ECONOMIC RESEARCH

The NewsLine

April 25, 2016

} MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

USA

How does the Fed view the risks?

Dr. Michael Heise
Phone +49.89.3800-16143
michael.heise@allianz.com

Thomas Hofmann
Phone +49.69.24431-4912
t.hofmann@allianz.com

Allianz SE
https://www.allianz.com/economic-research/en

Allianz Research
https://twitter.com/AllianzResearch

At this week's meeting, the Federal Open Market Committee will probably leave the target range for the key rate at 0.25%-0.5%. Despite what will probably turn out to be disappointing growth in the first quarter, the Fed is likely to stick with its fundamentally positive assessment of the economic outlook. The financial markets will be keeping a close eye on whether there is any change in the risk assessment. In our view, the strong emphasis on external risks is no longer appropriate.

For a while now the Fed has been signaling that it intends to change course gradually and will react flexibly to the incoming data. Having lowered the curtain on zero interest rates in December 2015, in January and March of this year it remained on hold, pointing to external risks.

In the statement accompanying the monetary policy decisions, the assessment of the pace of expansion in the US economy will probably be slightly less favorable than in mid-March. All told, the available data suggest that first-quarter growth was well below the average quarterly growth seen in the current cycle (2.1%, annualized rate). Unsurprising is that inventory investment continued to be throttled back and that net exports and investment spending in the energy sector dragged economic activity down. But the picture for consumption has also changed, above all because the encouragingly positive data originally published for January have been revised down sharply. This suggests that growth in consumer spending will have slowed compared with the final quarter of 2015. By contrast, the Fed is likely to stick with its positive assessment of the labor market situation. Averaging

more than 200,000 a month in the first three months of the year, jobs growth remained extremely robust.

However, the Fed is unlikely to read too much into the soft GDP data. After all, the constellation of weak growth in overall output and ongoing solid increases in the number of people in work in the region of 2% (annualized rate) has been seen frequently in the past few years. And recent statements by Fed officials have also highlighted this pattern, which in subsequent quarters was accompanied by a return to stronger growth. Moreover, concerns still linger that purely seasonal factors in the data are not being adequately filtered out, with the result that the underlying trend in economic growth at the start of the year is being understated.

Against this backdrop, we believe the Fed will stick with its fundamental assessment of the economic outlook (moderate growth, further improvement in the labor market situation and pickup in inflation to 2% over the medium term). At the same time, given that the dollar is no longer quite so strong, we would consider it appropriate to at least temper the current assessment of risks to the economic outlook. For one thing, a broadly stable external value of the US dollar enhances the outlook for industry, for another the downward pressure on import prices will fade. At an estimated 1.6% in the first quarter, the core inflation rate of the price index for personal consumption expenditures was already a good bit closer to the Fed's target than on average in 2015 (1.3%).

But the Fed is unlikely to take the step of describing the risks as entirely balanced, which would be a clear signal for a rate rise in June. It is likely to want to see more confirmation that growth is clearly firming up again. At present, the very low level of initial jobless claims – in mid-April they had fallen to the lowest level for more than 40 years – is the main pointer to ongoing solid demand for labor and hence evidently also upbeat sales expectations. We continue to see two further rate hikes during the course of this year. At the end of the year the federal funds rate is thus likely to be in a range of 0.75%-1%.

These assessments are, as always, subject to the disclaimer provided below.

ABOUT ALLIANZ

Together with its customers and sales partners, Allianz is one of the strongest financial communities. About 85 million private and corporate customers insured by Allianz rely on its knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks. In 2015, around 142,000 employees in over 70 countries achieved total revenues of 125.2 billion euros and an operating profit of 10.7 billion euros. Benefits for our customers reached 107.4 billion euros.
This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.