United States

Not this time either

- **The Fed is expected to leave its monetary policy unchanged again. After a few days of severe turmoil, the financial markets have levelled off, resulting in an easing of US monetary and financial conditions.**
- **After the rebound in oil prices came to a halt, inflation prospects have been pulled downward, albeit mildly.**
- **Once again, US cyclical trends – as well as the Fed's analysis – are closely linked to job market trends.**

The June FOMC meeting maintained the monetary status quo, also because its members thought it best to be cautious while awaiting the results of the UK referendum. A month after the vote, it is still too early to fully measure the consequences of the UK's decision to leave the EU. The financial markets' initial reaction was very abrupt, but the situation quickly stabilised. The dollar appreciated, but then levelled off, and it has not gained very much in effective terms (the effective exchange rate has increased by roughly 1.5% since the Brexit vote, but is still about 2% below the level at the beginning of the year). The equity markets plunged in the aftermath of the referendum, but have since recovered, and the S&P500 index is now about 3% higher than the pre-Brexit level. Interest rates are lower than before the 23 June referendum (by about 20 basis points for 10-year Treasuries, mortgage rates and the spread on BAA-rated corporate bonds). All in all, monetary and financial conditions have eased, which should give US economic growth a boost, even if mildly. In contrast, the rebound in oil prices was cut short, and prices have levelled off at about USD 6.55 below the peak of early June (West Texas Intermediate was trading at USD 51.2 per barrel on 8 June, before dropping to USD 44.7 on 21 July). This trend further pushes back the horizon for US inflation to return to the Fed's target rate, as illustrated by the slight decline in 5-year inflation expectations.

A rebound that came to a halt

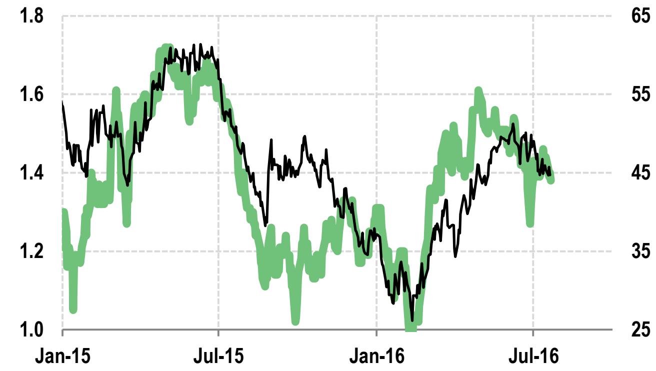

Chart 1 Source : Macrobond

Brexit seems to have left the US unscathed, at least for the moment. If the only reason for the June decision to maintain the monetary status quo had been the uncertainty that prevailed prior to the referendum, then we could be virtually guaranteed of a July rate increase. Yet this was not the case. Last month the Fed surely feared that a "leave" vote could potentially have severely disruptive effects on world financial markets, similar to the sell-off triggered by China's official announcements in summer 2015. This risk has certainly not been lifted yet, and the month of August must be approached with caution, especially since shallow liquidity could exacerbate the size of any adjustments. Even so, the risk seems mild. The UK's rapid and apparently serene transition of power, as well as the stabilisation of Sterling's external value, are very encouraging.

What seems to be worrying the Fed even more are job market trends. At the latest FOMC meeting, members only had access to the May jobs report: job creations were estimated at only 38k, a figure that was later revised downwards (to 11k). June's correction was just as impressive, but in the other direction, with 287k job creations. Yet smoothed over 3 months, these employment trends continue to indicate a slowdown (147k in June, down from more than 200k through March). In itself, there is nothing alarming about that: if this pace were sustained over time, it would be strong enough to stabilise the unemployment rate. Other job market indicators, in contrast, are less reassuring: 1) the labour participation ratio for the 25-54 age group shed 0.2 percentage points after rising constantly for six months, and 2) wage acceleration has stalled. Although it is too early to speak of a deteriorating situation, the overall improvement in job market conditions seems to have stalled.

This pause might be short lived if it is due solely to the consequences of the cyclical slowdown earlier this year. If this is the case, then the most recently available economic figures for June are rather encouraging, with manufacturing production up 0.5%, retail sales up 0.6% and housing starts up 4.8%. Our M&N composite economic indicator – the weighted sum of ISM survey data – rebounded very strongly recently to peak at 56 in June, the highest level since last fall.

The Fed probably wants to move away from the zero lower bound as quickly and as far as possible. Yet the persistent risks associated with a premature tightening of monetary policy also call for caution. If the good news is confirmed by September – and accompanied by another reduction in underemployment – then it could create a window of opportunity for a key rate increase.