United States

Sometimes there is no room for doubt

- When the Fed’s monetary policy committee meets next week, there will be no suspense. Last week, Janet Yellen already gave the green light to a rate increase under certain conditions, which were lifted by February labour market report.
- Inflation is finally about to come in line with the Fed’s target. Downward pricing pressures have evaporated as oil prices have picked up, the dollar has levelled off and above all, wage growth has strengthened.
- The US economy has returned to a steady stride that clearly surpasses its long-term potential. There can be no doubt about the normalisation of monetary policy, even without the support of a fiscal stimulus, which seems to be increasingly less probable as the days go by.

At next week’s meeting, the Federal Open Market Committee (FOMC) will certainly decide to raise key rates, probably by 25 basis points. It is hard to be more certain. The last bit of doubt was finally lifted by the latest labour market report: the job market shows no signs of running out of steam, and the Fed can check this last point off its list.

The normalisation of monetary policy first began in December 2015, before being put on hold for a year. We had to wait until December 2016 for the Fed’s second key rate increase. Seen from this angle, another rate increase in March might seem to be rushed. But this is not the case, for two reasons. First, it soon became apparent that the Fed would take advantage of any windows of opportunity. Without rushing matters, the Fed was clearly determined to move away from the zero lower bound as quickly as possible, which the central bank still considers to be its lower limit. Second, the US economy has been in a recovery since the third quarter of 2016, which has not only been confirmed with each statistical report, but also seems to be gaining strength.

Growth was slightly disappointing in the second half of 2016, but also because temporary “disturbances” made these statistics difficult to interpret at first sight. A closer look at the breakdown of data reveals an acceleration in final domestic demand, which is the core of US demand. There has been a particularly welcome rebound in business investment in equipment and software, even though the annualised quarterly increase of 1.9% might not seem very strong after four straight quarters of contraction.

We must keep in mind that the sluggish pace of capital expenditure by US companies is mainly due to the oil industry. Excluding “mining exploration, shafts, and wells”, productive investment by US companies only declined in the second half of 2015, and increased throughout 2016. Moreover, manufacturing new orders and shipments data indicate an ongoing solid trend, even though these components are not always very reliable. The capital goods industry, excluding defence and aircrafts, has accelerated strongly in recent months: in January, new orders were up 8.7% (annualised 3-month rate), and shipments rose 6.7%.

The recovery reaches beyond this industry alone. For the manufacturing sector as a whole, output increased in January at the fastest pace in the past two years, order books continued to swell and confidence is on the rise. The manufacturing ISM rose to 57.7 in February, the highest level since fall 2014, with two of its components being above 60: production (62.9) and new orders (65.1). The non-manufacturing ISM is also in good health, which is characteristic of the economy as a whole: it rose to 57.6 in February, with the production and new orders components both above 60. Our M&N index – the weighted sum of the two ISM indices – is compatible with growth way above 3%.

Growth clearly seems to have returned to a rate significantly higher than its long-term potential (with the FOMC members estimate at 1.8%). In December, even Janet Yellen esteemed that the output gap had finally closed. The forces that were restricting price formation have dissipated, and the Fed is much more confident in its projections that inflation will return to its medium-term target. Though still under the effects of the rebound in oil prices, the Fed’s target will almost certainly be reached as of February, for the first time since spring 2012. In January, the private consumption expenditure deflator was already at 1.9% year-on-year, and the index only needs to hold steady to rise above 2% in February. Excluding energy and food, core PCE inflation was still below 2%, and has held steady at 1.7% since August 2016. But it is showing signs of acceleration. One of these indicators is market-based PCE inflation, which only takes into account spending actually supported by households. Long limited to 1%, it has accelerated since early 2016, and recently rose above 1.7% year-on-year. Other indicators that statistically “clean up” any unsustainable variations, such as the Dallas Fed’s trimmed-mean index, confirm that inflation is returning to its 2012 levels.

With growth above its long-term potential, oil prices exerting less downward pressure and the dollar’s appreciation winding down, there are several arguments to support an upturn in inflation. We need to add one essential support factor: the dynamic labour market. The situation has come full circle and we can be sure that monetary policy will continue to be normalised. There is not even any need to talk about a possible fiscal stimulus, which seems increasingly improbable.