INVESTMENT
research

14 August 2015

by David Page
Research & Investment Strategy

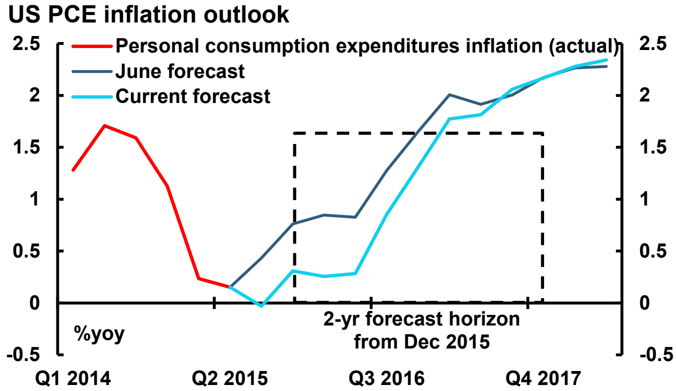
Adjusting our Fed rate outlook

Inflation outlook downgrade to postpone tightening cycle

Key points

- We are changing our long-standing call for the first Federal Reserve Fed funds rate hike to come in September, to December.
- We continue to anticipate three rate hikes in 2016, leaving policy at 1.00-1.25% by end-2016.
- A material downgrade to the short-term inflation outlooks prompted our change of view. This seemed inconsistent with fulfilling Fed Chair Yellen's "reasonable confidence" of rising inflation rate hike pre-requisite.
- The deteriorating inflation backdrop was prompted by lower oil prices, disappointing wage growth and a stronger dollar. This last factor was exacerbated by China's exchange rate regime change.
- Yet progress towards the US's longer-term goals, particularly in eliminating labour market spare capacity, continues to point to a 2015 rate hike.

Exhibit 1
Inflation rebound delayed, but in the post



Source: US Bureau of Economic Analysis (BEA) and AXA IM Research

Since the start of this year, we have considered the Federal Reserve likely to begin a gradual monetary policy tightening in September. However, economic data in recent weeks has led us to change our view. Though we concede this still appears a close call, we now expect the Fed to tighten policy in December, not September, raising the Fed Funds target range to 0.25-0.50% from its current 0.0-0.25%.

We maintain our outlook for policy in 2016, envisaging three 0.25% rate hikes in 2016. This would see the Fed funds target range at 1.00-1.25% by end-2016, in line with our current expectation. This would be consistent with the ‘gradual’ tightening the Fed has signalled.

The shift in our view reflects the material downgrade to the short-term inflation profile in recent months. Falling oil prices, surprisingly weak wage growth and a sharp rise in the dollar have combined to lower the inflation outlook over the coming quarters. These developments appear inconsistent with Fed Chair Yellen’s rate rise pre-requisite of “reasonable confidence” that inflation will return to mandate consistent levels in the coming years.

However, broader US progress towards long-term goals – notably unemployment close to its estimated long-run level and an expected rise in inflation after a more persistent adjustment in energy prices particularly – still leads us to expect a December hike.

We expect bond yields and the dollar to soften in the near future if the Fed leaves policy on hold next month. But otherwise, we see this revision as a modest adjustment to a longer-term outlook for gradual normalisation. We expect bond yields and the dollar to resume a slow upward path towards year-end. We also note some upside risks to bond yields and higher volatility associated with IMF concerns of a “super taper tantrum”. However, we stress, any such rise would likely prove short-lived.

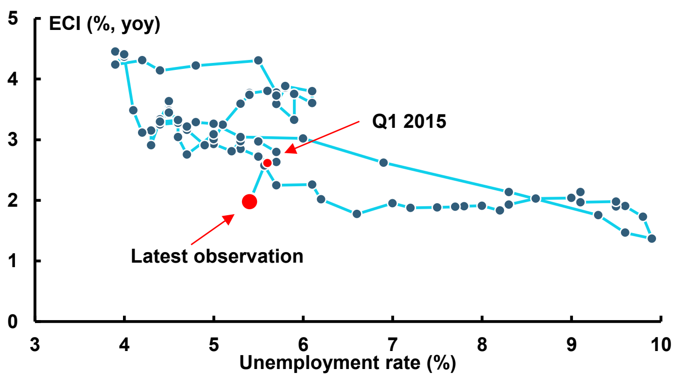
“Reasonable confidence” proves elusive

In June, Fed Chair Janet Yellen suggested the Federal Open Market Committee (FOMC) would likely raise rates in 2015 if the economy evolved as the FOMC expected, but that such a decision would be data-dependent and would require the Fed had “reasonable confidence” that inflation would return to target over the next few years. Since then developments, have almost uniformly argued against such a tightening.

Admittedly, GDP rebounded in the second quarter dismissing concerns of a more material weakening in the US growth outlook. Although second-quarter GDP recorded growth of just 2.3%, upward revisions to the first quarter left GDP in the first half of the year as a whole firmer than had been expected. Moreover, payroll growth has continued along a solid path and the ISM non-manufacturing survey has risen markedly, reinforcing our outlook for a faster pace of growth in the second half of 2015. Yet the inflation outlook has deteriorated markedly.

Exhibit 2

Employment cost index questions pace of wage growth

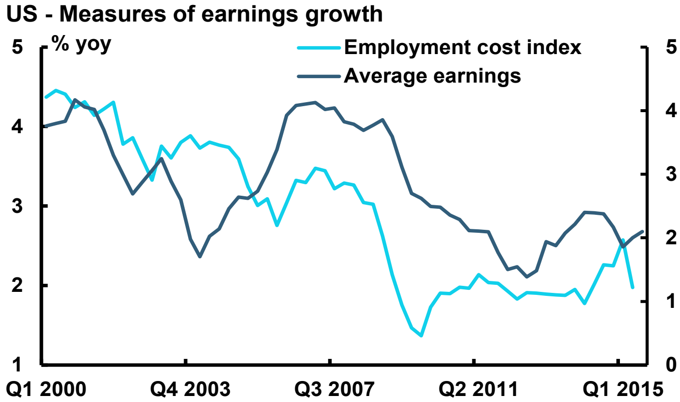


Source: US Bureau of Labor Statistics (BLS) and AXA IM Research

Before the July FOMC meeting, oil prices began to fall again. At the time of the July meeting, oil prices (WTI) had fallen by 19% since the previous meeting. This led to the Fed dropping its assessment that “energy prices appear to have stabilised” from its July statement. **Oil prices now stand 28% lower than in June**. While the pace of decline should prove temporary and encourage faster spending growth over coming quarters, it will delay the rebound in US CPI inflation from current subdued levels. It also increases the risks of a softening in medium-term inflation expectations.

Exhibit 3

Little evidence of wage growth acceleration



Source: BLS and AXA IM Research

Second quarter’s employment cost index reversed much of the acceleration in wage growth recorded over the past year. This dimmed the “tentative signs” of wages pick-up noted by the Fed. *Exhibit 2* shows a deviation in the jobless/wage growth relationship witnessed over the past twenty years. *Exhibit 3* shows little evidence suggesting emergent wage growth acceleration. This is likely to reduce the Fed’s confidence over the medium-term inflation outlook. Additionally it questions the Fed’s assessment of the tightness of the labour market.

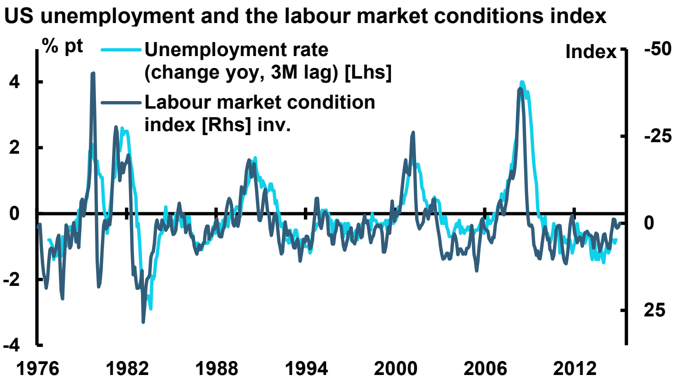
The dollar has also risen sharply. Market expectations of a tightening in Fed policy contributed to a rise in the trade-weighted dollar in excess of 3% since June. On 11 August, the People's Bank of China changed its exchange rate regime. While in part a reform to introduce greater market determination, it has also delivered outright depreciation, with the yuan down around 4% to date. With currencies in other emerging markets softening in sympathy with the yuan, this should put further upward pressure on the dollar.

The Federal Reserve's economic model suggests a similar effect on inflation over three years from a 2.5% rise in the trade-weighted dollar and a 0.25% Fed funds rate increase. In inflation terms, the rise in the dollar has delivered the equivalent of more than one rate hike since June.

Real economy risks

The FOMC is also likely to be mindful of downside risks to growth. Internationally, although the agreement on a third Greek bailout appears to have avoided the worst-case scenario of Grexit, China's slowdown continues to threaten. This has been exacerbated by the fall in Chinese stock markets and has played some role in the yuan's recent depreciation. Softer economic activity in China threatens weakening global growth.

Exhibit 4
Labour market improvement slows



Source: BLS, Federal Reserve Board (FRB) and AXA IM Research

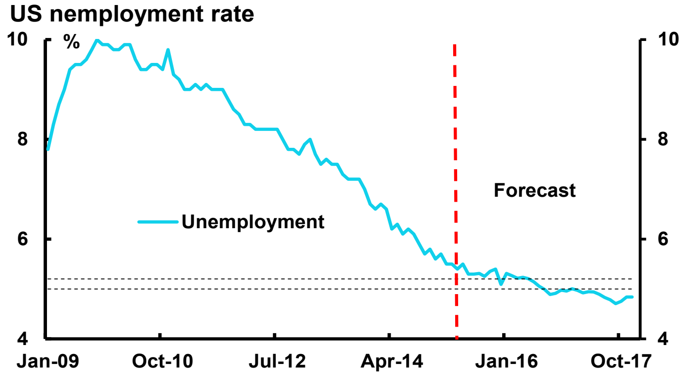
Domestically, while we remain confident in the consumer's ability to drive faster activity in the second half, the latest Conference Board measure of consumer confidence recorded a material decline. If persistent, this could further delay acceleration in US GDP growth. Moreover, manufacturing output remains weak, a trend reflected in other international economies. While we expect a pick-up in output reflecting stronger consumer spending, we note that the Fed has rarely tightened policy with the ISM survey – the leading US manufacturing indicator – at current levels. Moreover, the renewed decline in oil prices threatens further industrial weakness from the energy and supporting sectors, before the broader manufacturing sector has a chance to respond to yet cheaper energy prices.

Finally, while the labour market has continued to post steady improvement, the Fed's labour market conditions index has softened this year (*Exhibit 4*). On this measure, the labour market is exhibiting "some further improvement" as the FOMC sought in July. However, we argue that this pace does not require urgent attention from the FOMC.

But 2015 hike still looks likely

However, the US economy's ongoing progress to eliminate spare capacity still looks likely to require tighter monetary policy later this year. Comments from Atlanta Fed President Lockhart reinforced this outlook. He recently argued that the "accumulated progress we have seen quite literally over a number of years"[1] warranted tighter policy. Although this seems the antithesis of data-dependency, we have a lot of sympathy with his view

Exhibit 5
Unemployment soon to reach long-run rate



Source: BLS, FRB and AXA IM Research

Progress in the labour market is key. The unemployment rate has fallen dramatically in recent years and on our forecasts looks likely to fall into the Fed's 5.0-5.2% estimated range of the long-run unemployment rate before year end (*Exhibit 5*). There are doubts as to whether the natural rate of unemployment is actually lower than this estimate. However, the Fed is likely to feel increasingly uncomfortable with a labour market close to its equilibrium rate and monetary policy still "ultra-accommodative".

Wage growth is still likely to be important. While we argue that the second quarter's soft figures will have added uncertainty to the outlook, we still expect clearer signs of wage acceleration to emerge. Moreover, Fed Chair Yellen has previously suggested that an acceleration in wage growth was not a pre-requisite for a hike. With productivity weakening in recent quarters, unit labour costs have edged higher. Unit labour cost growth looks set to rise to around 2% over the second half of 2015 before rising higher thereafter. This should galvanise the Fed.

These projected developments are underpinned by our expectation for solid growth in the second half of 2015. Falling oil prices cast some downside risk to our forecasts of growth averaging in excess of 3% in the second half as this could prompt further energy sector cutbacks. However, this may also convince consumers that oil prices are set to be

[1] Interview with the Wall Street Journal, 4 August 2015

permanently lower – a factor that may have contributed to a lacklustre boost to spending to date. We expect solid income growth to underpin robust household spending.

Finally while we have argued that the short-term inflation outlook has softened, much of the adjustment merely delays a rebound in headline inflation from energy price base effects. *Exhibit 1* illustrates the evolution of our inflation outlook since June. On current forecasts, the Fed is likely to anticipate PCE inflation rising above 2% within a two-year time horizon by December.

Market implications

The immediate impact of the Fed leaving policy unchanged in September should be a lowering of interest rate expectations. Many believe the Fed could still hike rates in September and failure to do so is likely to see an adjustment of expectations, including rising doubts that the Fed will hike this year.

Such a shift in interest rate expectations is likely to arrest the dollar's appreciation in the short-term. It is also likely to see yields soften, particularly at the short-end, although 10-year yields may also soften immediately after the decision.

However, our new rate outlook suggests that the Fed is merely postponing the start of its gradual tightening cycle by 3-months. In the context of a slow normalisation of policy, this is likely to prove a mere fine-tuning. Moreover, the economy should achieve additional momentum from a delayed tightening and lower oil prices, which we see broadly offsetting downward pressure on inflation from a firmer dollar over the medium term.

As such, we maintain our outlook for a gradual increase in 10-year Treasury yields from here, expecting the eventual turn in the interest rate cycle and modest pace of tightening to push 10-year yields towards the upper end of a 2.5-3.0% range by end-2016 edging gradually higher thereafter.

However, a December hike may make for a volatile end-year. Rising interest rate expectations, an associated shift in term premia and uncertainty over how quickly the Fed might adjust its balance sheet policy could all lead to a noteworthy pick-up in yields after a hike. Such concerns have fuelled New York Fed President Dudley's expectation of "dislocation" around the time of the first hike and the IMF's warnings of a "super taper tantrum". This could be exacerbated if such an adjustment suffered another patch of illiquidity, potentially made worse by seasonal trading conditions.

However, we would see any such sharp rise in yields as temporary. We would expect the Fed to soothe any market indigestion with guidance of "gradual" tightening. The Fed may also issue clearer guidance over future balance sheet policy – particularly if a rise in yields appears associated with this risk. Finally we also expect international capital flows to mute any divergence in bond yields – although such flows have historically lagged moves in spreads.

DISCLAIMER