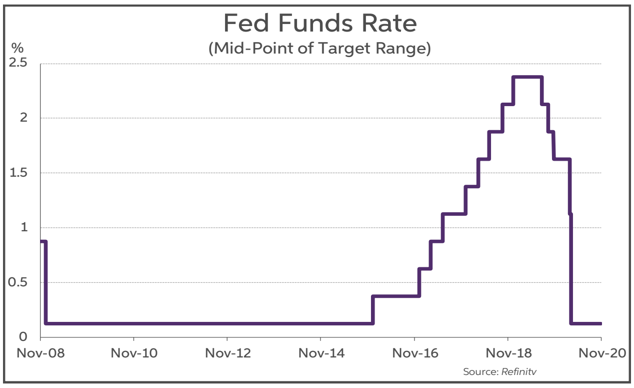
Fed Watch

AIB Treasury Economic Research Unit

November 2020

Fed maintains current policy stance

In contrast to events elsewhere in the US, the November meeting of the US Federal Reserve was very uneventful and dull. It concluded in line with market expectations for no change to monetary policy. The Federal Open Market Committee (FOMC) kept the fed funds rate in its target range of 0.00-0.25%, and it continues to operate an open ended programme of asset purchases.

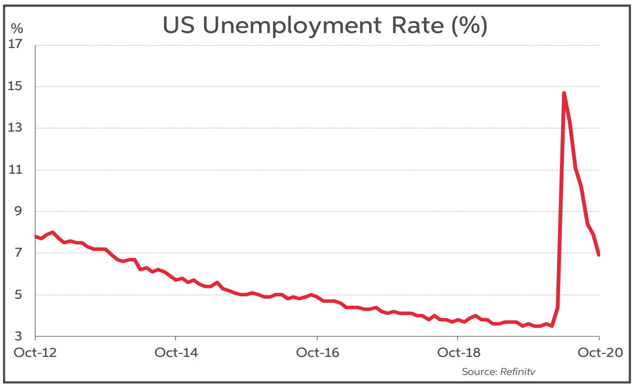


The November meeting statement contained very little change from its September version. It noted that economic activity and employment have “continued to recover” but “remain well below” their levels at the start of the year. On the inflation front, it continued to acknowledge that weaker demand and previous declines in oil prices have been “holding down” inflation. In terms of the outlook, it remained of the view that the path of the economy will “depend significantly on the course of virus”, and that the crisis will continue to act as a headwind to activity in the near term and poses considerable risks to the economy over the medium term.

Whilst the meeting statement did not make any reference to the recent spike higher in Covid-19 numbers, this was commented on by Chair Powell in the post-meeting press conference. He said the recent rise is “particularly concerning”. He also once again emphasised the Fed’s view that it will “take a while” for the economy to get to where it was before the current crisis struck, noting that that in recent months, the pace of improvement has “moderated” both from an economic activity and employment perspective.

Chair Powell also repeated the Fed’s view that the US economy has the potential for a stronger recovery “if we can just get at least some more fiscal support”. This is something the Fed has no control over and the onus is on politicians in Washington, once the dust settles on the 2020 Elections, to get agreement on a new stimulus deal. The general expectation is that a package will be agreed. However, there is uncertainty over the size of the fiscal stimulus. The potential for a split US Congress in the aftermath of the 2020 election may reduce the scope and size of the package.

The last update we got from the Fed in terms of the likely path of future interest rates was with the release of the updated interest rate projections back in September. These showed that all 17 members of the FOMC believe that that the current level of interest rates will be warranted until the end of 2021. The median projection for end 2022 was also for unchanged rates. Meanwhile, 13 participants also expect rates to remain on hold through to the end of 2023. Thus, the Fed ‘s view is that its current rate settings should remain quite appropriate for quite some time.



In a significant move, the Fed updated its policy framework in September whereby it has adopted an average inflation targeting approach. As part of this new approach, the Fed is now placing greater emphasis on the maximising employment aspect of its dual mandate versus its other objective of maintaining stable prices. This means that it will allow inflation move moderately above 2% for a period of time in order to achieve its employment objective. This change was significant in terms of the monetary policy outlook for the US economy.

The net effect of this is 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. This is reflected in futures contracts. The first US rate hike is not being priced in until 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 mid 2024.

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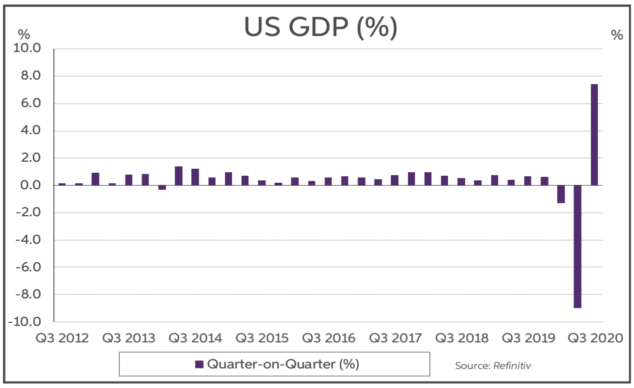
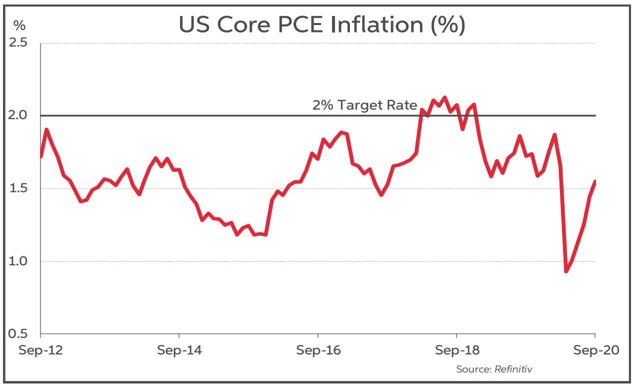
Strong rebound in Q3, outlook remains uncertain



US GDP rebounded by a record 33.1% annualised growth rate in Q3, following an unprecedented 31.7% contraction in Q2 and a 5% drop in Q1. This left the economy about 3.5% smaller than it was in the final quarter of 2019. The rapid rebound in activity was aided by the re-opening of many states and sectors across the summer months.

The underlying breakdown in the quarter, showed a robust rebound in consumer spending. It rose by 40.7%, which added 25.3 percentage points (p.p) to GDP, in part due to the release of pent up demand. Household spending was also boosted by enhanced benefit payments from the government. However, the rebound in consumption was uneven, with consumption of durable goods up 82.2%, while services, a much larger contributor to US GDP, grew by 38.4%, as social distancing measures hampered spending in the sector. This means that goods spending was 6.7% above its pre-Covid level, while service spending remained 7.7% lower. Net exports subtracted 3.1 p.p. from GDP growth, although, this was offset by a 6.6 p.p. rise in inventories. Fixed investment added 5 p.p., as record low mortgage rates supported a 59% increase in residential investment (+2.1 p.p.), while non-residential investment (+2.9 p.p.) also picked up. Meantime, government expenditure subtracted 0.7 p.p. from GDP.

Turning to the labour market, the unemployment rate fell to 6.9% in October, having peaked at 14.7% in April. Payrolls increased by 638k in October, with broad based gains. However, payrolls are still over 10m lower than they were in February. The slowing trend in payrolls is likely to continue over the coming months, as the labour market recovery loses momentum. While initial and continuing claims have been trending downwards recently, they remain at elevated levels.



Core-PCE, fell to 1.5% in September from 1.6% in August. Core CPI inflation remained at 1.7%. Both measures highlight that subdued demand continues to act as a headwind for price growth. This view is shared by the Fed which reiterated that weak demand and falling oil prices have been holding down inflation. The Fed's latest projections (from September) see inflation remaining subdued, with core-PCE expected to remain below the 2% average inflation target until 2023.

Survey data in Q4 indicate the recovery is continuing in the US. Both the services and manufacturing PMIs remained in expansionary territory in October, at 56.9 (prev. 54.6) and 53.4 (prev. 53.2). Likewise, Octobers manufacturing ISM rose to 59.3 (prev. 55.4), while the non-manufacturing ISM remained expansionary also at 56.6 (prev. 57.8). However, US consumer confidence edged lower in October to 100.9, a very subdued level.

While survey data suggests the recovery has been maintained, the short term outlook for the US economy remains uncertain. Record breaking Covid-19 cases over the past few days may lead to tighter restrictions being imposed. While the US election has ended with Joe Biden deemed the President-elect, the likelihood is that the Senate will remain in Republican control. This probably lowers the size of any future fiscal package, and thus the level of support for households. If Congress is unable to provide this assistance, it may hamper the recovery.

The latest IMF World Economic Outlook shows US GDP contracting by 4.3% in 2020. Although, the actual contraction is now likely to be smaller than anticipated, as the outlook was released before Q3 data showed the rebound in the third quarter was stronger than expected. Looking further ahead, output is expected to regain its pre-Covid level by mid 2022. The rebound in activity in Q3 demonstrates that the economy can recover quickly once businesses are able to re-open. While substantial easing measures implemented by the Fed remain in place, the recovery still requires continuing fiscal support. The speed of the recovery also depends on when a vaccine can be made available, and how quickly it can be rolled out, as this is paramount for a return to pre-Covid consumer and business norms.

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