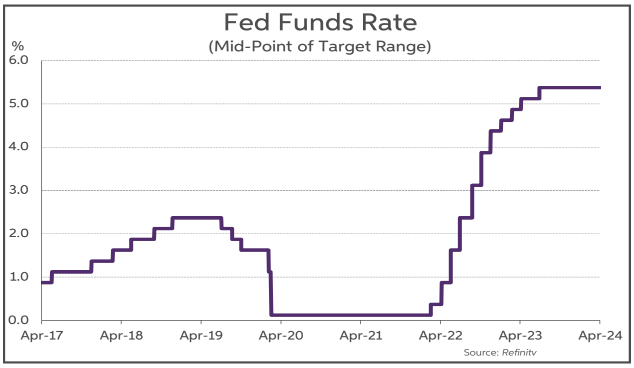
Fed Watch

AIB Treasury Economic Research Unit

2nd May 2024

US rates higher for longer

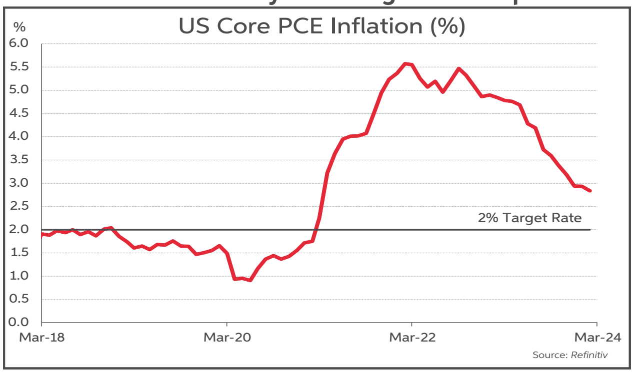


The US Federal Reserve Open Market Committee meeting for May saw the central bank leave its key interest rate policy unchanged. As a result, the target range for the Fed funds rate remains at 5.25-5.50%, a 22-year high. This was very much in line with market expectations, and it marked the sixth consecutive meeting that policy was left on hold. The decision by the FOMC to leave rates unchanged was once again unanimous.

The FOMC statement contained no major surprises. The Fed acknowledged the current 'stickiness' in price pressures, noting that "in recent months there has been a lack of further progress toward" its 2% inflation target. Associated to this changed view on inflation, in its assessment of the risks to achieving its dual employment and inflation mandate, it now states the risks "have moved toward better balance" from its previous characterisation of them "moving into better balance". The only other point of note from the statement was the Fed's announcement in relation to quantitative tightening (QT). From June, the Fed will slow the pace of redemption of its Treasury holdings, with the monthly run-off reducing from $60 billion to $25 billion. Fed Chair Powell emphasised that this change was to make sure that the QT process "is a smooth one" and to avoid financial market turmoil.

Given the overwhelming market consensus view in the lead up to the Fed meeting was for no change to the Fed funds rate, the focus was on what guidance would be forthcoming from the FOMC regarding the outlook for rates. The Fed's most recent projections (i.e. 'dot plot') were released at its March meeting, where it continued to guide 75bps of cuts this year, with long term rates expected to settle around 2.6%. The next dot plot is due at its June 12th meeting. However, it is likely to see a rowing back of its expectation for rate cuts this year.

In this month's post meeting press conference, **Chair Powell's comments indicated that the Fed intends to keep rates at their current level for longer than previously envisaged. He stated that it will "likely take longer than expected" to garner "greater confidence" that it will achieve its 2% inflation objective before it is comfortable in cutting interest rates.** He emphasised that the Fed is committed to "retaining our current restrictive stance of policy for as long as is appropriate". When questioned on whether the Fed would contemplate hiking rates, Chair Powell was quite clear that this was not in their mindset and "its unlikely that the next policy move will be a hike". Instead the focus within the FOMC is on "how long to keep policy restrictive".



In this regard, he outlined the scenario that would see rates maintained at their current level. This would involve inflation being "more persistent than expected" and at the same time the "labour market remains strong" meaning it "could be appropriate to hold off on rate cuts". On the other hand, possible "paths" for the economy that would see rate cuts being considered would entail greater confidence that "inflation is moving sustainably down to 2%" or an "unexpected weakening in the labour market".

Market expectations for US rate cuts have been scaled back significantly over recent months against the backdrop of higher than expected inflation, on-going strength in the labour market and the resulting less dovish soundings coming from FOMC members. There is now only around 35bps of rate cuts anticipated by end year, with the first 25bps rate cut not expected until the November meeting at the earliest. To note, at the start of the year, futures contracts were anticipating around 150bps of policy easing in 2024. Of course, the extent of any rate cuts this year will depend on incoming data with Fed Chair Powell noting that this will be "at the very heart of that decision". Therefore market expectations will remain reactive to the macro newsflow. In this context, inflation and labour market data over the coming months will determine the degree of policy easing we get from the Fed before the end of the year.

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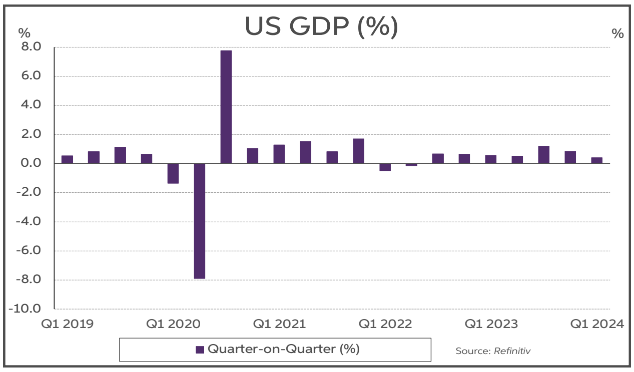
US growth slows as disinflation stalls

Having confounded expectations last year, growing by 2.5% up from 1.9% in 2022, US GDP expanded more slowly than anticipated in Q1 2024. GDP is estimated to have increased by 1.6% annualised at the start of the year. Despite elevated levels of inflation and interest rates, consumer spending and fixed investment remained the main drivers of growth, rising by 2.5% and 3.2% annualised, respectively in the quarter, and contributing 1.7 percentage points (p.p.) and 0.9 p.p. to the total. Government expenditure added a further 0.2 p.p. to growth. However, a sharp 7.2% jump in imports was only slightly offset by a meagre 0.9% increase in exports, meaning net trade knocked 0.9 p.p. from GDP. Changes in inventories clipped a further 0.3 p.p. from the total.

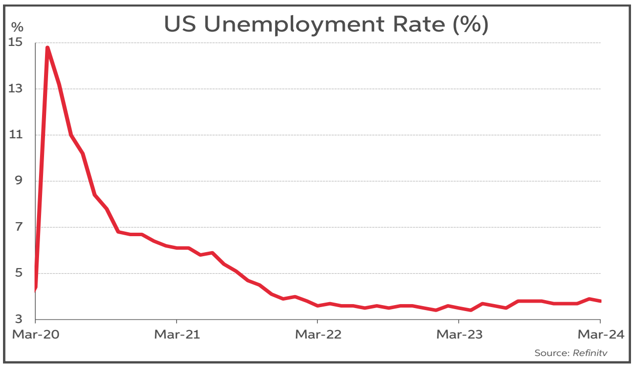


Regarding the labour market, there have been some signs that conditions are starting to ease. The unemployment rate rose to 3.9% in February, its highest level since January 2022 before edging back slightly to 3.8% in March. Meantime, having been stuck in a narrow 4.3-4.5% y/y range between August and February, average earnings growth slowed to +4.1 y/y in March, its lowest level since June 2021. However, the monthly increase in average earnings remained elevated at +0.3% m/m in March. Furthermore, the wages component of the Employment Cost Index increased by 1.1% in Q1. Meanwhile, payroll growth accelerated in Q1, averaging +276k, compared to +212k in Q4. **Overall then, despite some signs of easing, the US labour market still remains characterised by tight conditions.**

In terms of inflation, the disinflationary trend that had been in place in headline inflation throughout 2023 has stalled. After declining sharply in the first six months of last year, headline CPI has been in a 3.1-3.7% range since June 2023. Worryingly, this year it has accelerated from its low of 3.1% in January, rising to 3.2% in February and 3.5% in March. The March reading was also its highest since last September. Furthermore, the headline PCE deflator, rose to 2.7% in March, from 2.5% in January and February. **Meantime, core inflationary pressures are slowly dissipating.** Core-CPI has fallen in 16 of the last 18 months, but it was unchanged at 3.8% in March. 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 2.8% in February, its lowest level since March 2021, and stayed at that level in March. The Fed is forecasting core-PCE will ease to 2.6% in Q4 2024, 2.2% in Q4 2025 and to 2.0% by Q4 2026.

The limited amount of survey data available for Q2 have tended to disappoint to the downside. Both the services and manufacturing PMIs deteriorated in April, with the latter inching back into contraction territory, at 49.9 (compared to expectations for 52.0). Similarly, the manufacturing ISM moved into contraction mode, falling to 49.2 in April. Worryingly, the underlying details of the survey suggest inflationary pressures intensified and labour market conditions softened in the sector. Elsewhere, the Michigan and Conference Board measures of consumer sentiment fell in April, likely reflecting the recent softening in the labour market and stalling disinflation.

To summarise, the economy came into 2024 in rude health, on the back of strong growth, a tight labour market and falling inflation last year. Furthermore, the expansionary stance of fiscal policy continues to provide considerable a supportive backdrop. **The latest forecasts from the OECD are for the economy to maintain solid momentum this year, with GDP growth of 2.6%.** However, the large amount of excess savings build up during the pandemic, have been entirely run-down. Against this backdrop, some loss of momentum in the economy has started to appear in 2024, reflected in weaker GDP growth and survey data, as well as some softening in the labour market and stalled disinflation. Thus, the risks to the outlook are tilted to the upside for inflation and to the downside for growth.



Meantime, amid sticky inflation in Q1, the Fed seems much less dovish on the rates outlook now then it was at the start of the year. Owing to the higher interest rate environment and widening budget deficits in recent years, the CBO projects interest costs on US public debt will reach 3.2% of GDP in 2025, a new all-time high, reflecting a longer-term challenge for policymakers. However, the Fed remains very much in data dependent mode, meaning a resumption of the disinflationary path seen in 2023 would allow for policy easing to get underway later this year.

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