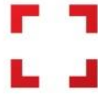


momentum
investments

The Macro Research Desk

From left to right: Herman van Papendorp (Head of Macro Research and Asset Allocation), Sanisha Packirisamy (Economist)

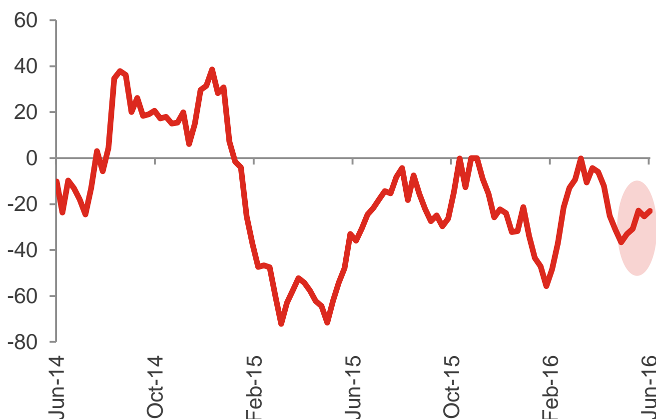
Making sense of the June 2016 US Federal Reserve rate-setting meeting

Growth is recovering and markets have quietened, but now hiring and expected inflation are a cause of concern

A dismal payrolls print for the month of May (38 000 jobs added versus a consensus expectation for a 162 000 gain) led to a significant repricing of interest rate hike expectations in the market in the run up to the June 2016 meeting. Although the Federal Open Market Committee (FOMC) admitted to the slower pace of improvement in the US labour market, it noted that economic activity had picked up.

Likewise, the Citigroup Economic Surprise Index turned less negative over recent weeks as the extent of downside surprises in US economic activity lessened (see chart 1). Although real GDP growth expanded at an upwardly-revised rate of 0.8% q/q in seasonally-adjusted annualised (saar) terms in 1Q16, growth forecasts for the second quarter of the year look healthier. The Atlanta Federal Reserve (Fed) NowCast (a model predicting GDP growth based on high-frequency data releases) indicates that growth could have expanded at 2.8% q/q saar in 2Q16 (above the Blue Chip consensus of 2.5%). Higher growth will most likely be driven by robust consumption expenditure, which is estimated to have expanded by 3.9% in 2Q16 based on realised retail sales figures to date.

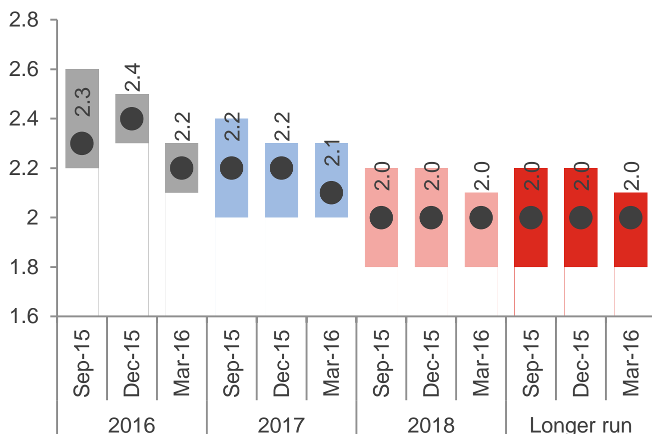
Chart 1: Momentum has turned less negative in US economic surprises recently



Source: Bloomberg, Momentum Investments

The Fed's growth forecasts have deteriorated in the near term, likely taking account of a weaker-than-anticipated first quarter print, but remain intact for the longer term (see chart 2).

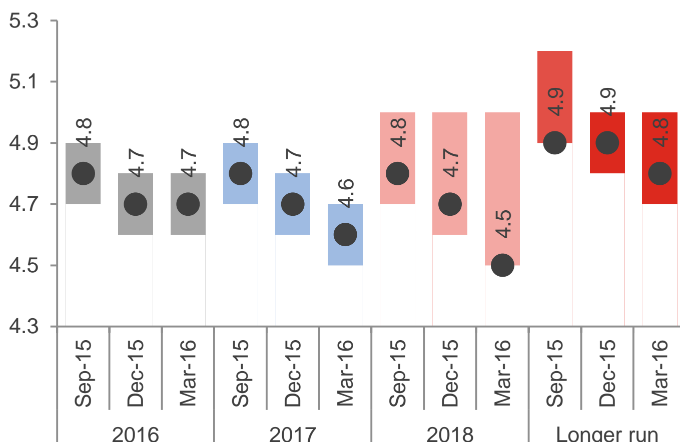
Chart 2: Fed's real GDP growth estimates (%) deteriorated for 2016 and 2017, but remained steady at 2.0% in the longer term



Source: Federal Reserve, Momentum Investments, dot = mid-point of central range

Notwithstanding a poor payrolls print in May, the Fed revised their unemployment rate estimates marginally lower in both the shorter and longer term (see chart 3).

Chart 3: Improvement in Fed's shorter- and longer-term unemployment projections (%)

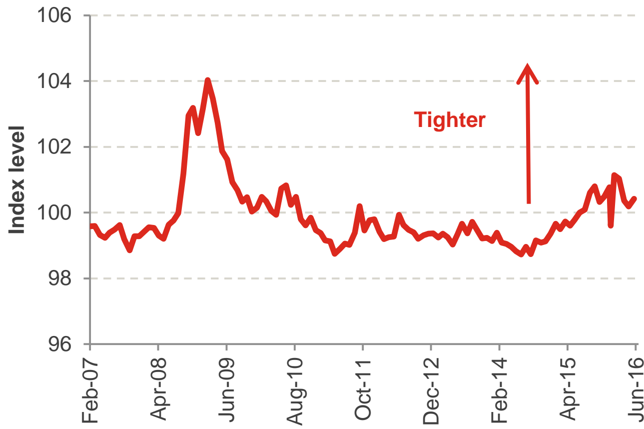


Source: Federal Reserve, Momentum Investments, dot = mid-point of central range

Transitory factors are still to blame for subdued short-term inflation forecasts

A previous concern of the FOMC was the extent to which the financial conditions index had tightened. This was largely a function of dollar strength and implied that interest rates would not have to be hiked by as much given that tighter financial conditions weigh negatively on growth. Nonetheless, the financial conditions index has rolled over in recent weeks (see chart 4) in response to relative US dollar weakness since the beginning of the year.

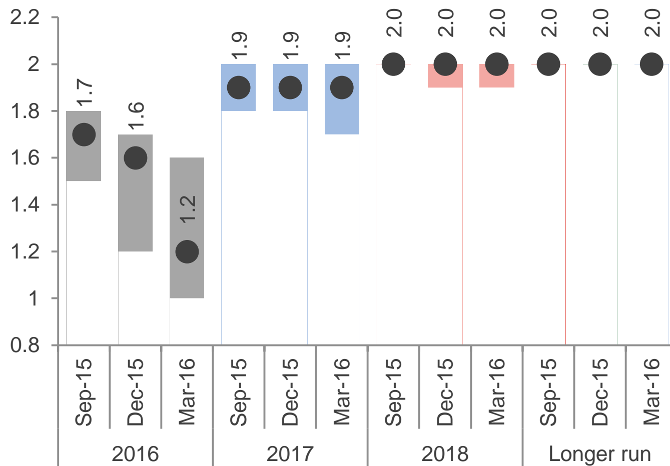
Chart 4: Looser financial conditions has an expansionary effect on growth



Source: Bloomberg, Momentum Investments

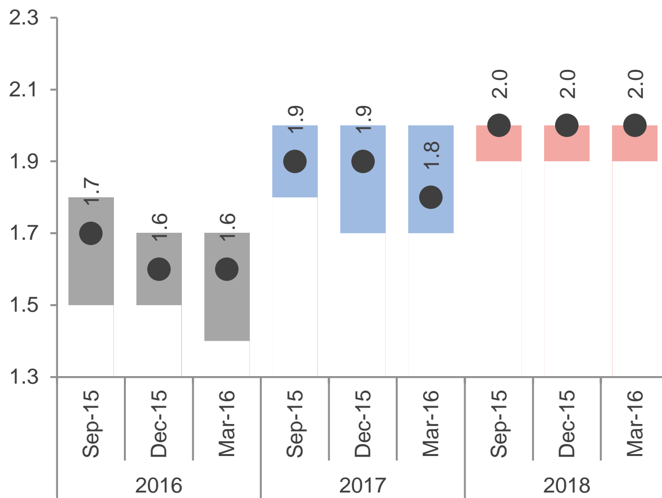
The Fed attributes low inflation to past declines in energy prices and an increase in the value of the dollar, but as these factors dissipate inflation is expected to rise. In the Q&A session, Fed Chair Yellen acknowledged that inflation was behaving roughly in the manner expected and that recent inflation outcomes were not a surprise to the Fed. The impact of transitory factors has led to the Fed lowering their 2016 inflation forecast (see chart 5), although estimates of core inflation have been little changed (see chart 6). Moreover, longer-dated market views on inflation remain comfortably above the Fed's 2% target (see chart 7).

Chart 5: Transitory factors affecting 2016 PCE inflation outlook (%)



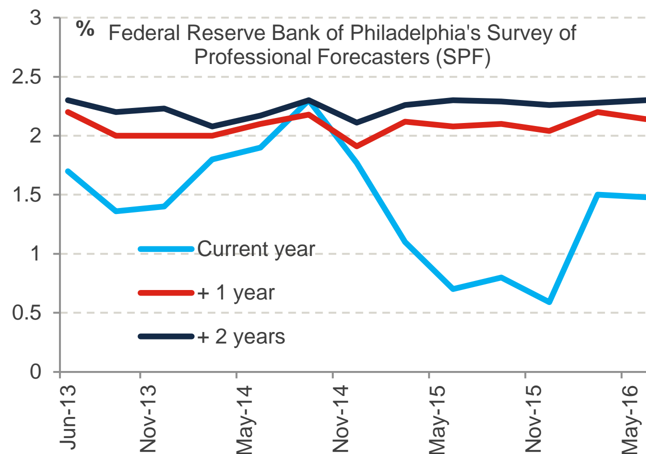
Source: Federal Reserve, Momentum Investments, dot = mid-point of central range

Chart 6 Marginally lower core PCE inflation outcome anticipated in 2017, but Fed expectations unchanged for 2018



Source: Federal Reserve, Momentum Investments, dot = mid-point of central range

Chart 7: Longer-dated inflation expectations remain above Fed's 2% target

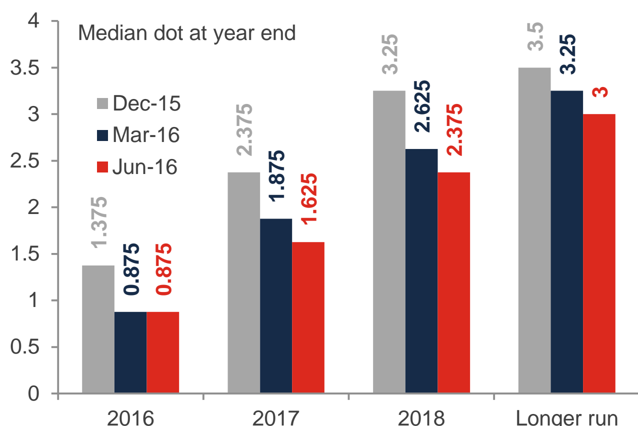


Source: Bloomberg, Momentum Investments

A more cautious mood amongst US FOMC members

The Fed statement was received as having a dovish overtone. The number of committee members only seeing one rate hike in 2016 went up from 1 to 6 (out of 17 members) relative to the March round of forecasting. Though the median forecast remains for two rate hikes before the year is up (see chart 8), the poor labour print for May has most likely dented perceptions of strength in the US labour market and the outlook for overall economic activity.

Chart 8: Fed members indicate a lower profile for interest rates



Source: Federal Reserve, Momentum Investments

Moreover, the FOMC's estimate of equilibrium interest rates (the rate at which the economy is in balance, growing with stable inflation and low unemployment) was lowered from 3.25% to 3% (see chart 9). Lower levels of productivity and the retirement of older workers (factors largely out of the Fed's control) have formed part of the debate around lowering the equilibrium interest rate.

Chart 9: Fed dot-plot shifting even lower and moving closer to market expectations

Source: Bloomberg

In response to global risks, Yellen admitted that Brexit was one of the uncertainties discussed by the committee and noted that the event could have consequences for the US economic outlook.

A more gradual approach to raising rates

The dovish tone of the statement and continued concerns over the impact of global economic and financial developments on the US economy confirms a gradual approach to interest rate normalisation. However, indications of a firmer growth outlook for the remainder of the year (largely driven by the consumer and services-related sectors) and a stabilisation in factors dragging near-term inflation lower suggest that interest rates could still be raised before the end of the year.

Even though longer-term interest rate expectations by the FOMC have moderated, ultimately higher interest rate prospects in the US should see capital flows accelerate away from emerging markets (EM), exacerbating funding concerns for those economies heavily reliant on foreign flows to fund fiscal and current account deficits. Apart from being exposed to potentially tighter financial conditions as a modest Fed hiking cycle gets underway, net commodity-exporting regions, including South Africa, are facing the headwinds of a less commodity-dependent Chinese growth model.

Table 1: Shift in key variables between the latest Fed meetings

	27 April 2016	14-15 June 2016 (before announcement)
Payrolls: 6-month moving average	c.239 000	c.170 000
Wage growth (average of employment cost index, average hourly earnings and compensation per hour): 6-month moving average (%)	2.6%	2.6%
Move in US stock market since previous Fed meeting (%)	3.4%	-1.1%
Change in EMBI spread (bps)	-34bps	+209bps
Move in trade-weighted dollar since previous Fed meeting (%)	3.2% weaker	0%
Gold price in USD/oz (move since previous Fed meeting, %)	USD1246/oz (-1.3%)	USD1294/oz (3.9%)
US 10 year yield (move since previous Fed meeting)	1.9% (0bps)	1.6% (-27bps)
Latest quarterly GDP print (% y/y)	2.1%	2.0%
Unemployment rate	5.0%	4.7%
PCE inflation (% yoy)	0.8%	1.1%
PCE core inflation (% yoy)	1.6%	1.6%

Source: Bloomberg, Momentum Investments (more dovish for rates, more hawkish for rates)

Language shift in the statements between the April 2016 and June 2016 meetings

- Labour market conditions have improved further → pace of improvement in the labour market has slowed
- Growth in economic activity appears to have slowed → picked up
- Household spending has moderated → strengthened
- Net exports have been soft → drag from exports appears to have lessened
- Market-based measures of inflation compensation remained low → declined
- Voting against the action was Esther L. George, who preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent → voted to keep rates unchanged

Disclaimer:
Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary. The content used in this document is sourced from various media publications, the Internet and Momentum Investments. For further information, please email us at ci.clientservice@momentum.co.za or contact us on 0860 111 899.