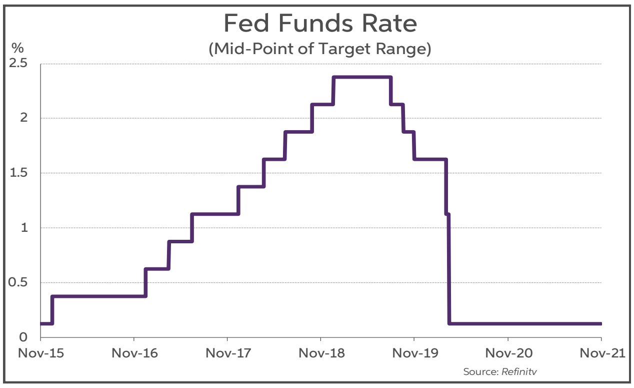
Fed Watch

AIB Treasury Economic Research Unit

4th November 2021

Fed, tapers QE but cautious tone on rate hikes

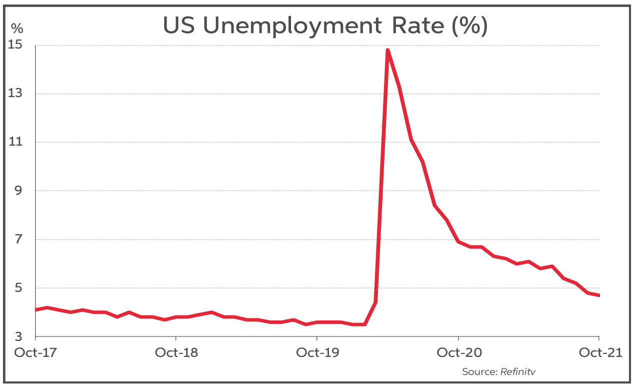
As expected, the November meeting of the US Federal Reserve saw the central bank announce a start to the tapering of its QE Programme. It will later this month, initially reduce its rate of monthly asset purchases by $15bn (incorporates a $10bn reduction in Treasuries purchases and $5bn in mortgage backed securities), leaving the new monthly total of QE purchases at $105bn. It also announced a further $15bn reduction in December, lowering the total pace of monthly QE purchases to $90bn. Meanwhile, in line with expectations, it kept the funds rate in its target range of 0.00-0.25%. There was unanimity within the Federal Open Market Committee (FOMC) on the policy announcements.



With the Fed having already well signposted QE tapering, a key focus for the market was on the FOMC's latest views on inflation and in turn what it implies for the interest rate outlook. In this regard, the meeting statement did show that the Fed was somewhat less confident in its view that the spike higher in inflation will prove temporary. It now states that while inflation is elevated, it largely reflects factors that "are expected to be transitory" whereas in the September statement it did not use the word "expected". However, the Fed also added to this month's text that imbalances between supply and demand linked to the pandemic and the re-opening of the economy have played a role in the notable price rises in certain sectors.

The most recent set of interest rate projections from the Fed were released at its last meeting in September. They illustrated the continuation of the trend of the Fed turning more hawkish on the rate outlook. The September 'dot plot' showed that half, or 9 of the 18 FOMC members, are of the view that a rate hike will be required in 2022, compared to 7 in June. Meanwhile, for 2023, all bar one (was five in June) FOMC member expected that rate hikes will be warranted. The median projection was for a small 12.5bps hike to 0.25% in 2022, while the FOMC sees rates rising to 1% by end 2023 and 1.75% at end 2024.

In terms of market expectations, futures contracts are pricing in a more aggressive pace of tightening compared to the Fed's September projections for the period 2022-23, but not in 2024. The market envisages a rate hike around the midpoint of next year, with a small rise of 0.125% being priced in. Additional rate hikes are expected in the second half of the year, bringing the Fed funds rate to 0.625% by end-2022. Markets are looking for rates to rise by a further 50-60bps in 2023, which would leave the funds rate near to 1.25%. However, the market anticipates the pace of rate increases to slow significantly in 2024, with futures contracts consistent with the funds rate at 1.5% by end-year. The Fed's own projection for end-2024 is 1.75%.



In the post meeting press conference, Fed Chair Powell was asked about his view on market expectations for rate hikes next year. In response he stated that the timing of any lifting in interest rates "will be dependent on the economy". He said that "we don't think it is time yet to raise interest rates" and that there is more improvement in the labour market required to reach its goal of maximum employment, but that this objective could perhaps be reached by late next year.

Overall, today's Fed meeting showed that the central bank is not contemplating any near term rate hikes. Chair Powell indicated that he believes the Fed will be patient in relation to interest rate increases, but that it will act if needed. It left its options open regarding lifting rates later next year. In this regard, the market will be paying close attention to the timing of the ending of QE. The Fed was non-committal last night beyond December on the pace of tapering. It had signalled previously that tapering could conclude around mid-2022.

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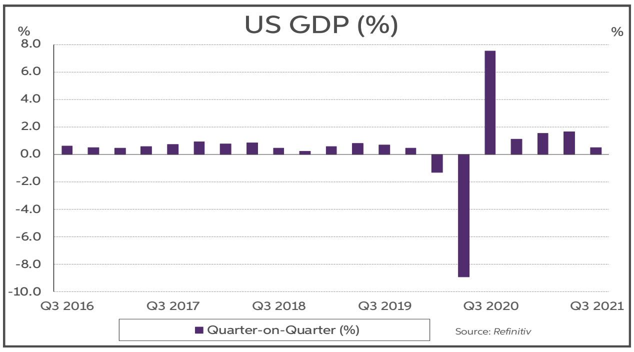
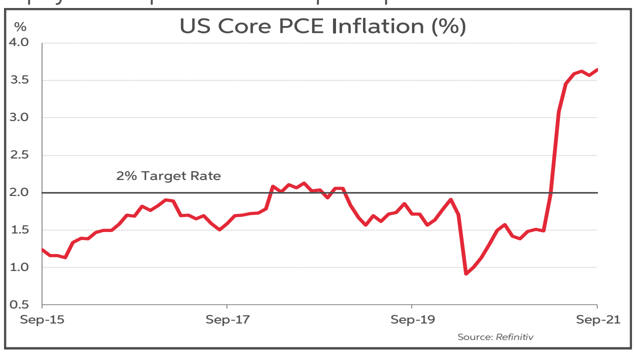
US economy grows more slowly in Q3

The pace of economic growth slowed considerably in the US in the third quarter. The economy expanded by 2% in annualised terms, as a surge in Covid-19 cases owing to the Delta variant, and widespread supply shortages weighed on activity. This follows growth of 6.7% and 6.3% in the first and second quarters. The rapid rebound in output in the first half of the year was supported by the quick paced vaccine rollout and substantial fiscal stimulus, which contributed to a surge in demand as restrictions were eased.



In terms of the underlying breakdown in Q3, the expansion continued to be led by a pick-up in consumer spending. Although consumer spending grew much more slowly in Q3 (+1.6%) then in Q2 and Q1 (+7.9% and +7.4%), it still added 1.1 percentage points (p.p.) to GDP. A closer look at the data shows a marked pick-up in spending on services (+7.9%) helped to offset a sharp fall in expenditure on goods (-9.2%). Government expenditure rose by 0.8% in the quarter, but this contributed just 0.1 p.p. to growth. Investment fell by 0.8% in the three months to September, clipping 0.1 p.p. off the total. In terms of net trade, exports declined by 2.5%, while imports jumped by 6%, resulting in net trade subtracting 1.1 p.p. from growth. Meanwhile, inventories fell by less than in Q2, boosting output by 2.1 p.p. in Q3. Despite the marked slowdown in growth in US, the economy is now 1.4% above its pre-pandemic size. This compares favourably to most other advanced economies, which are not expected to regain their pre-Covid level until the end of this year at the earliest.

Turning to the labour market, payrolls have risen more slowly than anticipated recently. In August and September, payrolls rose by 560k in total, less than half of the 1,228k consensus. Meantime, the unemployment rate fell to 4.8% in September from 5.1% in August. However, the labour force participation rate remains much lower than before the pandemic. The participation rate was at 61.6% in September, up from a trough of 60.2%, but below the pre-Covid level of 63.4%. The more subdued rise in payrolls recently and the lower participation rate are somewhat puzzling, as job openings remain near record levels above 10mn. Enhanced unemployment benefits ended nationwide in September, which may see payrolls expand and the participation rate rise more quickly in the months ahead.



Meanwhile, inflation readings have started to stabilise in recent months, albeit at very high levels. CPI inflation reached 5.4% in June and has printed at 5.3% or 5.4% throughout Q3. Similarly, Core-PCE inflation has remained at 3.6% since June. The Fed expects inflation to remain at elevated levels for the remainder of the year, as supply constraints continue to contribute to higher prices. However, the central bank still expects it to prove transitory, with the Q4 core-PCE rate falling from 3.7% this year, to 2.3% in 2022 and 2.2% in 2023. The Fed expects that inflation should start to decelerate from the second quarter or third quarter of next year

The limited amount of survey data for Q4 suggest the US economy has continued to grow in October. Both the services and manufacturing PMIs stayed well in expansion mode, with readings near the 60 mark. Similarly, the manufacturing and non-manufacturing ISMs were above 60 as well. Elsewhere, having declined sharply in July, and remained at low levels, there are signs that consumer confidence has regained some momentum in October

It is clear from the data, that the recovery in the US economy is facing challenges. Growth has slowed since mid-year due to the spread of the Delta Covid-19 variant. The jobs market recovery will take some time, and inflation may well remain elevated for longer than anticipated given the issues around supply chains. Relatively high vaccine hesitancy also poses a headwind to activity. Longer-term the President's infrastructure and social spending bills are still caught in a logjam in Congress, despite having been whittled down to about half their original size. Potential increases to the US corporate tax rate may act as a headwind to investment also. **The IMF is now projecting growth of 6.0% for this year and 5.2% in 2022.**

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