Fed Watch

AIB Treasury Economic Research Unit

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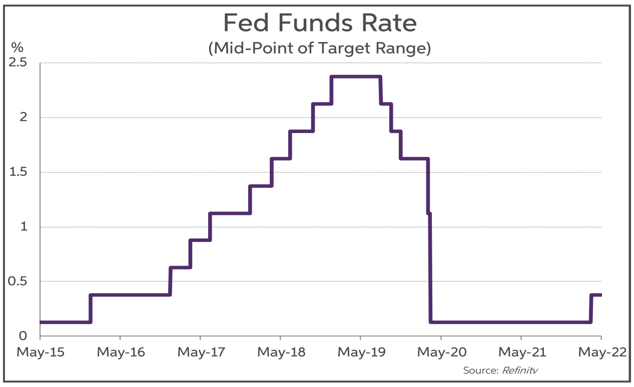
Fed hikes by 50bps, with more to come

As widely expected, the US Federal Reserve delivered its first 50bps rate hike in over 20 years at its FOMC meeting yesterday. The Fed also indicated that it would begin QT or quantitative tightening next month as it starts to reduce the size of the large bond portfolio that it has built up over the past two years. **The rate hike brought the target range for the Fed funds rate to 0.75-1.0%** and followed a 25bps increase in March. It was the first time the Fed has hiked rates at consecutive meetings since 2000. The decision was unanimous. Meanwhile, as previously guided, the Fed announced that **QT will begin on June 1st.** It will be done passively, initially allowing $47.5 billion of maturing bonds to roll off each month without being refinanced, increasing to $95 billion after three months.

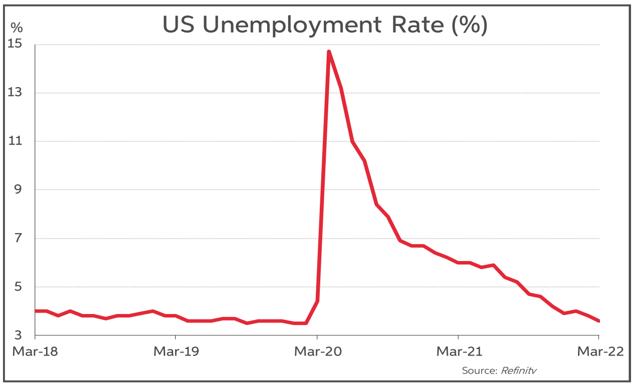


Thus, **the Fed is now on an aggressive policy tightening path as it seeks to rein in surging inflation,** with the headline CPI rate climbing to a forty year high of 8.5% in March and the core CPI rate also now very elevated at 6.5%. As a result, **the Fed has turned increasingly hawkish on policy in recent months and markets have been taking note, with substantial rate tightening now priced in for this year.** Futures contracts see the Fed funds rate being increased to circa 2.8% by end year and rising further to 3.375% by summer 2023.

We have not seen back-to-back hikes of 50bps or more from the Fed since 1994-95, but a series of such moves are now in store. Chair Powell indicated in the post-meeting press conference that **50bps increases are also on the table for the next two meetings, although he also stated that the FOMC is not actively considering a 75bps hike.** Once inflation starts moving in the direction that gives the Fed comfort, Chair Powell signalled it would move back to 25bps increases, but this would take several months of data. The FOMC in its statement said that it "is highly sensitive to inflation risks". Not surprisingly then, Chair Powell said **the Fed will raise rates expeditiously to a neutral level,** which is generally seen as circa 2.5%. He added it is certainly possible that the Fed could move to a restrictive policy if warranted. Two further 50bps hikes this summer followed by 25bps hikes at the three remaining FOMC meetings of the year would take the funds rate to a 2.5-2.75% range, close to what futures contracts are pricing in.

The key challenge the Fed faces in tightening policy is to slow activity sufficiently that inflation is brought under control, but not to the extent that it tips the economy into recession and risks inflation eventually moving below target again. In this regard, financial conditions have already tightened considerably this year. Ten year Treasury yields have doubled, rising by 150bps from 1.5% to 3% since the end of 2021, the S&P 500 stock market index is down 10% year-to-date, there has been a significant widening of credit spreads, while the dollar has soared.

Achieving a soft landing for the economy has proved a difficult task for the Fed in the past, especially when bringing inflation down from elevated levels. Fed Chair Powell has acknowledged this, saying the task ahead is going to be very challenging, but adding "it's absolutely essential to restore price stability". He said the economy is very strong and can handle more monetary tightening.



Inflation should ease back considerably over the summer, the housing market looks set to slow sharply on the back of much higher mortgage rates, while domestic spending may weaken given the hit to real disposable incomes. Thus, a move back to 25bps rate hike steps would seem a reasonable expectation after the summer.

The markets took some comfort yesterday from the fact that the Fed was not any more hawkish than had been anticipated, in particular the comment from Chair Powell that it is not actively considering a 75bps hike. US stock markets rose by 3%, while two year Treasury yields fell by 13bps and the dollar lost some ground. It is quite clear, though, that the Fed is focused on restoring price stability and will take whatever action is necessary to achieve this.

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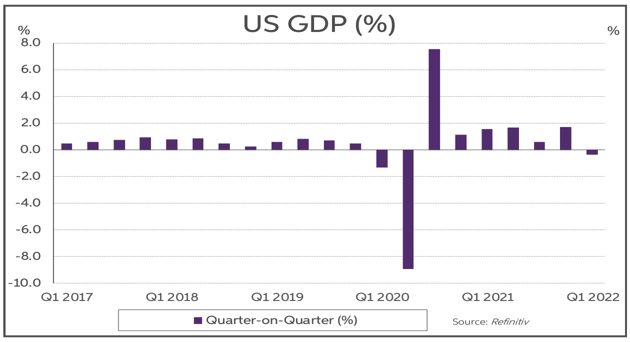
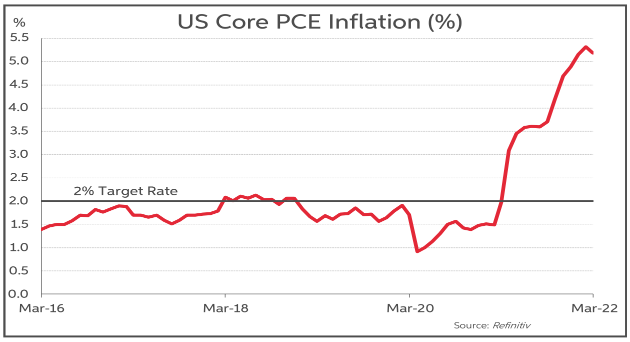
US economy to grow more slowly in 2022-23

US GDP unexpectedly contracted by 1.4% in annualised terms in the first quarter of the year. However, the headline rate masks continued solid growth in final domestic demand. Consumption rose by 2.7% in the quarter, contributing 1.8 percentage points (p.p.) to GDP, while fixed investment increased by 7.3%, adding a further 1.3 p.p.. A massive surge in imports though, as businesses continued to rebuild inventories, and a fall in exports meant that net trade subtracted 3.2 p.p. from growth. Meanwhile, although businesses continued to rebuild stock levels, they did so at a slower rate pace than in Q4, meaning inventories knocked 0.8 p.p. from GDP. Government spending clipped 0.5 p.p. from the total for the second consecutive quarter also.



In terms of the labour market, there are signs that it may be overheating. There are currently almost twice as many job openings as there are unemployed workers. Indeed, Fed Chair Powell has described the labour market as being tight to an "unhealthy level". This in part stems from the fact that labour force participation is still 1 p.p. below its pre-pandemic level. Payrolls though, have been increasing at a rapid pace, rising by circa 1.7m in Q1. The unemployment rate has declined sharply to 3.6%. Tight conditions in the labour market have placed upward pressure on wages, with average earnings 5.6% higher year-on-year in March. Meanwhile, the Fed's preferred measure of wage inflation, the private sector wages and salaries sub-component of the ECI, rose by 1.3% in Q1, up from 1.1% in Q4, indicating that wage growth remained elevated at the start of 2022.

Inflation, which was already at multi-decade highs, continued to rise in Q1. In March, CPI inflation rose by 1.2% in the month, lifting the annual rate to 8.5%, its highest level in 40 years. Core-CPI inflation rose by a more modest 0.3% in March, with the annual rate climbing to 6.5% yoy, indicating price pressures have become quite broad based in the past year. Meanwhile, headline PCE and core-PCE inflation were at 6.6% and 5.2% in March. Inflation may have peaked in Q1 though. It is expected to fall back over the course of this year, most notably as the upward pressure on energy prices eases and on favourable base effects in the core rate. Nevertheless, a decline back towards the 2% target level is likely to be slow. The latest projections, from the March Fed meeting, show core-PCE declining to 4.1% in Q4 2022 and 2.6% by Q4 2023.



Elsewhere, survey data for April suggest that activity continued to grow solidly at the start of Q2. Both the services and manufacturing PMIs were well above 50, at 55.6 and 59.7, respectively. Similarly, the manufacturing ISM remained consistent with growth in the sector, although, the index did fall to 55.4, its lowest level since September 2020. The non-manufacturing ISM slipped to 57.1. Meantime, both the University of Michigan and the Conference Board measures of consumer sentiment improved in April, albeit from subdued levels.

Having rebounded by a robust 5.7% in 2021, the US economy is set to grow more slowly this year. Although the economic links between Russia and the US are limited, disruptions to other trade partners caused by the war as well as higher inflation will weigh on US growth. Tighter fiscal and monetary policy will dampen output also. President Biden's Build Back Better initiative remains stuck in Congress. Meanwhile, the Fed looks set to tighten monetary policy aggressively between now and the end of this year, as it tries to rein in inflation. However, history suggests the Fed could find it difficult to cool the economy without eventually tipping it into recession. It has only managed to engineer a "soft-landing" on three occasions since 1945, but it has never done so when battling inflation this high. Thus, this will prove a challenging tightening cycle for the Fed.

There are grounds for optimism, though. Growth is likely to be positive in Q2. Savings have increased by $2.5trn more than their 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 driver of economic growth. Overall, the economy is still expected to perform solidly in 2022-23, although growth forecasts have been revised lower. **The IMF now sees GDP rising by 3.7% this year and 2.3% in 2023.**

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