26. March 2018

https://blog.en.erste-am.com/us-fed-tightens-monetary-policy/

US Fed tightens its monetary policy

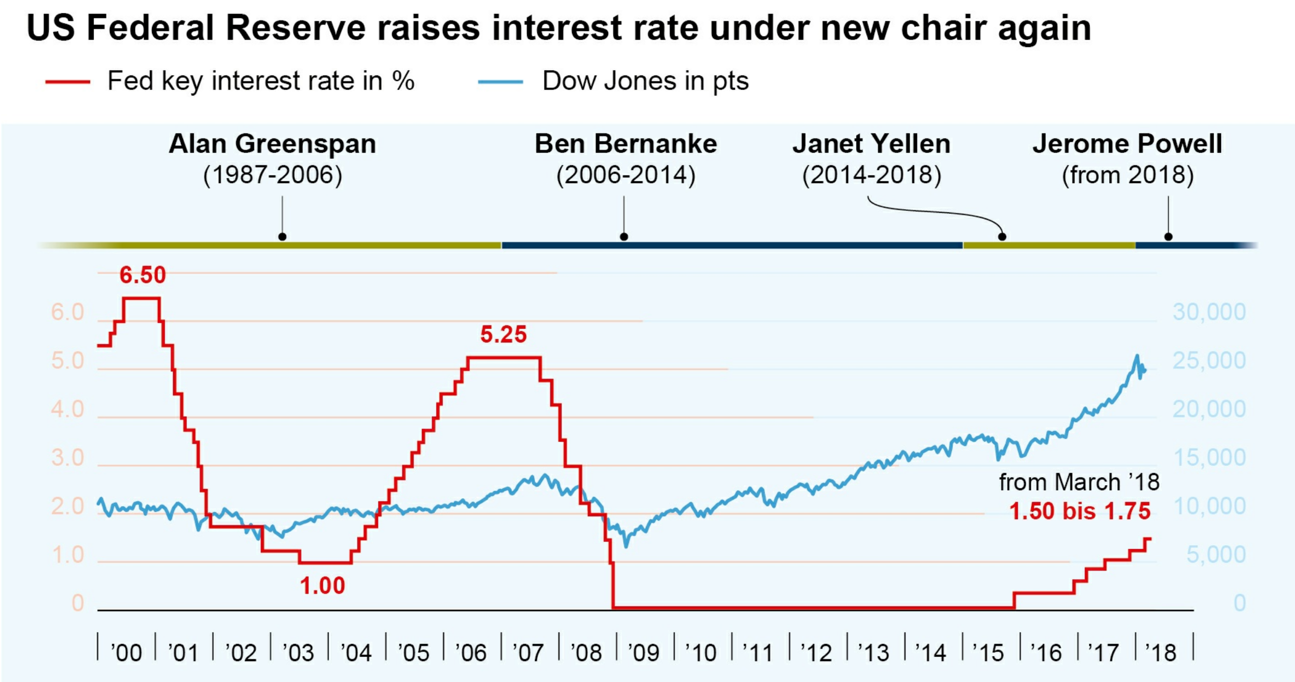
Gerhard Winzer

© (c) iStock

The most important central bank of the world, the US Fed, increased the Fed funds rate on 21 March and also published projections for economic key indicators. Even though this does not sound like much, the implications for the markets are significant.

Cycle of rate hikes

The target band of the Fed funds rate was increased by 0.25 percentage points to a range of 1.50 – 1.75%. This is the sixth increase of this cycle, which was started at the end of 2015. Economic growth is becoming gradually more self-supporting, i.e. it requires less support from the monetary policy.



Contracted by: Erste Asset Management; source: APA

APA-contract chart

Restrictive interest rate level

The natural key-lending rate is an important concept for the monetary policy. That is the level that is neither supportive nor dampening for economic growth and inflation. The central bank estimates this interest rate at 2.9%. Remarkably, the forecast for the end of 2018, 2019, and 2020 is 2.1%, 2.9%, and 3.4%, respectively. This implies a moderately restrictive Fed funds rate in about two years.

Boom phase

The projections of economic growth and unemployment rate suggest the continuation of the economic boom. In the foreseeable future, i.e. until 2020, economic growth is expected to exceed potential growth (i.e. the growth rate expected for the long term). As a result, the capacity utilisation of resources in the economy will continue to increase and exceed the long-term optimum level. In other words: while the actual unemployment rate at the end of 2020 is expected at only 3.6% (currently 4.1%), the structural unemployment rate (i.e. the non-accelerating inflation rate of unemployment) is envisaged at a higher level (i.e. 4.5%).

Weakening growth

However, there are two flies in the ointment of this favourable environment:

1. Potential growth is still seen at low levels (1.8%), i.e. productivity growth remains low. The currently strong economic growth is of a cyclical nature.
2. Both the Fed funds rate and economic growth are subject to normalisation. We are currently at the peak of the economic cycle, i.e. the acceleration phase of economic growth is over, and the growth rate is expected to gradually decline in the coming years (GDP growth 2018: 2.7%; 2019: 2.4%: 2020: 2.0%; long-term: 1.8%).

Low inflation

Despite the persistent boom phase, inflation remains low. Core inflation is expected to rise from the current, low level of 1.5% p.a. to 1.9% (end of 2018) and 2.0% (end of 2019), respectively. Technically speaking, the Phillips curve, which describes the relationship of unemployment rate and inflation, is very flat, but not horizontal.

Conclusion

1. The currently booming economic environment increases the optimism of the central bankers. The forecasts for economic growth, the Fed funds rate, and (minimally) the inflation rate have been revised downwards slightly relative to December 2017.
2. The level of the Fed funds rate will remain supportive for the risky asset classes for a while.
3. The uncertainty with respect to the estimates of the neutral interest rate, the structural unemployment rate, and the relationship of unemployment and inflation (Phillips curve) is a substantial one. The low inflation pressure in particular allows the central bank to proceed cautiously in this context. Some market participants had expected to see a revision from three to four rate hikes this year. This has not happened (yet).
4. The combination of rate increases and an expansive fiscal policy (expansion of the budget deficits) often suggests an appreciating currency. At the very least, the US dollar abandoned its downward trend at the beginning of the year.
5. One of the most important economic indicators is the difference between long and short-term government bond yields. A big difference implies an economic upswing. A negative difference is called an inverse yield curve, which often indicates a recession. The difference is still positive at the moment. However, the projections for the Fed funds rate (3.4% at the end of 2020) and the neutral interest rate (2.8%) suggest a further closing-in on the zero line.

Legal note:

Prognoses are no reliable indicator for future performance.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.