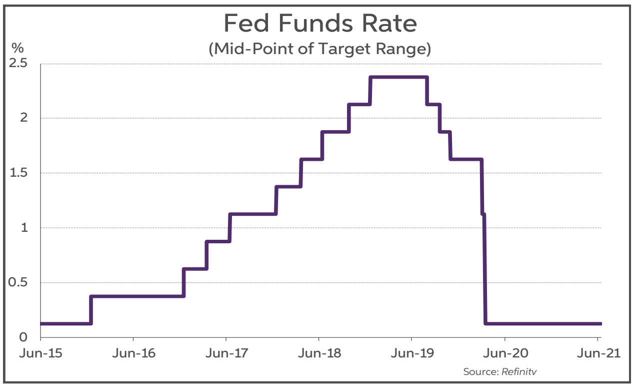
Fed Watch

AIB Treasury Economic Research Unit

17th June 2021

Fed sounding more hawkish

The June meeting of the US Federal Reserve concluded as expected with no changes to monetary policy. The central bank kept the funds rate in its target range of 0.00-0.25% as well as continuing to implement an open-ended asset purchase programme. There was unanimity within the Federal Open Market Committee (FOMC) on its decision to leave policy unchanged. **The main points of interest heading into the meeting were in relation to the Fed's updated interest rate projections (i.e. dot plot) and what it had to say in relation to QE tapering.**



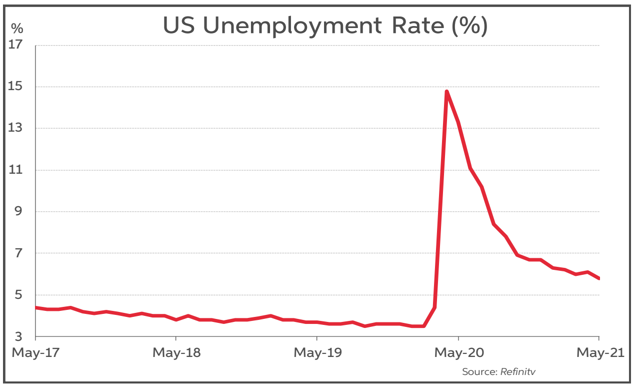
In terms of its interest rate projections, the June update represented a hawkish shift versus March in its 'dot plot'. There are now 7 of the 18 FOMC members of the view a rate hike will be required in 2022, up from 4 in March. Meanwhile, for 2023, a majority of FOMC members envisage that rate hikes will be warranted. 13 now expect this to be the case compared to 7 in March.

The median projection is for two 25bps hikes in 2023, which would see the fed funds rate ending the year at 0.625%. Only 5 FOMC members (from 11) anticipate rates remaining unchanged through to the end of 2023. However, Fed Chair Powell was keen to emphasise that rate hikes are "not the focus" of the FOMC and that the dots should be taken with a "big grain of salt", given they refer to a timeframe that is still full of uncertainty.

Despite, the hawkish shift in the Fed's rate projections, this is still less aggressive than the path of rate hikes that the market is expecting. The market is anticipating that the Fed will hike rates much sooner than this. Indeed, futures contracts are pricing in rate increases to commence in the second half of next year, with the fed funds rate being raised by 25bps by end 2022 to 0.375% and getting to 1% by end 2023. Further out, official rates are seen rising to around 2% by end-2025.

Meanwhile, on the issue of QE tapering, in the press conference, Fed Chair Powell advised to "think of the meeting as the talking about talking" about considering the matter. He emphasised that reaching the standard of substantial further progress in the economic recovery for tapering to begin "is still some ways off". Chair Powell guided that in the coming meetings discussions on tapering will take place. He once again highlighted, though, that the Fed will provide advance notice before announcing any decisions to make changes to its purchases.

If the US economy continues to improve significantly, then we would anticipate that such guidance on tapering could be forthcoming later in the summer. **This would allow the Fed to start tapering its asset purchases around the end of this year or in early 2022.**



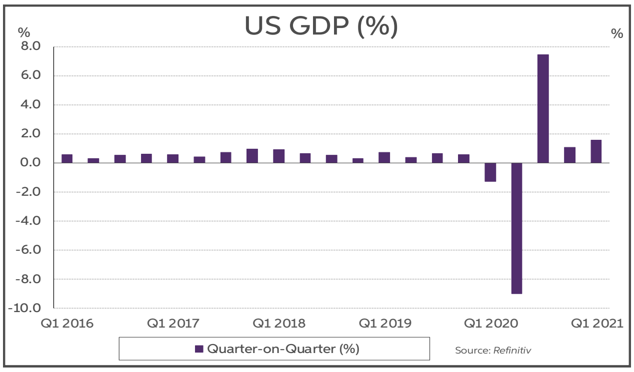
The Fed also released its updated view on the economic outlook. This saw upward revisions to its growth and inflation forecasts for 2021, while its 2022 and 2023 projections were largely left unchanged. On the growth front, the Fed revised its 2021 GDP growth forecast higher to 7.0% y/y by the end of the year (versus previous forecast of 6.5% y/y). Its growth forecasts for end 2022 and end 2023 were unaltered at 3.3% y/y and 2.2% y/y respectively. Meanwhile, it now expects core PCE inflation to rise to 3.0% (was 2.2%) by the end of this year, declining back to 2.1% (was 2.0%) by the end of 2022 and staying just above 2% by end-2023.

In terms of market reaction, the more hawkish tone from the June Fed meeting saw US Treasury yields and the dollar move higher. The 10-year Treasury yield moved back above the 1.5% level to 1.57%. Meanwhile, the firmer tone to the dollar was reflected in EUR/USD moving from the $1.21 level, to trade down below the midpoint of $1.19-1.20 and GBP/USD falling back from $1.41 to around the $1.395 level.

Oliver Mangan	John Fahey	Daniel Noonan
Chief Economist	Senior Economist	Economist
oliver.n.mangan@aib.ie	john.j.fahey@aib.ie	daniel.x.noonan@aib.ie

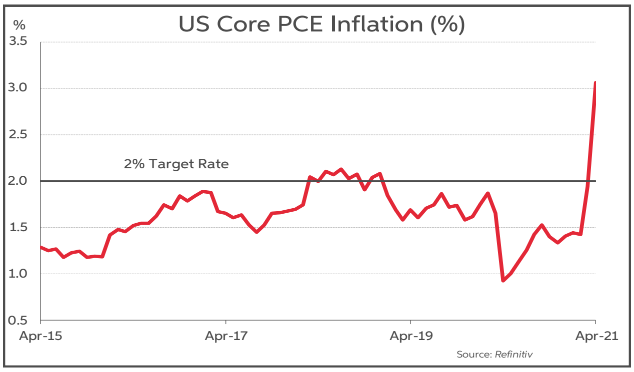
Rapid GDP growth, sharp price rises, slower job gains

The US economy grew by an annualised growth rate of 6.4% in Q1, as economic activity regained momentum buoyed by the rapid pace of the vaccine rollout and further fiscal stimulus. In terms of the underlying breakdown, the expansion was led by a 11.3% annualised rise in consumer spending, which added 7.4 percentage points (p.p.) to GDP. Government spending grew by 5.8%, largely due to a sharp rise in non-defence expenditure, boosting output by 1.0 p.p.. Investment contributed a further 2.0 p.p., although, a run down in inventories subtracted 2.8 p.p from growth. Meanwhile net trade clipped 1.2 p.p off the total.



Survey data suggest the economy is growing at an even more rapid pace in the second quarter. The composite PMI jumped to 68.7 in May from 63.5 in April, as the manufacturing PMI climbed to 68.7 and the services index printed at 70.4. Similarly, both the manufacturing and non-manufacturing ISMs remained above 60, and improved in May. The Conference Board measure of consumer confidence inched lower in May, having surged higher since February, while the University of Michigan consumer sentiment index rose in June, having dipped a month earlier. Homebuilder sentiment has continued to trend slightly lower in Q2, although, it remains near to its all-time high.

The hard data so for in Q2 have been a bit of a mixed bag, albeit most series were already at elevated levels. Thus, any insights taken from the most recent releases must be viewed in this context. For example, retail sales contracted by 1.3% in May, but soaring consumer demand in March and April meant they were 18% above their pre-pandemic level. Industrial production which grew by a modest 0.7% in Q1, has expanded by 0.9% so far in Q2, but remains 1.4% below its pre-Covid level. Meanwhile, activity in the housing market has cooled somewhat. Housing starts are 9.6% below their March peak (though they remain above their pre-Covid average) and existing home sales fell by 2.7% in April. Overall, the economy could grow at around an annualised rate of 10% in Q2.



The labour market recovery, though, appears to have slowed. Over April & May, payrolls increased by 837k, about half of the 1.6m expected. This means payrolls are still 7.6m below their pre-pandemic level, despite a record 9.3m jobs being advertised in April. However, recent slower jobs growth is not yet causing alarm in the Fed. It may be that the pandemic is causing some workers to seek different jobs rather than return to their previous employment. The Fed highlights a reluctance by some to re-enter employment due to fears of contracting Covid, increased caretaking of children as some schools and daycares remain closed, and enhanced unemployment benefits, as headwinds to job creation. As we move through the summer and into the autumn, though, the Fed expects these headwinds to recede.

Regarding inflation, rising price pressures and base effects have pushed the headline CPI rate to 5%. In May, the core rate rose by 0.7%, lifting the annual rate to 3.8%. Core-PCE, the Fed's preferred inflation measure surged to 3.1% in April from 1.9%. However, the increases largely came from reflation of recovering sectors, a rebound in energy prices, and building price pressures due to supply bottlenecks. Thus, the rise should prove to be transitory, a point Fed Chair Powell once again reiterated at the press conference yesterday.

It is clear from the data, that the recovery in the US economy is bringing challenges. Growth is rebounding strongly as the economy re-opens, aided further by substantial fiscal stimulus. However, the jobs market recovery will take some time, and each bumper inflation reading weakens the Feds argument that inflation will be transitory. Nonetheless, the economy appears to be heading in the right direction. **The OECD is projecting growth of 6.9% for this year, and further strong growth of 3.6% in 2022.** Thus, the US economy is expected to boom as it rebounds from the Covid-19 pandemic. Longer term, President Biden's proposed infrastructure bills may provide a further boon to GDP over the medium term, but higher taxes could act as a headwind. For now though, the focus remains on ensuring that the Covid crisis is fully overcome in the US.

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AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit