US FOMC PREVIEW (JUNE) – RATES TO RISE AGAIN

- We forecast that the US Federal Reserve will raise rates for the second time this year at its June policy meeting
- As markets are expecting the move there may not be much immediate reaction
- However, markets are far less certain about the Fed's policy intentions for the second half of the year and beyond
- We expect the Fed to change its forecast and signal an intention to hike rates four time in total in 2018
- This may be reinforced with a more 'hawkish' press conference by Fed Chairman Powell

FED TO HIKE FOR THE SEVENTH TIME SINCE LATE 2015

We expect the US Federal Reserve to increase its policy interest rates by 0.25% at its 12-13 June policy meeting, to move the target range up to 1.75-2.0%. If implemented it will be the seventh hike in total since December 2015. Many Federal Reserve Open Market Committee (FOMC) members have signalled that they favour a June hike. Moreover, a move at this point would seem to be consistent with the FOMC's stated intention of making "further gradual increases in the federal funds rate".

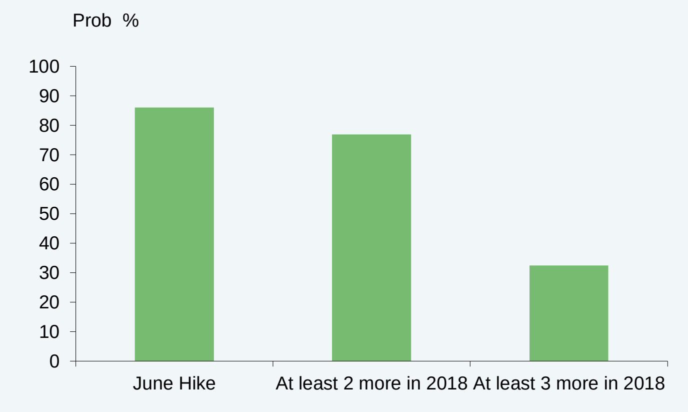
Recent economic data also supports the case for a tightening. Economic growth has picked up with the Atlanta Fed's 'nowcasting' model currently forecasting annualised Q2 GDP growth of 4.8%, which would be the biggest quarterly gain for almost four years. Employment growth continues to be strong, the unemployment rate has fallen to 3.8%, its lowest level for eighteen years, and the 'tight' labour market seems to be leading to at least a modest acceleration in wage growth. Finally, inflation has risen and is now close to the Fed's 2% target.

These trends make a further rate increase at this point easy to justify. Markets are seemingly expecting a move as the Fed futures market is attaching close to a 90% probability to a June hike (Chart 1). That means a decision not to move next week would be a shock and out of step with the Fed's practice in recent years of trying to avoid surprising markets. That seemingly adds up to a cast iron case for a move and we believe that a June rise is all but inevitable.

FORWARD GUIDANCE WILL BE CRUCIAL FOR MARKETS

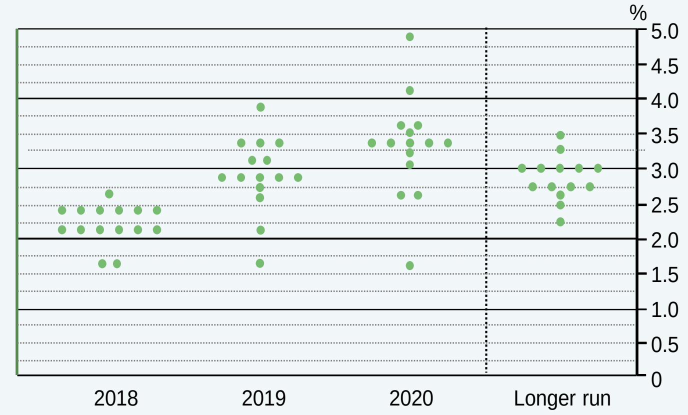
Markets are far less certain about the Fed's policy intentions for the second half of the year and beyond. The Fed futures market attaches about an 80% probability to only one further rate hike in the latter half of 2018 and sees only a 30% chance of two or more rises. Looking further forward to next year, only about a 40% probability is given to interest rates being more than 0.75% above current levels by June 2019. Markets then seem to expect the Fed will be very cautious in tightening monetary policy further in the second half

Chart 1: A June Fed hike is discounted but markets unsure about what happens after that



Source: Bloomberg and Lloyds Bank Commercial Banking analytics as of 6/6/18

Chart 2: March 'dot plot' showed FOMC divided on whether to hike three or four times in 2018



Source: US Federal Reserve and Lloyds Bank Commercial Banking analytics as of 6/6/18 of 2018 and into 2019, even though recent economic data arguably calls for a pick up in the pace of tightening.

We think that leaves room, at least in the near term, for markets to be surprised by the Fed signal on its policy intentions. Next week's meeting will be followed by the release of new FOMC participants' forecasts and by a press conference by Fed Chairman Powell. Both may have an impact on expectations.

The last set of forecasts showed the Committee almost evenly split over whether to raise rates three or four times this year (Chart 2). However, economic developments since then have upped the odds that the Fed will continue to hike at a pace of a move at every other meeting. Such a course would imply four increases in total this year and we expect that to be reflected in the 'dot plot' with the majority now likely to forecast that degree of tightening. The message seems likely to be reinforced with upward revisions to the forecasts for GDP growth and inflation. Also of interest will be whether the majority make any changes to their interest rate expectations for 2019 and beyond. These seem less likely to shift at this point, although it will be particularly interesting to see whether the majority revise their forecast of the neutral level of interest rates, currently estimated to be between 2.75% and 3%.

Any market reaction to these expected 'dot plot changes will be reinforced or tempered by the Fed Chairman's subsequent comments. We think the former is more probable. This will be Mr Powell's second press conference since his appointment. At his first conference he largely stuck with his predecessor's message that interest rates were likely to rise gradually but also pointed to some upside risks to economic growth. In the subsequent three months economic conditions have continued to strengthen, while inflation has picked up more quickly than the Fed expected, a combination that points to the need for a more 'hawkish' message. Admittedly in the statement following its May meeting the FOMC acknowledged the rebound in inflation but also reaffirmed that its inflation target was "symmetric". That was probably meant to be a signal that inflation moving above 2% would not necessarily result in the Fed becoming significantly more aggressive in its policy actions. Nevertheless, that need not preclude at least some reaction to recent data from Mr Powell. We expect him to reinforce his previous message about upside risks for economic growth, and also acknowledge less concern about the downside risks for inflation. He will probably continue to talk about only "gradual" increases in interest rates but the emphasis is still likely to be on more upside risk for the rate path.

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