US interest rates: Eight is not enough

Financial events

- **US Federal Reserve decision:** As widely expected, the US Federal Reserve’s Open Market Committee (“FOMC”) increased the target range for the federal funds rate by 0.25 per cent to 2.00-2.25 per cent. This was the eighth increase in interest rates of the current monetary policy tightening cycle. The decision by the Fed voters was a unanimous 9-0.
- **Monetary policy stance changes:** In its policy statement, the FOMC no longer describes the stance of monetary policy as “accommodative”. This suggests the FOMC believes the funds rate is approaching the neutral rate (estimated to be between 2.50-3.00 per cent over the long-run).
- **US interest rate outlook:** The FOMC is forecasting one further rate increase in 2018 (in December, total four) and three further hikes in 2019. The 2020 projection is for at least one rate hike.
- **US economic outlook revised higher:** Economic growth (GDP) forecasts were increased to 3.1 per cent in 2018, up from the previous forecast of 2.8 per cent. The 2019 forecast was lifted to 2.5 per cent, up from the previous projection of 2.4 per cent. Growth is forecast to decelerate to 2.0 per cent by 2020 and to 1.8 per cent from 2021 and beyond.
- **US at full employment:** The projected unemployment rate has been lifted slightly to 3.7 per cent in 2018, up from 3.6 per cent. The unemployment rate is expected to fall to 3.5 per cent in 2019-2020, before increasing back to 3.7 per cent in 2021 and 4.5 per cent over the longer-run.
- **Inflation to reach target in 2018:** Inflation is expected to remain at the FOMC’s “symmetric” 2.0 per cent target this year. The FOMC expects its preferred measure - the core Personal Consumption Expenditures (PCE) deflator - to increase to 2.1 per cent in 2019 and stay there through to 2021.

Changes in US monetary policy settings can affect rates in Australia as well as the sharemarket and currency.

What does it all mean?

- The US economy is on a strong footing. So much so that the US Federal Reserve (“the Fed”) recently described economic activity as “strong” for the first time since May 2006. And influential New York Federal Reserve President John Williams said that current US economic conditions are “as good as it gets”.

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• Rising trade tensions with China and emerging market volatility pose eventual downside risks to the US economy, but US policymakers appear emboldened by a robust data docket. Economic growth is the best in four years, consumer confidence is the highest in 18 years, manufacturing activity is the strongest in 14 years and the unemployment rate is the lowest in 18 years. At just 3.9 per cent, the unemployment rate is well below the Fed’s estimate of full employment. And asset prices (home and share prices) continue to lift.

• Inflation is building, primarily on the back of higher services prices, and the annual rate is seen climbing above the US Federal Reserve’s two per cent goal. And the long-awaited lift in wages growth has occurred, rising to nine-year highs in response to the tighter labour market.

• Today’s rate hike was well telegraphed. The central bank’s forward guidance has been predictable for investors. Rates have been lifted on a quarterly basis this year. The target range for the federal funds rate has increased by 0.25 percentage points to 2.00-2.25 per cent – the eighth increase since December 2015.

• Another rate hike is forecast in December. Financial conditions are tighter, but not enough to restrict broader economic activity, despite higher borrowing costs flowing through to households and businesses.

• Attention has now turned to the future path of the Fed’s rate increases. The Trump Administration’s fiscal stimulus has raised concerns from economists about whether the US economy is potentially overheating. The Federal Budget deficit has lifted to US$898 billion over the 11 months to August and government debt has hit a staggering US$21.5 trillion.

• With this in mind, a laser-like focus from policymakers is on the perceived “neutral” rate of interest – a level that neither accelerates, nor slows growth – and will that be the level where the Fed ceases its policy tightening?

• The widening economic and policy divergence between the US and the rest of the world will likely have implications for Aussie investors. US sharemarkets continue to outperform, given the stronger economic backdrop and more competitive tax environment for corporates. But Aussie Commonwealth Government Bonds are outperforming their US Treasury counterparts, given the Reserve Bank’s “lower for longer” interest rate policy. Australia’s prized AAA-credit rating (stable outlook) and improving fiscal position is attracting capital inflows from offshore-based investors.

US Federal Reserve decision: key commentary

• The FOMC statement reiterated that the pace of economic growth should pick-up, unaffected by rate hikes: “The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective over the medium term. Risks to the economic outlook appear roughly balanced.”

• In its statement, the FOMC, however, removed previous language saying that “the stance of monetary policy remains accommodative, thereby supporting strong labour market conditions and a sustained return to 2 percent inflation.” It was the first time since the tightening of monetary began in late 2015 that the FOMC hasn’t described policy as “accommodative”.

• The median path for the federal funds rate was little changed. The FOMC’s Summary of Economic Projections shows the median interest rate projections (the “dot plot”) implies one further 0.25 per cent interest rate increase in 2018 (to 2.4 per cent); three 0.25 per cent interest rate increases in 2019 (to 3.1 per cent); and one 0.25 per cent interest rate increase in 2020 (to 3.4 per cent). No change is expected in the new 2021 projection (3.4 per cent).

• The policy-relevant inflation projections were unchanged. Core PCE inflation is expected to remain at 2.0 per cent in 2018. Projections in 2019 and 2020 were unchanged at 2.1 per cent. The new projection for 2021 was 2.1 per cent.

• The FOMC upgraded its GDP forecasts, but increased its unemployment rate projections. The FOMC projects GDP growth of 3.1 per cent in 2018 (previously 2.8 per cent); 2.5 per cent in 2019 (previously 2.4 per cent); 2.0 per cent in 2020 (unchanged), but a lower 1.8 per cent in its new
2021 projection. Meanwhile, the FOMC expects the unemployment rate to be 3.7 per cent in 2018 (previously 3.6 per cent); 3.5 per cent in both 2019 and 2020 (unchanged); 3.7 per cent in 2021; and 4.5 per cent over the longer-run.

What are the implications for interest rates and investors?

- Australian investors and businesses won’t escape the increase in US borrowing costs. Rising US Treasury bond yields are dragging their Aussie counterparts higher, despite the Reserve Bank’s neutral policy stance.

- Global interest rates are lifting and so are bank funding costs, pressuring margins. Aussie banks derive around 40 per cent of their funding from overseas. Australian short-term interest rates reached the highest level in two years a few months ago. The 90-day bank bill yield is currently at 1.94 per cent, narrowing the gap to the official cash rate to 44 basis points. Therefore, there is a risk of home lending standards being tightened further, placing additional pressure on banks when it comes to the determination of mortgage rates.

- The Aussie dollar has weakened against the greenback in the face of growing US interest rate differentials, trade concerns and emerging market volatility. Strong capital inflows and US company profit repatriation has also supported the greenback. But the US’ deteriorating credit quality, including rising government debt and budget deficits, together with an unexpected policy pause from the Fed all have the potential to weigh on the US dollar.

- Commonwealth Bank currency strategists expect the Aussie dollar to finish 2018 near US72 cents, with the currency around US73 cents by June 2019.

- We continue to expect that the US Federal Reserve will increase the federal funds rate by 0.25 percentage points in December and twice more in 2019, before potentially easing policy in 2021. But the continuing flattening (and possible inversion) of the US Treasury yield curve, escalating trade tensions, tighter financial conditions and higher borrowing costs could encourage a pause or slowing in the pace of interest rate hikes.

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