Four things to watch from the Fed this week

The strength of the domestic economy and rising price pressures will ensure another rate hike on Wednesday, but will emerging market and trade concerns result in a slower path of Fed tightening next year?

Source: Federal Reserve

Expect the Fed to hike by another 25bp this week

The Federal Reserve's FOMC gathers again this week to set monetary policy and a 25 basis point interest rate rise is the near-universal expectation. Growth is undoubtedly very strong, with high-frequency indicators suggesting activity likely accelerated in 3Q18 after the economy expanded at an already stellar 4.2% annualised rate in 2Q18. At the same time, all of the major inflation measures are at or above the Federal Reserve's 2% target, wages are picking up, the unemployment rate is close to an 18-year low and asset prices continue to rise. All this points to further tightening of policy.

We are also seeing a broadening out of the reasoning for higher interest rates. For example, Boston Fed President Eric Rosengren has repeatedly warned that monetary policy should be tightened from a financial stability perspective. He and others worry that unduly low borrowing costs could be the trigger for excessive risk-taking, which will store up trouble for the US economy in the future.

For that reason, we expect a rate hike this week and another in December. But markets will be watching closely for hints about the Fed's plans for 2019. Here are four things worth watching at this week's meeting:

1 Shrugging off trade tensions

For now, the Federal Reserve does not seem particularly worried about the intensifying trade war. The domestic story is clearly robust and the Fed will no doubt want to see some impact from trade tensions before altering its course – survey evidence that some businesses are reconsidering investment decisions is not going to be enough.

As for the inflation threat, as we noted last week, even in a worst case scenario where all Chinese imports were immediately subject to a 25% tariff and this was passed directly onto consumers, it would only lift headline inflation by around one percentage point. More likely, we see mitigating factors limiting this to 0.4 percentage points.

2 America First at the Fed despite EM risks

Strife in emerging markets is also unlikely to deter the Fed. Under former Fed Chairs Alan Greenspan, Ben Bernanke or Janet Yellen things may have been different, but the Jay Powell Fed is much more focused on the domestic story. Earlier this year he brushed aside criticism that the Federal Reserve wasn't thinking enough about the international implications of higher US borrowing costs, saying "the role of US monetary policy is often exaggerated". We agree that there isn't a great deal the Federal Reserve can do to address the fundamental challenges facing many of these emerging market economies, but a strong dollar and higher US borrowing costs certainly won't help their situation.

As such we expect the Federal Reserve to continue describing monetary policy as "accommodative", which will warrant "further gradual increases" in interest rates. The Federal Reserve will also be updating their forecasts, which were last published in June. This could see their GDP prediction nudged a tenth higher, while their so-called "dot diagram" of Fed member views is likely to continue pointing to a December rate rise with a median projection of three more 25 basis point rate increases next year – although with the usual broad spectrum of views within that.

3 Trump's reaction?

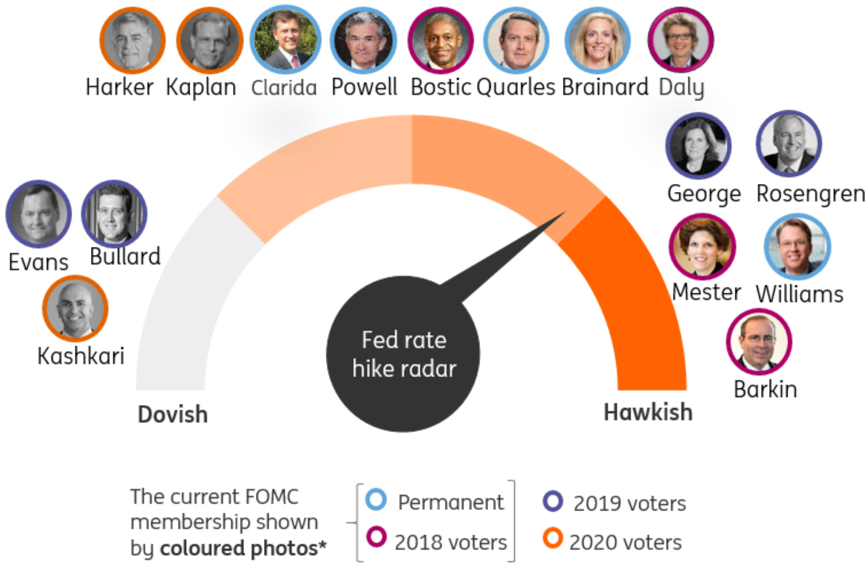
Donald Trump is unlikely to be particularly happy about this decision, having stated he was "not thrilled" by higher interest rates earlier this year. President Trump believes that the Fed is offsetting "all of this work that we're putting into the economy" and given the proximity to the upcoming mid-term elections, he could voice his irritation again after this week's interest rate rise. Presidential concerns are likely to fall on deaf ears though, given the strength of the US economy right now and the Fed's determination to defend its independence.

4 Fed to slow the pace of hikes in 2019

However, we do see the US economy facing more headwinds as we move into 2019. The massive fiscal stimulus of tax cuts and increased Federal spending early this year won't be repeated and the support from that stimulus will gradually fade. Tighter financial conditions in the form of higher US borrowing costs and the stronger dollar will also act as a brake on growth. Then there is the gradual drag from trade tensions that will impact supply chains and put up the cost of doing business, while emerging market weakness could start to exert more of a drag on global and US activity. This should help to dampen inflation pressures in the medium term.

That is not to say the US economy runs the risk of a sharp downturn - we still think the economy will expand a very healthy 2.3% next year versus 2.9% this year – but we wouldn't be surprised to see a slower pace of interest rate rises in 2019. After four hikes in 2018, we are looking for a more conservative two rate moves next year, with 1Q19 and 3Q19 our favoured periods.

What Fed members are saying



Neutral
"The economy is strong. Inflation is near our 2 percent objective, and most people who want a job are finding one. My colleagues and I are carefully monitoring incoming data, and we are setting policy to do what monetary policy can do to support continued growth, a strong labor market, and inflation near 2 percent.."

Jerome Powell, Fed Chair

Hawkish
"These developments raise the prospect that, at some point, the Committee's setting of the federal funds rate will exceed current estimates of the longer-run federal funds rate"

Lael Brainard, Board of Governors

Hawkish
"I don't see an inverted yield curve as being a deciding factor in terms of thinking about where we should go with policy"

John Williams, New York Fed

Neutral
"I will not vote for anything that will knowingly invert the curve and am hopeful that as we move forward I won't be faced with that"

Raphael Bostic, Atlanta Fed

Hawkish
"If things work out well for the economy, and that's what I expect and hope for, then we'll be in a situation where we need to have somewhat restrictive policy over time"

Eric Rosengren, Boston Fed

*Richard Clarida has joined as vice-chair of the Board (permanent voter), and Mary Daly has been appointed as new head of the San Francisco Fed (voting in 2018), though she will not formally take up her position until October 1st. Three of the seven positions (permanent voters) on the Board of Governors remain vacant.

Source: ING

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

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