Weekly Economic Outlook

14th March 2022

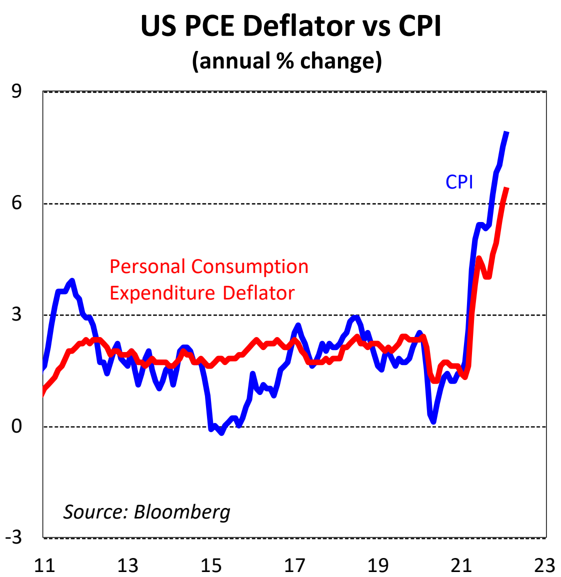
Fed to Kick Off Hiking Cycle This Week

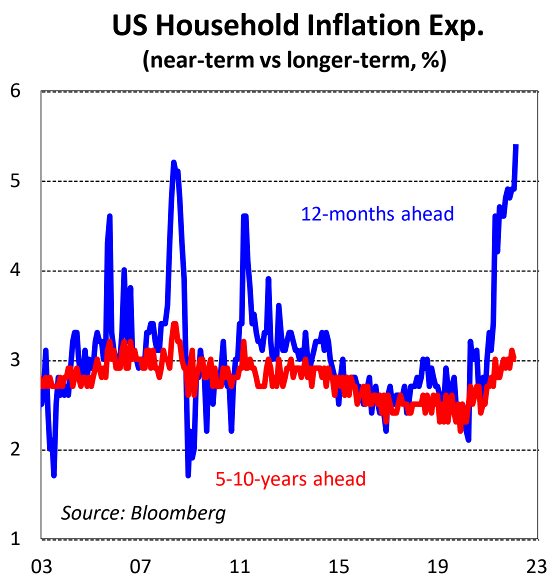
The US Federal Reserve's two-day meeting commences on 15 March (Washington DC time). Fed Chair Powell has effectively confirmed the central bank will kick off the hiking cycle at this meeting. He has stated he favours an initial 25 basis point hike. This would lift the target range for the federal funds rate from 0.00-0.25% to 0.25-0.50%.

Markets are fully priced for a 25-basis point move at the meeting (priced at 107% at the time of writing). As a result, bond markets may react more to any colour provided in the statement and Powell's press conference, rather than the rate hike itself.

The first hike from the Fed is a clear demarcation that the era of ultra-easy monetary policy is behind us. Several central banks have already begun hiking rates, including the Bank of England, the Bank of Canada and the Reserve Bank of New Zealand. However, the actions of the Fed have the most significant implications for global financial conditions. Effectively, the Fed sets the most important benchmark interest rate for the world.

Inflation is running red hot in the US. The consumer price index (CPI) rose to a 40-year high in February, up 7.9% in year ended terms. The economic recovery, rising energy prices and supply-chain disruptions have all contributed to the price pressures. Meanwhile, headline personal consumption expenditure – the measure targeted by the Fed – hit 6.1% in January. This is more than three times than Fed's 2% inflation target!

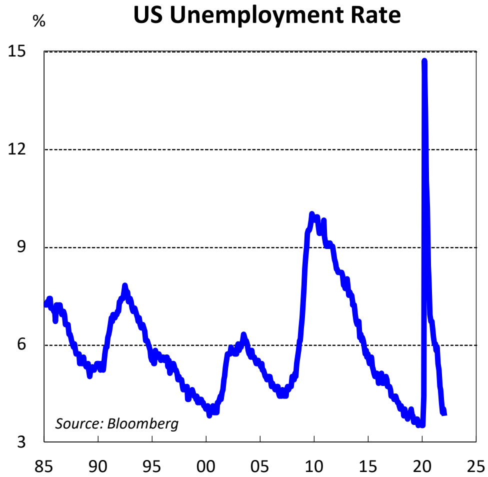


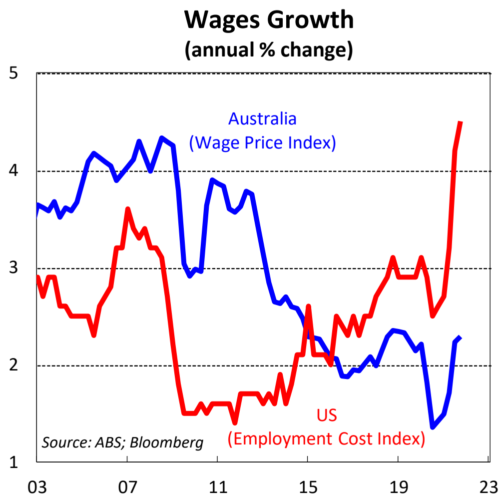


Plus, inflation is expected to rise further after oil prices surged in early March as the war between Russia and Ukraine broke out. The price of West Texas Intermediate crude oil peaked over $130 early last week, although has since pared back to close at $109 on Friday. Prices at the petrol pump remain elevated in the US and around the world, including in Australia. Accordingly, cost-of-living pressures are becoming an increasingly high-profile issue. Meanwhile, Russia is pressing further into Ukraine and there are ongoing questions about the implications for global geopolitical relations. Notably, the US reports that Russia has asked China for military equipment to support its invasion of Ukraine. Chinese and US diplomats are set to meet this week in Rome.

Central bankers will also be keeping a close eye on inflation expectations, which can be a key determinant of actual future inflation. According to the University of Michigan household survey from March, consumers expect prices to rise by 5.4% over the next 12 months – the highest reading since the early 1980s. However, inflation expectations over the next 5-10 years held steady at 3.0%. This may provide some comfort to the Fed as it tries to prevent longer-term expectations from spiralling out of control.

Powell has also said the Fed has achieved its goal of 'maximum employment', a term which the Fed has not defined. In February, the US unemployment rate fell to 3.8%, not far off the pre-pandemic low of 3.5%. Plus, wages in the US have also taken off. In fact, US wages growth hit 4.5% over the year to the December quarter – as measured by the employment cost index. This is the fastest growth rate in the series in decades. In contrast, Australia's wage price index was up 2.3% over the year to December, which is fairly low relative to historical levels, despite widespread reports of labour shortages and a rise in wage expectations.





The expected move from the Fed this week will mark the first hike from the central bank since 2018. The Fed has already dialled back its bond-buying program; purchases are scheduled to end this month.

The focus now is how fast and how much the Fed will lift rates. We expect a total of five Fed hikes in 2021, including successive hikes at the May and June meetings, followed by more hikes in 2023. This would take the federal funds target range to 1.75-2.00% (with a mid-point of 1.875%, as indicated in our forecast table). Markets are fully priced for six 25-basis-point rate hikes this year. Powell has not ruled out a 50 basis point move in the future. In his testimony to the House of Representatives earlier this month, Powell flagged that the Fed is prepared to tighten more aggressively if inflation was higher than expected, or remained persistently high.

The Bank of England (BoE) also meets this week and are expected to lift their policy rate by a further 25 basis points to 0.75%. The BoE kicked off rate hikes in December 2021 when it lifted the policy rate from 0.10% to 0.25%, and has already begun the process of quantitative tightening (i.e. shrinking its balance sheet). Annual consumer price inflation in the UK hit 5.5% in January and the central bank has forecast it will peak at 7.25% in April, more than triple the 2% target.

Separately, labour force data for February will be released this week. Omicron disruptions eased in February as case numbers declined and the impact of the Queensland and NSW floods will not be felt until the March survey. As a result, we expect the jobs market tightened further and have projected that 60k new jobs were added in the month. We anticipate a lift in the participation rate from 66.2 to 66.4% – a new record high. In turn, if we are correct, this will result in a 0.1 percentage point decline in the unemployment rate to 4.1% – the lowest level in more than 13 years. The surge in case numbers from the Omicron variant underpinned a sharp fall in hours worked in January, alongside the summer holidays, while employment numbers held up.

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