Fed Watch

AIB Treasury Economic Research Unit

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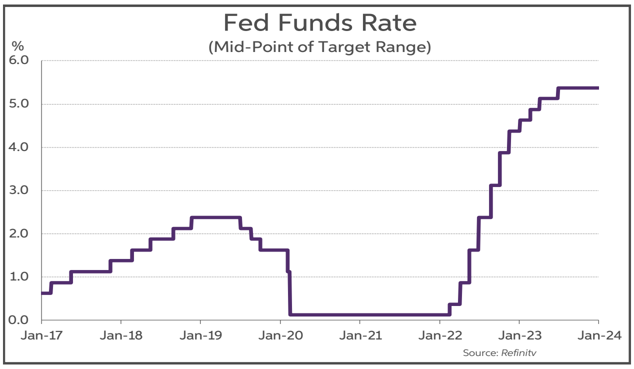
Fed moves nearer to easing but says March cut unlikely

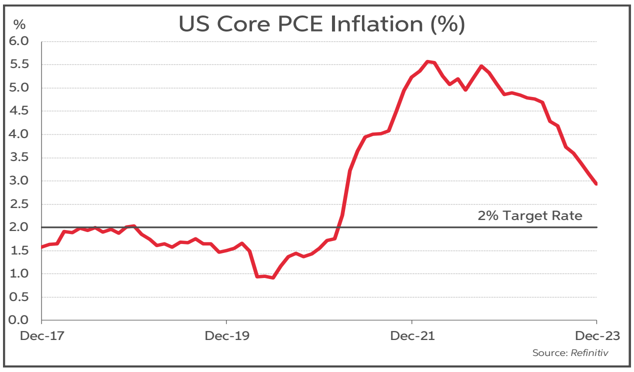
To no great surprise, the first US Federal Reserve Open Market Committee meeting of 2024 saw the Fed's key interest rates left on hold last night. The target range for the funds rate remains at 5.25-5.50%, a 22-year high. This was the fourth consecutive meeting that policy was left unchanged. The Fed had enacted 525bps worth of rate increases during its tightening cycle which began in March 2022, with the most recent hike occurring last July. The decision to leave rates unchanged was unanimous.



The FOMC statement did contain some key changes though and positions the Fed to move onto a policy easing stance over the coming months. This was signalled by the Fed dropping its tightening bias by removing the reference to the "extent of any additional policy firming". Instead, it replaced it with a more neutral phrase, stating that "any adjustments to the target range for the fed funds rate". **The Fed's assessment of the economic backdrop** was that economic activity is expanding at a solid pace, while jobs growth remains strong, albeit the pace has moderated. Meanwhile, it noted that inflation has eased but remains elevated. It stated though that the "economic outlook is uncertain" and that the FOMC "remains highly attentive to inflation risks".

The most recent set of Fed quarterly macro forecasts were published in December. In terms of economic activity, the Fed lowered its Q4 2024 projection slightly, from 1.5% y/y to 1.4%. Growth is seen running at 1.8% y/y in Q4 2025 and 1.9% by Q4 2026. The Fed's unemployment forecasts were largely unchanged, with the jobless rate seen as rising to 4.1% by end 2024 and remaining at that level throughout the remainder of the forecast horizon. **Meanwhile, the Fed's projection for the core-PCE inflation rate show it falling to 2.4% in Q4 2024, down from 2.6% previously.** The rate is seen at 2.2% by Q4 2025, compared to 2.3% before. It is then seen hitting the 2% target in Q4 2026**.** Thus, after experiencing a sharp fall last year, the Fed expects core inflation to decline much more slowly back to 2% over the next three years.

The Fed's interest rate projections, known as the 'dot-plot', were also published in December. They represented a more dovish view within the FOMC on the rate outlook compared to September. All FOMC members now believe that the next move in rates will be downwards. The December dot-plot shows **the median projection of FOMC members is that rates will be cut by 75bps by end 2024 to 4.5-4.75% range,** which is 50bps lower than in September. **Rates are then seen as being cut by a further 100bps in 2025 and 75bps in 2026.**



In the post-meeting press conference, in response to questions on the potential timing of the first rate cut, Fed Chair Powell guided that a March cut is "probably not the most likely case". The Fed though is of the view that the "risks to achieving its employment and inflation goals are moving into better balance". However, it will wait for further data until it has "greater confidence" that inflation is "moving sustainably" towards its 2% target before it starts to cut rates.

Meantime, market rate expectations have been volatile in the opening weeks of the year. Overall though, the market continues to expect a more aggressive pace of rates cuts this year compared to the Fed's guidance. Futures contracts suggest that the market is envisaging the first rate cut by May and a total of circa 140bps of easing by the end of this year. This suggests that the market may be anticipating core inflation to fall more quickly as well as a more pronounced slowdown in the US economy this year. As ever the data will determine the timing of rate cuts, with the Fed emphasising it will continue to monitor incoming data to determine when to alter rates.

Further out though, by end 2026, the market is not expecting rates to be cut to the same extent as outlined in the Fed's own projections. The market is anticipating rates bottoming in a 3.25-3.5% range. In contrast, the Fed's projections have rates being lowered to a 2.75-3.00 range.

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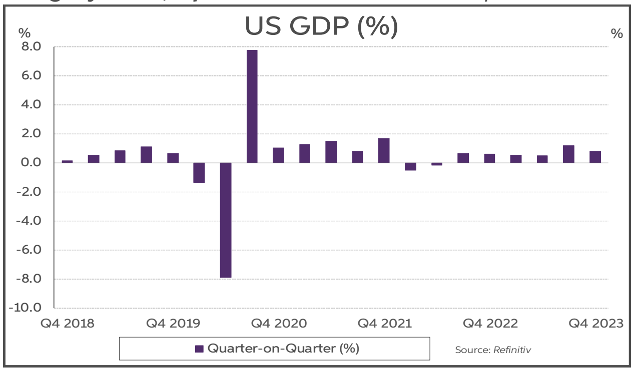
Soft landing in sight for the US economy

The US economy confounded expectations last year, growing by 2.5%, up from 1.9% in 2022. Despite elevated levels of inflation and an aggressive tightening of monetary policy, consumer spending remained a key driver of growth throughout 2023. Furthermore, increased government expenditure and business fixed investment boosted GDP, particularly in the first half of the year. In the second half of 2023, economic growth broadened, with all of the main sub-categories, including residential investment, net exports and inventories contributing positively to GDP.



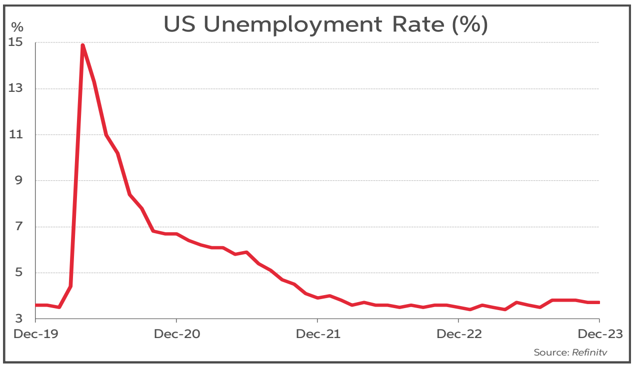
The most recent GDP update showed the economy expanded by 3.3% annualised in Q4. Consumer spending continued to grow strongly, increasing by 2.8% annualised, to contribute a significant 1.9 percentage points (p.p.) to the total rise in GDP. Fixed investment added a further 0.3 p.p. to growth. Government spending jumped by 3.3% in Q4, led by an increase in state and local expenditure, boosting GDP by 0.6 p.p.. Meantime, exports rose by more than imports, meaning net trade added 0.4 p.p. to the total.

The limited survey data available for January suggest the economy maintained its momentum at the start of the year. Both the manufacturing and services PMIs improved. Indeed, the former printed above 50 for the first time since April, while the latter registered its highest reading since June. Likewise, the Michigan and Conference Board measures of consumer confidence, as well as homebuilder sentiment, rose sharply in January.

In terms of the labour market, conditions remain tight, but are starting to ease. Payroll growth slowed from an average of 245k per month in the first three quarters of 2023, to 165k per month in Q4. The number of job openings also declined to circa 9.0m in December, from 10.5m last January. However, the unemployment rate remains low, at 3.7% in December, although this partly reflects a drop in labour force participation. Weekly jobless claims numbers have remained muted. Amid still tight labour market conditions, average earnings growth remains strong, at 4.1% year-on-year in December, only slightly down on the 4.4% rate seen at the start of 2023. However, the closely followed wages component of the employment cost index rose by 0.9% q/q in Q4, compared to 1.2% in Q3.

Headline CPI inflation has proven to be range bound in a 3.1-3.7% corridor since mid-year, having fallen sharply in the first half of 2023. Indeed, it stood right in the heart of this range, at 3.4% in December. The stickiness in CPI can largely be attributed to a sharp rise in fuel prices, which jumped by 10.6% in August, and 2.1% in September, and an uptick in electricity prices in December. The headline PCE deflator, though, declined to 2.6% y/y in November, and stayed at that level in December. **Meantime, core inflation has trended lower,** with core-CPI falling in fourteen of the last sixteen months. It printed at 3.9% in December. Similarly, core-PCE inflation, had been in a narrow 4.3-4.9% range between December 2022 to July 2023, before declining in the second half of last year. It fell to 2.9% in December, its lowest level since March 2021.

To surmise, the US economy performed very strongly in 2023, with GDP rising by 2.5%. The expansionary stance of fiscal policy has been a considerable support to the economy. Furthermore, the US appears to be relatively unscathed by the stresses which emerged in parts of its banking system last spring. Looking ahead, the economy is expected to continue to perform well this year, with the IMF predicting a modest slowdown in growth to 2.1%. The IMF sees GDP rising by 1.7% in 2025.



Overall, the economy appears to be on course for a soft landing, although the Fed continues to warn that it is too early to proclaim victory in the fight against inflation. We would note, that the large amount of excess savings in the US, which provided a supportive backdrop for consumption, a key driver of growth in 2023, have largely been run-down. Thus, the risks to the outlook, appear to be tilted to the upside for inflation and to the downside for growth. However, **with long term rates falling sharply since late October, rate cuts expected this year, and real incomes starting to rise on lower inflation, the elusive soft landing may be at hand.**

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