US: CHANGE TO FED OUTLOOK MARCH 2017

The Fed is set to increase the fed funds rate at its March meeting

NAB Group Economics

Following clear signals from the Fed over the last week we now expect the next increase in the fed funds rate will be in this month's meeting. We are also now expecting three rate hikes this year rather than two.

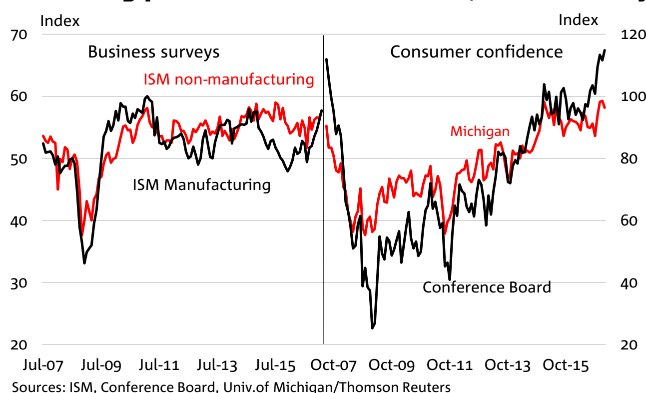
Change to fed rate call – March hike now expected

We have brought forward our call for the timing of the next federal funds rate hike from June to March. This would take the fed funds target range to 0.75 to 1.00%.

The change in our call reflects clear signals from a slew of Fed speakers over the last week or so, capped off by the Chair Janet Yellen on Friday (US time). Referring to the upcoming Fed meeting on 14-15 March, the Chair indicated that if employment and inflation have moved in line with their expectations, "…a further adjustment of the federal funds rate would likely be appropriate."

The message from Fed speakers – including dovish ones such as Fed Governor Lael Brainard - over the last week or so is that this bar has been met. As a result market implied pricing from 30% on 28 February to around 80% now.

Fed seeing positives from businesses/h'hold surveys



Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

This is despite some recent weakness in the 'hard data' which will be used to estimate Q1 GDP.

However, weakness in first quarter GDP has not been unusual in recent years and surveys of business and consumers show a solid underlying economy. These surveys were cited by New York Fed President William Dudley, together with rising stock prices and narrowing spreads, as factors that increase confidence that the economy will remain on track. Fed members have also indicated that risks to the outlook have become more balanced, with overseas risks receding and expectations of stimulative fiscal policy providing some upside as well.

The main risk to a Fed hike in March is Friday's employment report. However, it would have to be very weak to change Fed views. The Fed is used to seeing a degree of volatility in the data and won't be put off by a soft report particularly as other indicators of the labour market are running strong; highlighted by the decline in initial jobless claims to a new low.

Labour market in good shape

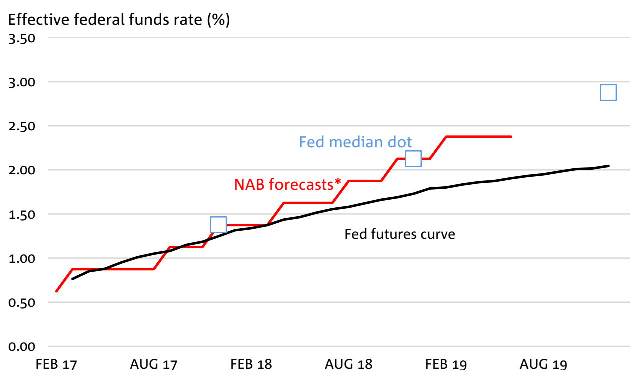
Source: Department of Labor

The more open question is what a decision to hike rates in March would mean for the fed funds rate over the next few years.

In her speech the Fed Chair indicated that the process of tightening monetary policy "…likely will not be as slow as it was in 2015 and 2016."

Of course the pace over this period was only one rate hike a year, so this does not provide that much direction and Fed speakers still refer to a 'gradual' tightening in monetary policy. We had been allowing for two rate hikes over 2017, but with the Fed more confident about the outlook and jettisoning some of the caution of recent years, we now expect three rate hikes. This brings us in line with the median Fed member projection from the December meeting (updated projections will be released following the March meeting), but above what is priced into the fed futures curve.

Now expect total of 3 rates hikes this year



Source: Bloomberg, NAB *mid-point of NAB's projection of the fed funds rate target range

Key risks around this rate track are the extent to which fiscal policy is loosened as the President seeks to implement his tax and infrastructure policies, as well as how the US dollar and other measures of financial conditions such as credit spreads responds to it. Major fiscal stimulus would stoke Fed fears of getting behind the curve and likely lead to a faster pace of tightening, while a large appreciation of the dollar could slow it down.

Assuming the March hike goes ahead, we tentatively expect the next move by the Fed will be at its September meeting and the last hike for the year in December. We assume that the Fed's bias for using meetings with a scheduled press conference (March, June, September and December) to hike rates continues.

At this stage, the risks between the next hike being in June or September are probably balanced. However, we have pencilled in September as: it would represent a pause in which the Fed could evaluate the early impacts of two rate hikes in quick succession (by recent standards); our forecast that inflation, on a core basis, will remain below the 2% target for much of 2017; and a likely desire to gain clarity around the fiscal outlook. While the Administration is likely to release a budget request shortly, what will get through Congress may take longer to emerge - the Treasury Secretary does not expect to see tax legislation passed until August.

We have not made any change to our expected peak for the fed funds rate – 2.5% – although we have brought forward the timing at which it will be reached. The expected peak is based around our view of the long-run neutral rate (the rate where policy is neither stimulatory nor contractionary) of 0.5% in real terms (2.5% nominal terms given the Fed's 2% target), below the current Fed consensus of around 1%, and reflects a range of factors including the economy's growth potential.

NAB fed funds rate projections

	Previous	Revised
31-Dec-16	0.75	0.75
31-Mar-17	0.75	1.00
30-Jun-17	1.00	1.00
30-Sep-17	1.00	1.25
31-Dec-17	1.25	1.50
31-Mar-18	1.25	1.50
30-Jun-18	1.50	1.75
30-Sep-18	1.75	2.00
31-Dec-18	2.00	2.25
31-Mar-19	2.25	2.50
30-Jun-19	2.50	2.50

note: top of federal funds rate target range shown

Bottom or range assumed to be 25 bp lower

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