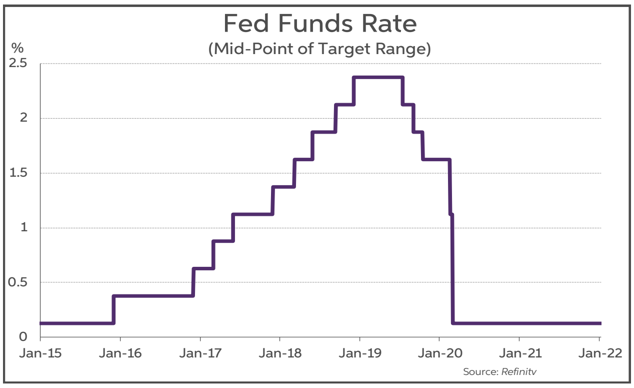
Fed Watch

AIB Treasury Economic Research Unit

27th January 2022

Fed signals March rate hike

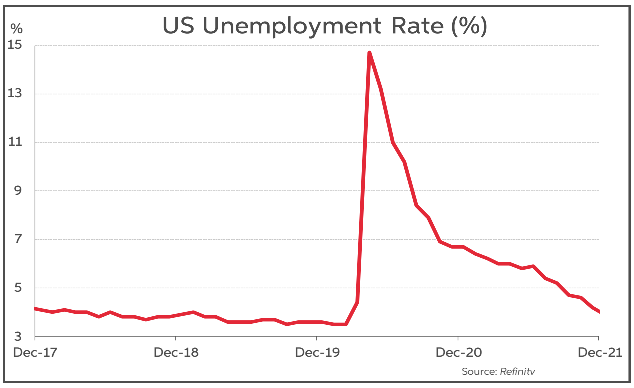
The first US Federal Reserve meeting of 2022 saw the central bank leave its key interest rate unchanged, as expected. It kept the funds rate in its target range of 0.00-0.25%. There was unanimity within the Federal Open Market Committee (FOMC) on keeping its interest rate policy unchanged. At its December meeting it announced a further acceleration in the pace of QE tapering, which means the Fed remains on track to end net asset purchases in March.



The main focus for markets in the lead up to the Fed meeting was what guidance the central bank would give regarding the timing of the first rate hike. In this regard, the meeting statement noted that given inflation is well above its 2% target, the FOMC "expects it will soon be appropriate" to raise interest rates. In the press conference Fed Chair Powell reiterated this view as well as stating that the economy no longer needs "sustained high levels of monetary policy support". **The meeting statement and Chair Powell's remarks, suggest that a rate hike is on the cards at the Fed's next meeting in March, which is in line with market expectations.**

The overall tone, though, of Chair Powell's press conference was notably hawkish, especially in relation to his remarks on what to expect from the Fed regarding the pace and extent of rate hikes. He commented that the economy is in a much different place compared to the last tightening cycle. He noted that it is in a stronger position, including a far stronger labour market, while at the same time inflation is running well above its target, and much higher than it was the last time the Fed started to hike interest rates. Crucially he advised that these differences are likely to have "important implications for the appropriate pace of policy adjustments". In other words, the pace of rate rises is likely to be quicker than during the last tightening cycle.

The most recent interest rate projections (i.e. dot plot) from the Fed were produced at the meeting in December. These dots showed that all FOMC members expect at least one rate hike this year with the median projection for three 25bps hikes in 2022. This would leave the funds rate at 0.875% by end-2022. Meanwhile, for 2023 and 2024, the median projections were for three and two rate hikes respectively. This would leave rates at 1.625% at end-23 and 2.125% by end-24. **Prior to the January FOMC meeting the market had been envisaging rates hikes starting in March, with around 100bps of rate rises pencilled in for this year.** It had around 75bps of rate hikes priced in for 2023. The market though, was anticipating that the pace of rate increases would slow significantly in 2024, with increases nowhere near to the same extent as to what the Fed was guiding in its December rate projections.



Following the hawkish press conference, the market has moved to price in more rate hikes from the Fed for this year. Futures contracts are now anticipating that the fed funds rate could rise rates by around 112.5bps by the end of year, to 1.25%. There is around 50bps of tightening priced in for 2023. However, the market continues to expect that rates may level off, settling just below 2% in 2024.

The other key aspect to the Fed's tightening cycle will be in relation to reducing the size of its balance sheet holdings, i.e. quantitative tightening (QT). As mentioned above, the Fed expects to finish net asset purchases in March. Chair Powell stated that QT would be discussed at its next two meetings. This indicates that the earliest an announcement on QT could be made is May.

Overall, the Fed, and specifically Chair Powell's press conference, struck a more hawkish tone than had been expected. He guided markets to expect more rate hikes than had been priced in. The market reaction to his comments, saw the dollar strengthen, reflected in EUR/USD falling down below the $1.12 threshold. At the same time, US Treasury yields rose, with the policy sensitive 2-year yield rising by around 15bps to towards 1.20%.

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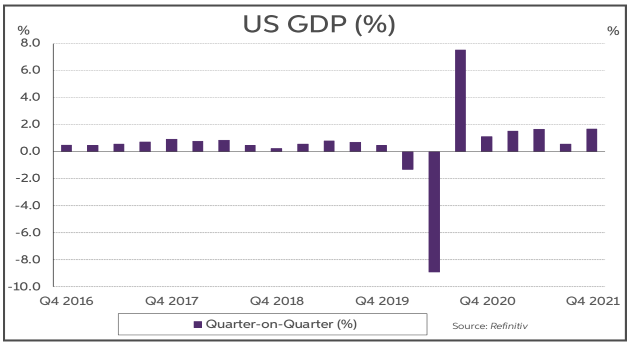
US economy to grow less quickly in 2022

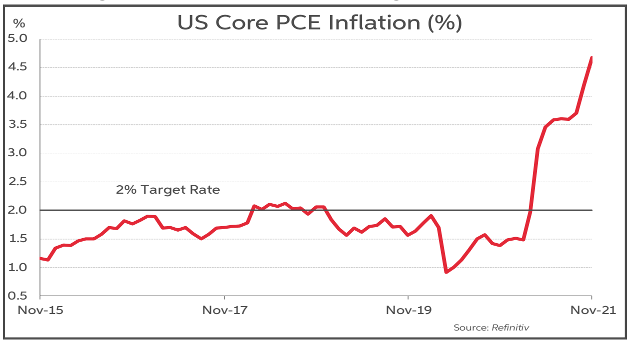
US GDP grew at an annualised rate of 6.9% in Q4, up from 2.3% in Q3. However, the pick-up was very much driven by inventory building, as final demand grew by only 1.9%. Overall, the US economy experienced a robust recovery in 2021, having contracted by 3.4% in 2020. In the first half of the year, a rapid re-opening of the economy, and substantial fiscal policy supports saw GDP grow by 6.3% and 6.7% in Q1 and Q2, respectively. The US economy grew by 5.7% overall in 2021, and GDP was 3.1% above its pre-pandemic level in Q4.

With regard to the Q4 2021 underlying breakdown, consumer spending continued to rise, adding 2.3 percentage points (p.p) to GDP in Q4. Fixed investment increased by 1.3%, and added 0.3 p.p., while government expenditure subtracted 0.5 p.p. from growth. Exports rose by 24.5%, but were completely offset by a 17.7% jump in imports. However, a sharp rise in inventories boosted GDP by 4.9 p.p.

Meanwhile, the labour market recovery slowed in the fourth quarter. In Q3, payrolls rose by 888k per month on average, but this fell to just 365k in Q4. In December, payrolls grew by just 199k, the lowest monthly increase in a year. However, the slowdown in payrolls growth is not due to a lack of demand for workers, but rather, it is caused by a lack of supply. The unemployment rate has continued to trend lower, falling to 3.9% in December. This is just 0.4% above its pre-pandemic level of 3.5%. Labour force participation though, remains subdued. The participation rate stands at 61.9% currently, circa 1.5% below its pre-Covid level. Indeed, it has increased by just 0.2% since August 2020. Tight labour market conditions have placed upward pressure on wages, with average earnings up by 4.7% year-on-year in December.



In terms of price developments, inflation has continued to rise, from already elevated levels. In December, CPI inflation rose to 7%, its highest level in almost 40 years. Similarly, core-CPI inflation rose to 5.5% from 4.9% as price pressure became more broad based. Meanwhile, the core-PCE deflator is also at a multi-decade high of 4.7%, in November. The Fed has become more perturbed by elevated levels of inflation, and has stopped describing it as transitory. However, inflation is still expected to fall back over the course of this year, as supply chain issues start to get resolved and upward pressure on energy prices ease. The latest projections, from the December Fed meeting, show core-PCE declining to 2.7% in Q4 2022 and 2.3% in Q4 2023.



Elsewhere, the limited amount of available data for January indicate that activity was curtailed by the Omicron wave of the pandemic. The flash readings of both the services and manufacturing PMI fell in January, with the services index declining to 50.9, its lowest level since July 2020. Consumer confidence deteriorated also, with the Conference Board and the Michigan measures both moving lower in the month.

To surmise, the US economy experienced a robust recovery in 2021, as fiscal and monetary policy remained highly supportive of growth. However, growth slowed in the second half of 2021, and the Omicron variant dampened activity further at the start of 2022. There are reasons for optimism though. The impact from Omicron is likely to be less severe than from previous variants. Savings have increased by $2.5trn more than the pre-Covid trend, and wages have risen the most for lower earners. This means households are in a better position to deal with the rising costs of living, and that consumption can continue to remain a key driver of economic growth. Overall, the economy is expected to perform strongly in the years ahead.

It is clear though, the US economy is also facing challenges. Inflation is now forecast to remain elevated for longer than previously anticipated. Monetary policy is set to be tightened, with significant rate hikes likely this year and next. The threat of new Covid-19 variants is accentuated in the US also, given the still low vaccination rates. President Biden's Build Back Better initiative remains stuck in Congress as well. The IMF has revised down its growth forecast for the US in 2022, given the likelihood of less fiscal stimulus, and greater monetary tightening. **It now expects GDP to rise by 4% this year, and 2.6% in 2023.**

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