15 December 2016

ECONOMIC REVIEW | December 2016 US FOMC Meeting

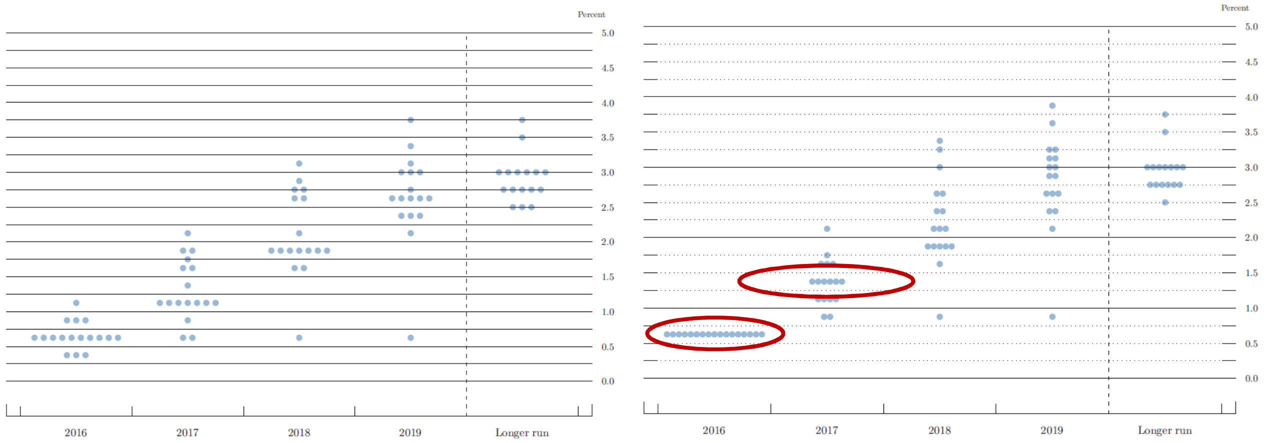
Fed Raised Rate, Expecting Three Hikes in 2017

- *As been expected by market participants, the Fed unanimously decided to increase its benchmark interest rate by 25 bps in December FOMC meeting, leading the Fed funds rate to 0.75% level. At the same time, in line with the higher inflation expectation next year due to Trump's possible-expansionary economic policy, the Fed's dot plot is currently pointing towards to three rate hikes in year 2017, leading the FFR to 1.50% by year-end 2017.*
- *Contrary to the market, which is easily affected by sentiment, Fed is only expecting a slightly better economic performance next year at 2.1% as compared to its previous September projection at 2.0%. It is more interesting however, to realise that there has been no change in its PCE inflation for next year which is to be kept at 1.9%. We believe the Fed is being wary due to the appreciation of USD, which leads to imported deflation due to the stronger currency.*
- *Although the Fed is expecting a faster pace of rate hike in 2017, at the moment we are maintaining our expectation of two rate hikes which will lead the FFR to 1.25%. This is mostly contributed to the uncertainties in the global economic condition, particularly the multiple elections to be held in the Euro Area next year. The fact that there has been a rise in right-wing movement and possibility of more countries chose to exit the European Union could possibly hold the Fed back from being too rigorous with its normalisation process.*

Fed reached unanimous decision to raise rate. As been expected by market participants, the Fed unanimously decided to increase its benchmark interest rate by 25 bps in December FOMC meeting, leading the fed funds rate to 0.75% level. At the same time, in line with the higher inflation expectation next year due to Trump's possible-expansionary economic policy, the Fed's dot plot is currently pointing towards to three rate hikes in year 2017, leading the FFR to 1.50% by year-end 2017.

Chart 1: Fed's March vs June dot plot chart

Sept FOMC **Dec FOMC**



Source: Federal Reserve, MIDFR

Jobs and consumer spending improved, and we expect it to improve further. Clearly the US job market has been improving, with the latest unemployment rate at 4.6%. Furthermore, even the U-6, the unemployment measure which includes those who have given up looking for work and underemployed (part-time workers who would like to have full-time jobs), fell to the lowest number since April 2008 at 9.3%. Looking at the optimism on US economy at the moment, we believe these numbers could improve further in the future. This would surely help in terms of private consumption and its resilience to global economic uncertainties.

However, investment and inflation numbers remained soft. Despite the optimism and higher level of employment in the economy, business fixed investment remained soft while there has been little change in the Fed's favourite inflation measure i.e. core PCE price index. We opine that the slowdown in investment activity was due to a slower global demand and declining global trade activity. However, the better performance in US stock market which will lead to a wealth effect combined with the fund flow into the US economy should improve the inflation performance next year. On the investment side, we believe it will be pretty much dependent on Trump's fiscal policy – which to be fair the thing that is holding it back is US fiscal position.

Chart 2: Fed's Economic Projection

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8	1.8 – 1.9	1.9 – 2.3	1.8 – 2.2	1.8 – 2.0	1.8 – 2.0	1.8 – 2.0	1.7 – 2.4	1.7 – 2.3	1.5 – 2.2	1.6 – 2.2
September projection	1.8	2.0	2.0	1.8	1.8	1.7 – 1.9	1.9 – 2.2	1.8 – 2.1	1.7 – 2.0	1.7 – 2.0	1.7 – 2.0	1.6 – 2.5	1.5 – 2.3	1.6 – 2.2	1.6 – 2.2
Unemployment rate	4.7	4.5	4.5	4.5	4.8	4.7 – 4.8	4.5 – 4.6	4.3 – 4.7	4.3 – 4.8	4.7 – 5.0	4.7 – 4.8	4.4 – 4.7	4.2 – 4.7	4.1 – 4.8	4.5 – 5.0
September projection	4.8	4.6	4.5	4.6	4.8	4.7 – 4.9	4.5 – 4.7	4.4 – 4.7	4.4 – 4.8	4.7 – 5.0	4.7 – 4.9	4.4 – 4.8	4.3 – 4.9	4.2 – 5.0	4.5 – 5.0
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.5	1.7 – 2.0	1.9 – 2.0	2.0 – 2.1	2.0	1.5 – 1.6	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	2.0
September projection	1.3	1.9	2.0	2.0	2.0	1.2 – 1.4	1.7 – 1.9	1.8 – 2.0	1.9 – 2.0	2.0	1.1 – 1.7	1.5 – 2.0	1.8 – 2.0	1.8 – 2.1	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0		1.7 – 1.8	1.8 – 1.9	1.9 – 2.0	2.0		1.6 – 1.8	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	
September projection	1.7	1.8	2.0	2.0		1.6 – 1.8	1.7 – 1.9	1.9 – 2.0	2.0		1.5 – 2.0	1.6 – 2.0	1.8 – 2.0	1.8 – 2.1	
Memo: Projected appropriate policy path															
Federal funds rate	0.6	1.4	2.1	2.9	3.0	0.6	1.1 – 1.6	1.9 – 2.6	2.4 – 3.3	2.8 – 3.0	0.6	0.9 – 2.1	0.9 – 3.4	0.9 – 3.9	2.5 – 3.8
September projection	0.6	1.1	1.9	2.6	2.9	0.6 – 0.9	1.1 – 1.8	1.9 – 2.8	2.4 – 3.0	2.8 – 3.0	0.4 – 1.1	0.6 – 2.1	0.6 – 3.1	0.6 – 3.8	2.5 – 3.8

Source: Federal Reserve

Slightly stronger economic growth in 2017. Contrary to the market, which is easily affected by sentiment, Fed is only expecting a slightly better economic performance next year at 2.1% as compared to its previous September projection at 2.0%. It is more interesting however, to realise that there has been no change in its PCE inflation for next year which is to be kept at 1.9%. We believe the Fed is being wary due to the appreciation of USD, which leads to imported deflation due to the stronger currency.

We are maintaining our expectation of two rate hikes in 2017. Although the Fed is expecting a faster pace of rate hike in 2017, at the moment we are maintaining our expectation of two rate hikes which will lead the FFR to 1.25%. This is mostly contributed to the uncertainties in the global economic condition, particularly the multiple elections to be held in the Euro Area next year. The fact that there has been a rise in right-wing movement and possibility of more countries chose to exit the European Union could possibly hold the Fed back from being too rigorous with its normalisation process.

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