Open Market Committee (FOMC) for 2020 concluded as expected on Wednesday with no changes made to policy. The target range for the key fed funds rate was maintained at 1.5-1.75%. Last year, the Fed reversed course on its policy stance, by implementing three rate cuts, totalling 75bps. The decision to leave policy unchanged in January was unanimous. Overall, the view of the Committee is that the "current stance of monetary policy is appropriate" to support the on-going expansion in the US economy and achieve its 2% inflation objective.

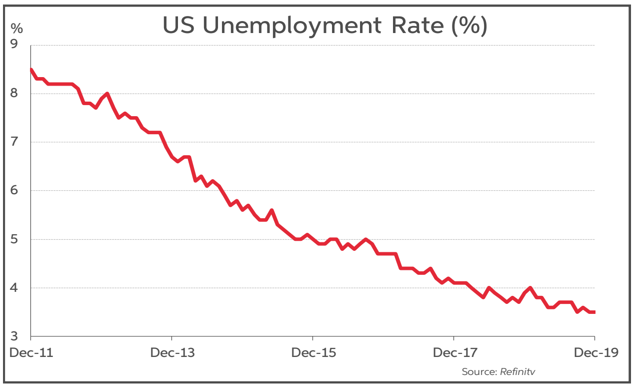


The FOMC statement contained very few changes from its December version, when the central bank also left policy unaltered. The Fed continues to state that the labour market "remains strong" and the economy is growing at a "moderate rate".

It did slightly downgrade its characterisation of household spending. It noted that it had been rising at a "moderate" pace rather than its previous description of a "strong" pace.

However, in the post meeting press conference, Fed Chair Powell commented that a "healthy jobs market, rising incomes and upbeat consumer confidence" means there remain "solid" fundamentals to support household expenditure. The Fed continues to acknowledge the weakness in business investment and exports. Chair Powell did state, though, that some of the factors weighing on these sectors, such as trade uncertainties and sluggish global growth have shown some signs of abating. In this regard, he referenced signs that global growth may be stabilising amid some easing in trade tensions after slowing since mid-2018.

The Fed's most recent update to its economic forecasts were released back in December. These showed that the central bank is expecting the economy to grow by 2.0% this year. Meanwhile, for 2021 and 2022, it is pencilling in growth of 1.9% and 1.8% respectively. **In other words, the Fed is envisaging close to trend growth for the US economy over the next three years.**



In terms of the inflation outlook, the Fed is forecasting core PCE of 1.9% this year. Further out, it is anticipating inflation to be at 2% in both 2021 and 2022, in line with its target.

Overall, similar to the message from its December meeting, the Fed again indicated that it does not envisage easing policy further as long as the incoming data remain consistent with its economic outlook. It appears satisfied that the three rate cuts it implemented in 2019 will be enough to sustain the economic expansion and help it achieve its 2% inflation target. Indeed, it is worth noting in this context that in its most recent set of interest rate projections (released in December), **no FOMC member believes that rates will be cut below their current level of 1.625%.** Instead, the Fed's projections indicate that it envisages rates remaining on hold this year.

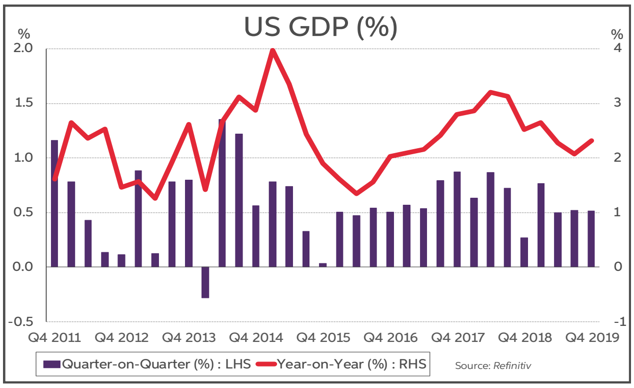
Meanwhile, it is guiding for a rate hike in both 2021 and 2022, which would see the feds fund rate at 2.125% by the end of the period. **The market, though, expects the next move from the Fed will be a rate cut this summer,** with futures contracts pricing in a further rate cut in 2021. This would almost certainly require a further weakening of growth in the US economy. Traders, then, would seem to have a much more pessimistic outlook for the economy than the Fed, despite the strong performance of the stock market over the past year.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Conor Beakey
Economist
conor.x.beakey@aib.ie

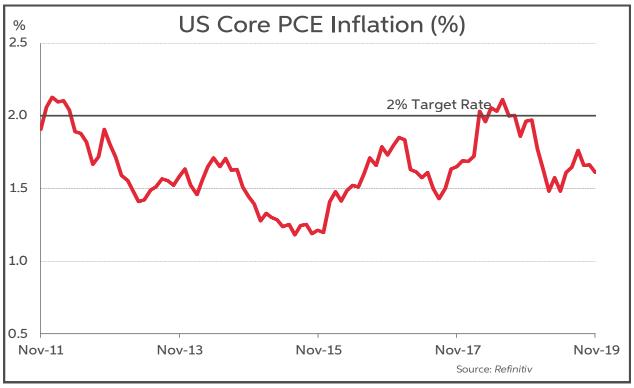
US economy continues to perform solidly



US GDP growth came in at 2.1% in annualised terms in Q4, unchanged from the previous quarter. In 2019, the economy expanded by 2.3%, which represents a moderation from 2018's 2.9% rate when growth was boosted by significant tax cuts.

With regard to the underlying breakdown in the quarter, consumer spending moderated, but remained strong and added 1.2 percentage points (p.p.). The trend in consumption had looked unsustainable and may have been linked to accelerated purchases ahead of the planned imposition of tariffs on Chinese consumer imports that have since been cancelled. In this regard, falling imports in Q4 aided net exports, which contributed a further 1.5 p.p. to growth. However, this was partially offset by a run down of inventories, which subtracted 1.1 p.p.. Meantime, government spending rose (+0.5 p.p.), while fixed investment was unchanged. It has declined or stagnated for three straight quarters.

Meanwhile, the labour market remains strong. Non-farm payrolls rose by 145k in December, which left the average monthly increase in 2019 at 176k. While this is down on 2018's average of 223k, given the late stage of the economic cycle it is still an impressive figure. Decent jobs growth has also seen the unemployment rate decline to a 50-year low of 3.5%. However, despite the tightness of labour market conditions, earnings growth has yet to accelerate. Indeed, in December wage inflation moderated to 2.9%, a 17 month low.



As a result, price pressures remain reasonably well contained. Indeed, the Fed's preferred measure, core-PCE, was recorded at just 1.6% in November. Although, base effects will likely see it pick up slightly in the first half of this year. In December, core CPI was registered at the higher rate of 2.3%, but the trend in the index appears steady at present. Meantime, the headline rate recently accelerated to 2.3%. Although, this mainly reflected the fading impact of lower energy prices.

In terms of the limited amount of data available for January, the indications are that the US economy is continuing to grow at a steady pace. The flash composite index came in at 53.1 in January, up from Q4's average of 51.9. The improvement was driven by an increase in the services PMI, with the manufacturing index edging down from 52.1 in Q4 to 51.7. On the demand side, the University of Michigan and Conference Board measures of consumer sentiment remain at elevated levels, suggesting that household spending will act as a ballast for growth again this year.

To surmise, the near-term outlook for the US economy remains positive. Growth has moderated since 2018 but this was to be expected as the boost from tax cuts waned. Overall, the economy remains well underpinned by the strength of the labour market which is aiding consumer spending. The Fed has also eased monetary policy to support activity. The housing market in particular is being helped by the fall in long term interest rates. Meanwhile, the signing of the 'phase-one' trade deal with China should help business confidence recover, which in turn may lead to a pick-up in investment. Although, tariffs do remain at an elevated level. **Overall, the Fed is projecting solid GDP growth of 2% in 2020 and 1.9% in 2021. These are broadly similar to the IMF's forecast for growth of 2% in 2020 and 1.7% in 2021.**

It should be noted that there are some downside risks to these projections. The protectionist stance of the current US administration means that the possibility of a renewed flare-up in trade tensions cannot be discounted. Heightened tensions in the Middle East are another possible source of worry. The loose stance of monetary policy also runs the risk of creating asset price bubbles in financial markets that could unwind quickly. On the political front, this year's elections will bear close watching and uncertainty surrounding the possible outcome could at times weigh on sentiment.