The Fed returns to its real mandate

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The minutes of the FOMC meeting in April have paved the way for a hike in the Fed's policy rates in June and July. The market's position had been for the status quo to be maintained until early 2017, but its stance has radically changed. The three prerequisites for a rate hike (growth picking-up, employment strengthening and inflation making progress toward 2%) seem to be met. A potential obstacle would be if financial conditions were to deteriorate again now that the Fed has re-initiated the cycle of monetary policy normalisation. It is still not clear whether it is the Fed or the markets which are leading the dance.

The week's focus

Subtlety is not necessarily the best way of making oneself heard or understood. After its meeting of 27 April, the Fed omitted to mention that the global economic and financial situation was posing a risk, as it had done six weeks earlier. There was more information in what was not said than what was said. In comparison, the minutes of the same meeting are crystal clear. They indicate that the majority of FOMC members were ready to vote for a rate hike at the meeting of 15 June if three conditions are met: 1) There is a rebound in economic growth in Q2. 2) Conditions on the labour market continue to firm. 3) Inflation continues on its path towards the 2% target set by the central bank. The majority of the economic statistics recently published have gone in the desired direction.

The phase of monetary easing was concluded in the US, initially with the asset purchase programme being tapered off (2013-2014) and then with the exit from the zero interest rate policy (2015). The Fed's communication towards the financial markets has then completely changed. There is no longer any question of setting a calendar for future monetary policy as was the case in the strong form of the forward guidance. This change is reflected in the notion of "data dependency" which has been pushed for more than a year now. Short-term visibility suffers as a result, as shown by the changeability of the market's views. In contrast, the focus is more firmly back on the mandate. The gap vs the Fed's targets, i.e. unemployment at 5% and inflation at 2%, is minimal (rhs chart), justifying a more normal course for monetary policy.

And what about "market dependency"? The Fed denies this, but its hesitations over the past few months raise some doubts (rhs chart). If investors were to deem the Fed too hawkish, this could trigger a rebound in the dollar. In turn, this could cause the Fed to forget its real mandate and invent another - stabilise the global markets, for instance. The game of cat and mouse between the Fed and the financial markets is not over.
Economy

- In April, retail sales rose by 1.3%. These figures include a positive price effect caused by oil via service-station sales (+2.2%). Stripping out volatile items, core sales rose 0.9%, i.e. the strongest increase in two years. With the upward revision in previous months, spending on goods got off to a good start in Q2 2016. According to the Atlanta Fed, household consumption should grow 3.6% q-o-q annualised vs 1.9% in Q1. As a result, the nowcast for growth in real GDP came to 2.5% at 17 May.

- Residential construction also showed positive results in April with a 7% increase in housing starts and a 4% rise in building permits. Note that permits for individual homes (the most important segment for the activity) have remained more or less stable for the past six months. Given that homebuilders’ confidence is still high (stable at 58 points in April according to the NAHB), we can expect the trend to rise again.

- Industrial production rallied in April (+0.7%). Much of this is attributable to the utilities sector (electricity and water) whose production showed a rebound of 5.8%. Manufacturing output was more hesitant (+0.3%) and its trend has been more or less flat over the past year. In addition, the initial regional manufacturing surveys remained low (drop in the New York district, stable at low levels in Philadelphia).

- The rise in consumer prices slightly outstripped expectations in April. Headline inflation, driven by gasoline prices, accelerated to 1.1% per year. The core CPI rose 0.2%, which is equivalent to its monthly average of the last six months. The four core inflation metrics currently available for April – trimmed-mean CPI, core CPI, chained-core CPI and median CPI – are at 2.0%, 2.1%, 2.1% and 2.5% year-on-year respectively, in line with or a shade higher than the Fed’s target.

Monetary and fiscal policy

- Over the past few days, a large number of Fed officials have made comments that demonstrate their intention of reviving the scenario of monetary normalisation, which was put on the back burner following the market correction at the beginning of the year. One notable contribution was that of Eric Rosengren, the president of the Boston Fed and a member of the dovish wing of the FOMC, who deems the markets fairly unreceptive to this option. These comments prepared the way for the publication of the minutes of the latest FOMC meeting (see page 1). They unequivocally raise the possibility of a second interest-rate hike at the meeting of 15 June. In response, the futures market, which at the beginning of the week expected no new hike before Q1 2017, drastically revised its forecasts. On 19 May, the implied probability of an interest-rate hike increased to around one third for the June 2016 meeting and to around 50% for the meeting in July. The president of the New York Fed, Bill Dudley, said that he was satisfied with this correction since it would allow the Fed to choose either option (status quo or increase) without necessarily triggering an overreaction from the market.

- This does not signify that a decision has already been reached. First, the Fed might want to make sure that the positive economic signals (see above) are solid and decide that it does not have the sufficient information on 15 June. Second, the next meeting falls one week before the Brexit referendum. If the opinion polls remain as close run as they are currently, the Fed could adopt a cautious stance in the face of a risk that could create serious financial turmoil. Here again, this suggests that the decision might be put off until the following meeting on 27 July. Third, the decision will also depend upon the trend in financial variables (dollar, S&P500, credit spreads). It will be important to follow Janet Yellen’s next speech on 6 June, just ahead of the blackout period which precedes these meetings. This appears to be the perfect opportunity to guide anticipations for a last time.

The week ahead

- Given the upward revision to retail sales data, it is likely that the first estimate for real GDP growth in Q1 (+0.5% q-o-q annualised) will be raised, towards 0.8%, thus slightly easing the negative sentiment that it generated. Industrial orders in April are expected to be up slightly (+0.3% m-o-m). This remains one of the current black spots for the US economy, principally reflecting the crisis in the oil sector.
Appendix 1 - Labour market

Appendix 2 - Consumer

Sources: Thomson Reuters, Bloomberg, Oddo Securities
Appendix 3 - Business climate

Appendix 4 - Conditions of economic activity

Sources: Thomson Reuters, Bloomberg, Oddo Securities
Appendix 5 - Inflation and monetary policy

Appendix 6 - Financial markets

Sources: Thomson Reuters, Bloomberg, Oddo Securities
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