ECONOMIC RESEARCH

The NewsLine

June 16, 2016

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USA

Fed not yet budging from two rate hikes this year

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At its fourth meeting this year the Federal Reserve's Open Market Committee remained on hold. The key rate has thus been standing at 0.25%-0.5% since December. We nevertheless view two rate hikes this year as appropriate and likely. Assuming that the UK votes to remain in the EU, a rate hike in July is by all means on the cards.

Alongside the uncertainty surrounding the outcome of the referendum in the UK, the weak May jobs report was doubtless a key factor behind the decision to leave the federal funds rate unchanged. It had raised the question whether it signaled persistent reticence by businesses on the hiring and capital spending fronts.

Essentially, the Fed appears to be assuming a temporary lull on the labor market. With its updated economic projections, the Fed is sticking to its fundamentally positive picture for the economic outlook: moderate growth, improvement in the labor market situation and a pickup in inflation to 2% over the medium term. Hence, the signal of a gradual correction in monetary policy remains in place, even if, at 200 basis points, the scale of rate hikes deemed appropriate over the forecast horizon (to end-2018) has been tempered compared with the March projection. This change largely reflects the assessment of a lower "neutral" interest rate level. However, the Fed continues to indicate that the federal funds rate could be lifted to a target range of 0.75%-1% by the end of this year. At the subsequent press conference Janet Yellen stated that a rate hike in July was not impossible should the data – above all the labor market indicators for June – be convincing.

We incline to the view that recent subdued jobs growth and the concomitant stagnation in aggregate hours worked represent a reaction to the slowdown in the pace of growth in the winter months. Labor productivity slipped both in the final quarter of 2015 and at the start of this year.

With the pace of growth picking up again in the current quarter on the back of brisk consumption in particular, the weak performance in the previous quarters looks set to go into reverse. To this extent the prospects are good that, amid ongoing solid economic momentum, jobs growth will bounce back.

Inflation could also serve up a surprise in the months ahead. With the drop in the US dollar compared with the start of the year, import prices (ex petroleum products) have of late shown signs of picking up for the first time since early 2014. Although the Fed has nudged up its projection for the core inflation rate of the price index for personal consumption expenditures in the final quarter of 2016 (1.7%, median value), this correction looks to be on the cautious side.

All in all, we do not think a rate hike in July would be premature. And also considering that the Fed had already raised the prospect of an early rate hike prior to the publication of the May jobs report.

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