Federal Reserve: Onwards and upwards

The Fed voted unanimously for another 25 basis point rate rise and while policy is no longer described as "accommodative" the "gradual increases" in the Fed funds rate look set to continue for at least another couple of quarters

Source: Shutterstock

A tweak in the language...

As almost universally expected the Federal Reserve has decided to raise the Fed funds target rate range another 25 basis points to 2-2.25%. The accompanying statement has dropped the sentence that described the Fed's monetary stance as "accommodative", but hasn't replaced it with any other descriptors. However, the Fed continues to expect that "further gradual increases" in the policy rate will be required for them to achieve their growth, labour market and inflation mandate. There were no other changes to the text with activity and job gains still described as "strong" while inflation remains near target.

New Forecasts suggest upside risks

The Fed has updated is economic projections though, with an extra "dot" in the form of new Fed Vice Chair Richard Clarida. GDP growth expectations for 4Q18 have been upped to 3.1% from 2.8% in June while the 2019 forecast has been raised a tenth of a percentage point to 2.5%. The forecast range has been extended to 2021, which is expected to see growth of 1.8%, down from 2% in 2020. This 1.8% figure is in line with the Fed's longer-run growth expectation. These projections are broadly in line with our own forecasts.

Inflation forecasts have barely changed and point to ongoing outcomes close to 2%. Unemployment projections are also broadly unchanged with 3.5% expected to be the low through 2019 and 2020.

As such the Fed continues to predict a central rate of 2.4% for end 2018 – implying one more rate rise this year. While 2019 is pencilled in at 3.1%, implying three rate rises and 2020 is at 3.4%. This appears to be the peak with the new 2021 prediction also 3.4%. However, the Fed has bucked the recent trend of cutting its longer-run projection and actually nudged it up to 3%.

ING's view

In terms of our view for Fed policy, economic activity is undoubtedly very strong with another 4%+ GDP growth figure looking possible for 3Q18, while 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. These all point to further interest rate rises, with another 25 basis point rate hike looking probable for December – 12 of 16 Fed officials predict it in the "dot diagram".

However, the outlook is more clouded for 2019. A recent Bloomberg survey suggests that analysts are favouring a 25bp rate hike in each of the first three quarters of 2019, identical to the Fed's guidance within today's forecasts. The market, on the other hand, is only really pricing in one hike next year. We are in the middle favouring two – one in 1Q19 and one in 3Q19.

We see the US economy facing more headwinds as we move into 2019. The support from this year's massive fiscal stimulus will gradually fade while 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. The caveat is that if these external tensions ease then we would be willing to raise our forecast to three 25 basis point rate rises in 2019.

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