Thursday, 18 December 2014

Door Widens for US Rate Hikes

- The Federal Reserve has offered its strongest signal yet that it is on track to raise interest rates next year, by removing the pledge to maintain rates near zero for a “considerable time”.
- The Statement was more hawkish, but the Fed still offered some assurance that rate hikes were not happening in a hurry; the Fed indicated the new guidance was consistent with its previous guidance.
- Chair Yellen in her press conference hinted that rates would not rise before April at the earliest.
- The path of the Federal funds target rate is still dependent on how economic conditions evolve.
- We continue to expect the Fed to start hiking rates in June 2015, but an earlier move cannot be ruled out. The USD should strengthen from this possibility. With the RBA unlikely to raise rates until 2016, the AUD/USD exchange rate should soften further towards the mid 70s next year.

The Federal Reserve this morning offered its strongest signal yet that it is on track to raise interest rates next year, by removing the pledge to maintain rates near zero for a “considerable time”. The Fed tweaked the language of the statement to say that its committee would “be patient in beginning to normalise the stance of monetary policy”. The statement was more hawkish, although the Fed also provided some assurance by adding that this (new) guidance was consistent with its previous statement that rates would stay low for a “considerable time”.

Fed Chair Janet Yellen told a news conference suggested the policy-setting Federal Open Market Committee (FOMC) was unlikely to hike rates for "at least a couple of meetings”. These remarks hint that rates are not likely to rise until April next year at the earliest. Yellen also said that a number of committee participants have indicated that in their view conditions could be appropriate by the middle of next year, but there is no pre-set time and there are a range of views as to when the appropriate conditions will likely fall in place.

One can conclude from these comments that the Fed’s path of rates is still dependent on how economic conditions actually evolve. The labour market will continue to receive a lot of focus in this regard. On the labour market, the statement said that “a range of labour market indicators suggests that underutilization of labour resources continues to diminish”. This is more hawkish than the previous statement that described it as “gradually diminishing”.

The economic conditions also include inflation. Inflation in the US is still relatively benign and more recently has come under downward pressure by falling oil prices. In data released overnight, consumer prices dropped 0.3% in November, representing the biggest percentage monthly fall since December 2008.

Yellen said by the time of lift-off, committee participants can expect to see core inflation to be running near current levels, but foresee being reasonably confident that inflation will move back toward the Fed’s 2% longer-term inflation objective over time. The Fed’s inflation forecasts also suggest the downward pressure on inflation will be short-lived and inflation will head back towards 2% in the longer run.

The Fed would also expect to see some further decline in the unemployment rate and additional improvement in labour market conditions.

On the recent turmoil in financial markets, namely Russia, Yellen told reporters that she sees the spillover from Russia to the US as pretty small.

Fed Projections

Fed economists also provided their quarterly projections along with the policy statement. The projections are presented as a range that excludes the three highest and three lowest individual forecasts.

The Fed has stuck to its economic growth forecasts for 2015 of 2.6-3.0% in 2015. GDP growth for this calendar year was more optimistic.

The unemployment rate is expected to move down to an average of between 5.2-5.3% toward the end of next year, a slight improvement from 5.4%-5.6% in their September assessment.

Officials projected 1.0% to 1.6% consumer price inflation in 2015, a large downward revision from earlier estimates. But they saw it returning to between 1.7% and 2.0% in 2016 and between 1.8% and 2.0% in 2017. Core inflation, which excludes volatile items like food and energy, is projected to dip only slightly next year and reach the Fed's target by the end of 2016.

Fifteen of the seventeen Fed officials said they expected to raise rates in the coming year. The median estimate (or consensus) among officials put rates at 1.125% by the fourth quarter of 2015. They see a modest path of increases once they start. The median estimate for rates at the end of 2016 was 2.5% and for 2017 3.625%. Those estimates are all modestly lower than the Fed projected in September; it suggests that officials continue to expect to move rates up next year, but they project a mild approach to tightening. The estimates also imply Fed officials have in mind around four 25bp moves in 2015.

St.George Outlook

We continue to stick to our long-held view that the US will start raising rates in June next year, although there is a growing a risk of an earlier move.

We also continue to expect the USD to strengthen on US rate-hike expectations. With the RBA unlikely to raise rates until 2016, the AUD/USD exchange rate should soften further towards the mid 70s next year.

Please refer to our AUD outlook dated 10 December for more information on the AUD Outlook:
htttp://www.stgeorge.com.au/assets/stg/downloads/report-centre/eco_reports/AUD-Outlook-10Dec14.pdf.

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