Economic Flash

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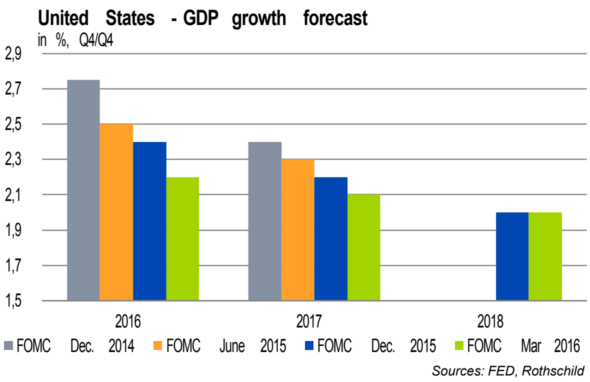
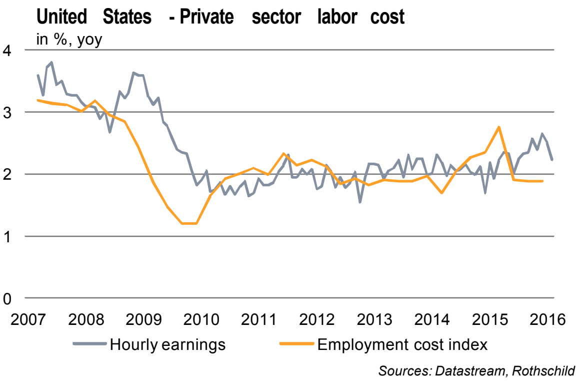
ROTHSCHILD

Fed more worried than it seems

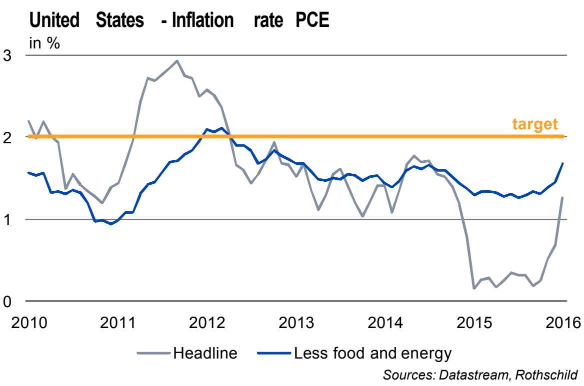


Unsurprisingly, the Fed opted for the status quo and decided to keep its key rate unchanged. Even though activity trends remain favorable, the diagnosis of the US economy was uncertain enough to pause the normalization process which will most likely be very gradual. On the one hand, household spending is expanding at a moderate rate and the housing sector remains a supportive factor. However, weaknesses remain: business investment is sluggish and US exports remain soft. In addition, the deteriorating global economic outlook and tighter financing conditions have led Fed members to reduce – yet again – their forecasts for US GDP growth. The pre-conditions for a tighter monetary policy remain the same: the Fed will only start its monetary normalization once it is reasonably confident that the inflation rate will converge to its 2% target over the medium term and that labor market will have further improved.



On the latter, recent statistics show that wage growth is still very moderate, which seems, at least in part, to corroborate the existence of some underutilization of labor resources. As for inflation, the Fed members have minimized the recent rise, noting that temporary factors were probably at work. The inflation forecasts for 2016 were even lowered, and those for 2017 and 2018 remained unchanged.

In short, the Fed decided to play it safe, and if its Chairwoman Janet Yellen tried to sound reassuring during her press conference, the fact remains that uncertainty regarding the outlook has clearly increased. It is therefore not surprising that the graph of the famous dots – that sums up the expectations of Fed members on interest rates – shows the FOMC no longer expects 4 but only 2 rate hikes in 2016 and that the projections of tightening for 2017 have also been revised downwards.



In the end, the dovish message has resulted in a fall in the dollar. Yet, the exchange rate has become a primary tool of monetary policy transmission for the ECB and the Bank of Japan. In this sense, the very accommodative stance from the Fed further reinforces the need to maintain – or even enhance – their quantitative easing programs that have been implemented by these central banks. For emerging economies, the dollar depreciation is definitely good news. Indeed, in its latest report, the Bank for International Settlements (BIS) has highlighted the risks associated with the sharp rise in private debt in most emerging countries, while the foreign currency debt occupies a prominent place in this increase. The appreciation of emerging currencies is thus a welcome development as it will facilitate the debt service that had deteriorated sharply in recent quarters.