## Fed Watch

AIB Treasury Economic Research Unit



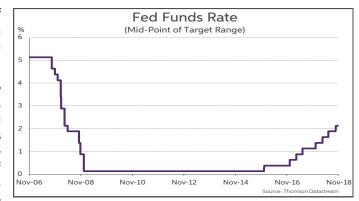
9th November 2018

## Fed on course to hike in December

The November meeting of the Federal Reserve Open Market Committee (FOMC) concluded as expected with no changes to its monetary policy. At its previous meeting in September the Fed hiked rates by 25bps, with the target range for the key fed funds rate raised to 2.0-2.25%. The committee was unanimous in its decision to leave rates unchanged at the conclusion of yesterday's meeting. The market is expecting the Fed will hike again in December.

There was no press conference or updated staff forecasts scheduled for the November meeting. Therefore, the main focus was on the meeting statement.

There were only minimal changes to the statement compared to the September version. One of these minor changes saw the Fed acknowledge that growth in fixed business investment had "moderated from its rapid pace earlier in the year". However, the overall tone of the statement remained very upbeat on the US economy. The Fed continued to describe

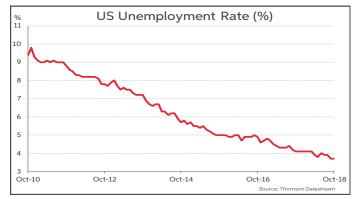


economic growth performing at a "strong rate", as well as noting the continued strengthening in the labour market.

This view on the economic outlook is in keeping with its most recent set of macro forecasts which were released back in September. These showed that the Fed expects the US economy to grow by 3.1% in 2018, 2.5% in 2019, 2.0% in 2020 and 1.8% in 2021. The jobless rate is forecast to drop to 3.5% next year and remain there in 2020, while inflation is anticipated to be stable at 2.1%

over the next three years.

The most recent Fed assessment of the likely future path of interest rates was also released at its September meeting. It showed that the Fed is expecting to hike again in December, which would represent the fourth 25bps hike in 2018, bringing the fed funds rate up to 2.375% by year end. The Fed's projections indicate that it expects to deliver three rate increases over the course of 2019 and one hike in 2020, with rates levelling off at around 3.4% by the end of this period.



The market has been moving more into line with

the Fed's projections over the course of this year, but despite this, it continues to expect a less aggressive pace of rate tightening from the Fed. While the December rate increase is priced in, futures contracts show that the market is pricing in just two further rate hikes in 2019, taking official rates up to around 2.9%, with rates levelling off thereafter. This is some 50bps points below what the Fed is projecting.

However, continuing strong growth by the US economy over the next year, combined with rising inflationary pressures, could force the market to further re-evaluate its outlook on rates. Note, at end 2017, the market was expecting rates would only get up towards 2% during the current tightening cycle. We expect that the Fed funds rate will rise to 3.125% next year. The outlook for Fed tightening in 2020 is likely to depend on the extent to which the US economy slows as the boost to growth from the fiscal stimulus fades and higher rates impact on activity.

In summary, as expected, the Fed's November meeting proved to be a non-event. The slight changes to the meeting statement did nothing to suggest that the Fed had altered its intentions to hike again in December. Whilst there were no surprises from the Fed, the dollar did make some gains following the meeting. This may in part be due to the fact that the text of the statement made no reference to the recent volatility on equity markets.



## US growth remains very strong

US annualised growth eased to a still very strong 3.5% in Q3, from 4.2% in Q2. The underlying data showed that a worsening of the US trade deficit subtracted 1.8 percentage points (p.p.) from growth, as the temporary boost to exports in Q2 faded. However, this was offset by a large increase in inventories (+2.1 p.p.). Consumer spending remained very strong (+2.7 p.p.), while government expenditure continues to add to growth, contributing 0.6 p.p. in Q3. Investment, though, declined in the quarter.

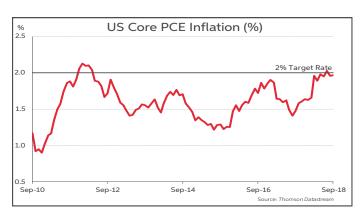


The labour market data for Q3, while somewhat distorted by extreme weather in August/September, were on the whole positive. The impact was mostly clearly seen in Q3's non-farm payroll figures, which averaged monthly growth of 189k, against 217k in Q2. However, the latest release shows an increase of 250k in October, as some of the Q3 weather effects unwound. Meanwhile, the unemployment rate edged down at end-quarter to just 3.7% and held at this rate in October. The NFIB's 'jobs hard to fill' index was also recorded at a record high in October, reflecting the tightness of the labour market.

The lack of slack of appears to be translating into higher earnings growth. Data suggest that wage inflation is rising, with average hourly earnings increasing by 3.1% in October. This follows solid wage growth in Q3; the Fed's preferred measure, the Employment Cost Index, ticked up to 2.8% in the quarter.

Headline CPI inflation has edged downward through autumn, falling back to 2.3% in September compared to 3.0% at the beginning of Q3. However, the core rate has been less volatile and was confined to a 2.2-2.4% range in the last six months, coming in an 2.2% in September. This is marginally higher than the Fed's preferred measure of price pressures, core-PCE inflation (ex-energy costs), which has remained constant at 2.0% in the same period.

Meanwhile, survey data for October suggest that the economy has maintained its strong momentum at the beginning of Q4. The Markit Composite came in at 54.9, broadly in line with Q3's average of 54.8. Similarly, the ISM indices (which have tended to overstate growth recently) continue to point toward strong growth. The manufacturing component was recorded at 57.7 in the month, while the services index was registered at 60.3. On the demand side of the economy, consumer confidence remains at very high levels.



The near-term outlook for the economy

remains positive. The strong labour market continues to support the key consumer sector of the economy (c. 70% GDP), indicating that household expenditure will carry on supporting growth. Meanwhile, although monetary policy is tightening, interest rates remain low and hikes are taking place at a gradual pace. Expansionary budgetary measures adopted at the beginning of the year should also continue to aid growth, although their impact will start to fade next year. The recent IMF forecasts are for strong US GDP growth of 2.9% in 2018 and 2.5% in 2019.

However, in the medium term there are some risks facing the US economy. The marked loosening of fiscal policy will result in a big rise in the budget deficit and possibly the balance of payments deficits as well. It also risks overheating the economy, with the unemployment rate now below 4% and wage growth beginning to edge up. The US economy could slow quite sharply once the fiscal stimulus fades and higher interest rates begin to impact on activity. The Fed sees GDP growth slowing to 1.8% by 2021, but it could weaken more than this, especially if inflation rises, forcing the Fed to tighten policy by more than is generally expected.

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