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Fed eyes December rate hike

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The Fed steered clear of changing key rates in the nervous pre-election environment. But in line with the signals it had already provided in September, it stresses that an increase in the federal funds rate is imminent. This is logical as the economic data are moving in the desired direction. We are assuming that the rate hike will now be enacted at the December meeting. Our expectation of continued cautious monetary policy normalization next year with rate hikes totaling 50 basis points also remains unchanged.

In the Fed's view the arguments for a rate hike have continued to strengthen. For the time being, however, it intends to wait for some further evidence of continued progress toward its objectives on employment/unemployment and inflation. The accompanying statement suggests a clear improvement in the assessment of the inflation outlook. Confidence that the 2% goal will be reached has evidently risen.

After a year-long hiatus we believe the available data do indeed justify further monetary policy correction. At 1.7% on a year earlier, the core inflation rate of the price index for personal consumption expenditures was already 0.3 percentage points higher than in the final quarter of 2015. In the fourth quarter inflation could even reach 1.8%, within spitting distance of the Fed's 2% goal. Given such a marginal shortfall, interest-rate rules à la Taylor would flag up an appreciable correction of the policy rate. Moreover, the various measures of wage growth confirm underlying upward pressure due to the firm labor market. With a further drop in the unemployment rate, as the Fed is expecting next year, this process is likely to become entrenched.

Ongoing solid job gains are on the cards as economic activity has picked up again of late following a phase of modest growth driven primarily by consumption. At an annualized 2.9% in Q3, the quarterly increase in overall output was more than twice the rate seen in the second quarter. This pickup supports the Fed's September projections showing an increase in real gross domestic product of 1.8% in the course of 2016. In the current quarter GDP would have to expand by "only" 2%-2½% in order to reach this figure. We think such an outturn is achievable as the expansion in overall demand is now more broadly-based. All in all, only an abrupt turn for the worse could prompt the Fed to delay the rate hike.

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