DOLLARS & SENSE

TD Economics

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DELAYED, BUT NOT DISSUADED: STILL ON COURSE FOR TWO RATE HIKES IN 2016

Highlights

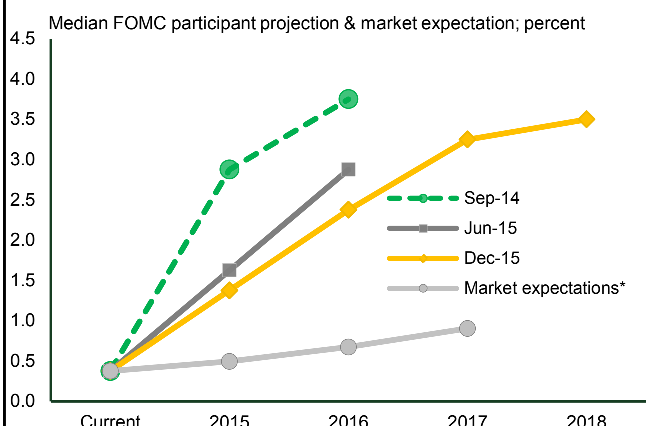
- As they did last October, market expectations for interest rate hikes from the Federal Reserve have moved further away from the Fed's own projections. While a March rate hike is off the table, financial markets appear to have gone too far in pricing out rate hikes altogether for 2016.
- A necessary condition for the Fed will be some calming in financial market conditions and evidence of a persistence in solid economic underpinnings, particularly in relation to consumer and housing-led growth. We believe this should be apparent in June, and still view two rate hikes this year as a material probability.
- Part of the Fed's challenge is in helping markets understand the lower threshold for economic growth necessary to evoke a policy response. While we have nudged down our outlook for 2016, reflecting the lingering impact of tighter financial conditions, the U.S. economy still appears on course to grow by around 2.0%. This is sufficient to continue to tighten labor markets and support a gradual upward trend in inflation.

In October of last year, we discussed the Federal Reserve's conundrum in raising rates amid conflicting market expectations. At that time, markets were discounting the odds that any rate hike would occur by the end of the year, despite FOMC participants' communication of the opposite outcome within their "dot plot". We argued that the economic foundation was sturdy enough to support a modest rise in rates, even with a backdrop of emerging market uncertainty.

In what will likely be a persistent theme, conflicting expectations again dominate the rate outlook. Amid an intensification of global economic uncertainty and financial market volatility, markets are once again second guessing the Fed, pricing out rate hikes altogether for 2016.

As has happened in the past, the Federal Reserve will likely revise down its expectations for the pace of rate hikes closer to the market's view, but not altogether. While a March rate hike is off the table, by June, the persistence in solid economic underpinnings should be evident, particularly in relation to consumer and housing-led growth. In our view, it is simply too early to dismiss the odds of two rate hikes by the end of this year (June and December). The market appears to have gone too far in this regard.

CHART 1: FEDERAL FUNDS PROJECTIONS & EXPECTATIONS



*OIS curve, Febraury 18, 2016. Source: Federal Reserve Board, Bloomberg.

The U.S. economy is still growing

Fears of a downturn can become self-fulfilling, but our current modelling of the U.S. economy entering a recession within the next six months puts the probability at 30%. The more likely outcome is that the bout of risk aversion does not upend the economic recovery.

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Nonetheless, we have revised down our near-term economic outlook modestly. This is partly due a somewhat greater drag from net-exports as a result of the dollar's more extended increase. It also includes a measure of caution to the outlook for business and household spending, reflecting the lingering impact of tighter financial conditions. On an annual average basis, we expect real GDP growth roughly 2.0% in 2016, compared to our previous forecast of 2.4%.

Don't count out the American consumer

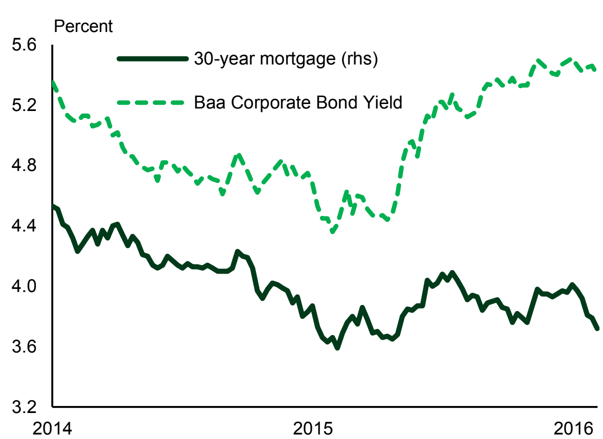
Still, the economic fundamentals remain solid. Household spending will continue to be supported by the decline in energy prices and the notable acceleration in wage growth. With rising wages, both real disposable income and real consumption are likely to grow by close to 3.0%.

What is more, there is little evidence of contagion effects to consumer or mortgage credit from recent financial market instability. On the contrary, mortgage rates have fallen by over 30 basis points since the start of the year (Chart 2) and the Federal Reserve's Senior Loan Officer Opinion Survey shows continued easing in residential mortgage conditions. As long as credit remains available, this will continue to be an important source of growth for the American economy.

Markets still adjusting to the reality of slower trend economic growth

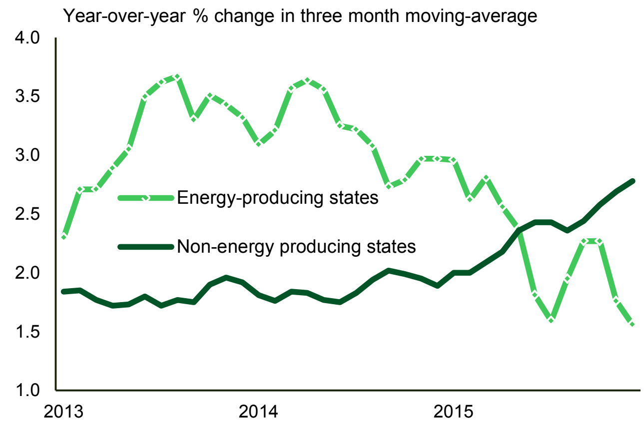
Granted, unlike in the past, a "solid" growth rate is one in the 2%-2.5% range. Part of the Fed's conundrum is in helping markets understand the threshold for economic growth that should evoke a policy response. It does not have to be gangbusters to justify gradually higher interest rates. Over the past seven years of the recovery, real GDP growth has averaged just 2.1% annually, which was sufficient to bring the unemployment rate down by over five percentage points. With relatively weak productivity and a slowing labor force, this is about as fast as the U.S. economy can be expected to grow.

CHART 2: INTEREST RATES



Source: Federal Reserve Board

CHART 3: AVERAGE HOURLY EARNINGS



Source: BLS, TD Economics.
Note: Energy-producing states include: TX, NM, AL, CO, OK, WY, LA, WV.

Nonetheless, a lower rate of trend economic growth means that the central bank may have to act sooner than markets are anticipating in order to stem inflationary pressures. As long as the U.S. economy continues to post jobs of +100k, the unemployment rate will keep trending down and wage pressures will build. There are already nascent signs of this (Chart 3), especially in non-energy producing states.

Bottom line

All of this suggests the Fed will continue to opt for a risk management approach, raising rates as long as the domestic data continue to show improvement, but not ceasing to do so all together in 2016. International developments support the notion of a more tempered pace to the Fed's tightening cycle than the "dot plot" of expectations currently displays. This should adjust downward with time.

The necessary condition for the next policy move is some calming in financial markets and sufficient evidence that recent events did not undermine economic fundamentals. This makes June the more ideal timing for a second modest lift in rates. As it currently stands, markets have pushed rate-hike expectations too far into the future, reminiscent of September of last year. With wage growth at 2.5%, the yield on 10-year government bond under 1.8% is looking a tad out of tune. Don't be surprised to see it move up further as the reality of a still resilient U.S. domestic economy sets in.

INTEREST RATE & FOREIGN EXCHANGE RATE OUTLOOK

		Spot Rate	2015				2016				2017			
		Feb-22	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		0.50	0.25	0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50
3-mth T-Bill Rate		0.29	0.03	0.01	0.00	0.16	0.30	0.55	0.55	0.80	0.80	1.05	1.05	1.30
2-yr Govt. Bond Yield		0.76	0.56	0.64	0.64	1.06	0.70	0.90	1.00	1.25	1.30	1.45	1.50	1.70
5-yr Govt. Bond Yield		1.24	1.37	1.63	1.37	1.76	1.20	1.40	1.50	1.75	1.80	2.00	2.05	2.25
10-yr Govt. Bond Yield		1.75	1.94	2.35	2.06	2.27	1.80	2.00	2.05	2.30	2.30	2.40	2.45	2.60
30-yr Govt. Bond Yield		2.61	2.54	3.11	2.87	3.01	2.60	2.80	2.85	3.05	3.05	3.10	3.15	3.25
10-yr-2-yr Govt Spread		1.00	1.38	1.71	1.42	1.21	1.10	1.10	1.05	1.05	1.00	0.95	0.95	0.90
Exchange rate to U.S. dollar														
Japanese yen	JPY per USD	113	120	122	120	120	115	115	118	120	121	121	122	122
Euro	USD per EUR	1.10	1.07	1.12	1.12	1.09	1.03	1.06	1.10	1.12	1.15	1.15	1.20	1.20
U.K. pound	USD per GBP	1.41	1.49	1.57	1.51	1.48	1.36	1.43	1.49	1.56	1.62	1.64	1.67	1.67
Swiss franc	CHF per USD	1.00	0.97	0.94	0.98	1.00	1.04	1.01	0.97	0.96	0.92	0.94	0.92	0.92
Canadian dollar	CAD per USD	1.37	1.27	1.25	1.34	1.38	1.43	1.43	1.40	1.37	1.35	1.34	1.34	1.33
Australian dollar	USD per AUD	0.72	0.76	0.77	0.70	0.73	0.70	0.68	0.68	0.69	0.70	0.71	0.74	0.76
NZ dollar	USD per NZD	0.67	0.75	0.68	0.64	0.68	0.65	0.63	0.62	0.61	0.60	0.60	0.61	0.62
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.10	1.07	1.12	1.12	1.09	1.03	1.06	1.10	1.12	1.15	1.15	1.20	1.20
Japanese yen	JPY per EUR	125	129	136	134	131	118	122	130	134	139	139	146	146
U.K. pound	GBP per EUR	0.78	0.72	0.71	0.74	0.74	0.76	0.74	0.74	0.72	0.71	0.70	0.72	0.72
Swiss franc	CHF per EUR	1.10	1.04	1.04	1.09	1.09	1.07	1.07	1.07	1.07	1.06	1.08	1.10	1.10
Canadian dollar	CAD per EUR	1.51	1.36	1.39	1.50	1.50	1.47	1.51	1.54	1.53	1.55	1.54	1.61	1.60
Australian dollar	AUD per EUR	1.53	1.41	1.45	1.59	1.49	1.47	1.56	1.62	1.62	1.64	1.62	1.62	1.58
NZ dollar	NZD per EUR	1.64	1.44	1.65	1.75	1.59	1.59	1.68	1.77	1.84	1.92	1.92	1.97	1.94
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	113	120	122	120	120	115	115	118	120	121	121	122	122
Euro	JPY per EUR	125	129	136	134	131	118	122	130	134	139	139	146	146
U.K. pound	JPY per GBP	159	178	192	181	177	156	165	175	187	196	199	203	203
Swiss franc	JPY per CHF	113.2	123.5	130.6	122.6	120.1	110.7	113.9	121.3	125.6	131.3	128.8	133.1	133.1
Canadian dollar	JPY per CAD	82.6	94.6	97.9	89.4	86.9	80.5	80.5	84.4	87.6	89.5	90.1	90.9	91.5
Australian dollar	JPY per AUD	81.6	91.5	94.1	84.1	87.6	80.5	78.2	80.2	82.8	84.7	85.9	90.3	92.7
NZ dollar	JPY per NZD	75.9	89.8	82.8	76.6	82.3	74.8	72.5	73.2	73.2	72.6	72.6	74.4	75.6

F: Forecast by TD Economics, February 2016; Forecasts are end-of-period; Source: Federal Reserve, Bloomberg.

GLOBAL STOCK MARKETS

	Price Feb-22	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	1,918	0.6	-6.9	2,131	1,829
DAX	9,555	-2.1	-2.6	12,375	8,753
FTSE 100	6,038	2.3	-8.0	7,104	5,537
Nikkei	16,111	-5.0	-7.7	20,868	14,953
MSCI AC World Index*	370	0.5	-11.4	443	353

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg

COMMODITY PRICE OUTLOOK															
	Price	52-Week	52-Week	2015				2016				2017			
	Feb-22	High	Low	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	32	61	26	49	58	46	42	30	36	46	55	57	57	60	60
Natural Gas ($US/MMBtu)	1.81	3.27	1.53	2.87	2.78	2.75	2.10	2.25	2.30	2.45	2.60	3.25	3.10	3.40	3.60
Gold ($US/troy oz.)	1210	1247	1051	1218	1191	1124	1104	1165	1225	1200	1185	1185	1175	1150	1125
Silver (US$/troy oz.)	15.1	17.7	13.7	16.74	16.44	14.92	14.78	15.30	16.43	16.43	16.30	16.35	16.25	15.25	15.00
Copper (cents/lb)	210	294	196	264	275	238	222	209	209	215	215	220	220	230	230
Nickel (US$/lb)	3.89	6.58	3.45	6.51	5.94	4.78	4.27	3.92	4.00	4.18	4.45	4.75	5.00	6.00	6.25
Aluminum (Cents/lb)	70	90	65	82	79	72	68	67	69	72	72	74	74	76	76
Wheat ($US/bu)*	5.93	8.11	5.77	7.45	7.34	6.39	6.36	6.00	6.15	6.50	6.75	6.90	7.00	7.00	7.25

F: Forecast by TD Economics, February 2016; Forecasts are period averages; Source: Bloomberg, USDA (Haver). *As at February 18, 2016.

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