NATIONAL BANK OF CANADA
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FED Policy Monitor

Economics and Strategy

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Fed optimism points to September rate hike

As widely expected, the Federal Reserve left the fed funds rate unchanged at 1.75-2.00%. However, the Fed sounded more bullish about the economy, tweaking some of its wording in the statement. Economic activity is now seen rising at a "strong" rate (as opposed to "solid" in the June statement), while the Fed also says that household and business fixed investment "have grown strongly" versus its depiction last June that household spending "has picked up". The Fed also says both headline and core inflation "remain near 2%", a more confident statement compared to June's depiction of "have moved close to 2%". Risks to the economy continue to be viewed as "roughly balanced". The Fed continues to warn about "gradual increases in the target range for the fed funds rate". The decision to leave rates unchanged was unanimous within the FOMC.

Bottom line

The Fed's statement did nothing to change market expectations of the path of interest rate hikes this year. Yet, the FOMC is now more positive about consumer spending (which accounts for 70% of the economy) and also sounded slightly more comfortable about inflation. There are indeed signs of mounting cost pressures (e.g. employment cost index) and the Fed may want to nip inflation in the bud before it intensifies. Moreover, thanks to revisions, U.S. real GDP growth this year (Q4/Q4) is on track to top even the most optimistic forecast in the Fed's last summary of economic projections — if growth averages 3% in the second half of the year, Q4/Q4 growth will be 3.1% versus the Fed's current forecast range of 2.5-3.0%. That might be enough to encourage a majority of FOMC members to call for an additional hike in December (after the one in September), although this will depend on data and the impact of trade policy on the economic outlook. All in all, the Fed remains on course to raise interest rates in September, a meeting that will coincide with the release of new economic projections.

Paul-André Pinsonnault/Krishen Rangasamy

Fed's statement (sections highlighted by us):

Information received since the Federal Open Market Committee met in June indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. 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 view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 1-3/4 to 2 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments..

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Thomas I. Barkin; Raphael W. Bostic; Lael Brainard; Esther L. George; Loretta J. Mester; and Randal K. Quarles.

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