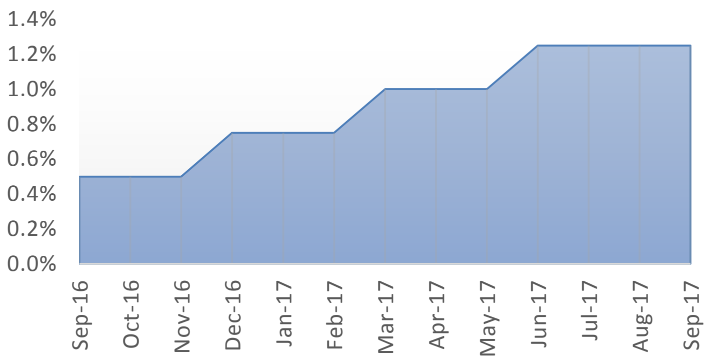
Federal Reserve policy outlook for 2017

On 20 September 2017, the Federal Reserve has decided to maintain its benchmark interest rate at the current level, but the regulator is widely expected to consider a further interest rate rise later this year. In addition, the Fed announced that it would start paring back its USD4.5tln balance sheet in October. This decision reflects the Fed's expectations that the US economy's continued progress toward the full employment will result in higher and sustainable 2% core inflation.

Federal funds rate, % (September 2016 – September 2017)

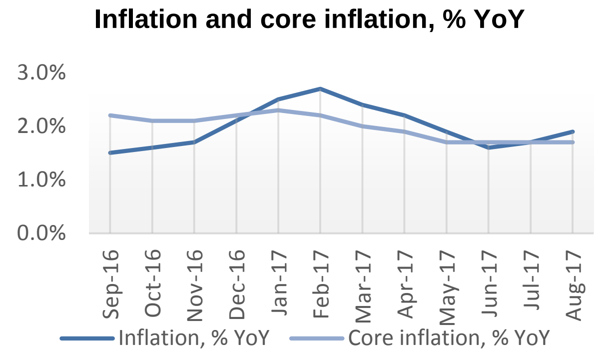


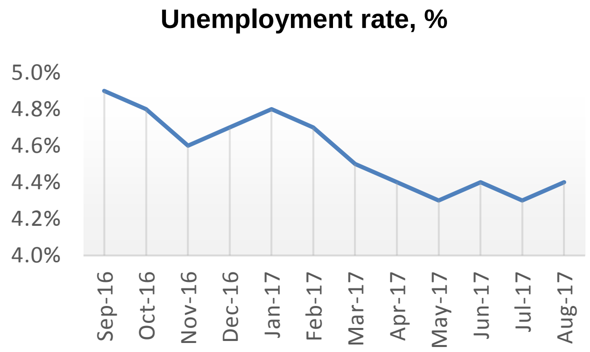
Source: US Federal Reserve System, Samruk-Kazyna

At the moment, the US central bank reinvests the payments it receives on the portfolio of government bonds and mortgage-backed securities (MBS) it amassed during the crisis, keeping its overall holdings steady. The announced plan on unwinding the balance sheet involves setting a steadily increasing set of caps: payments will only be reinvested to the extent they exceed the caps. The caps will initially be set at USD6bln per month for US Treasuries and USD4bln for MBS. They will be steadily lifted in three-month intervals until they peak at USD30bln for US Treasuries and USD20bln for MBS, in about a year's time. The initial cap will first be applied to holdings of US Treasuries on October 31, while an announcement will be made on MBS holdings on October 13.

Most policymakers maintained with forecasts for another rate rise in 2017, most likely in December, as well as three rate increases in 2018 and two rate hikes in 2019, lifting the key interest rate near the long-term sustainable rate of 3%. For 2017, federal funds rate is forecasted at 1.4%, while the median projection for 2018 stood at 2.1%. The Fed, however, lowered its 2019 outlook for the federal funds rate from its June projection, it now expects the benchmark rate to be 2.7% by the end of 2019, instead of the 2.9% it previously projected. Compared to the projections made in June 2017, the median pace for the interest rates is essentially unchanged, with the uncertainty in the economic outlook possibly leading to adjustments to the policy stance in the future.

Latest assessment of the US economic conditions indicate that the labor market remains strong, while economic activity is losing some momentum mainly due to the recent hurricanes. The US economy demonstrated a strong rate of job gains, with the unemployment remaining at historically low levels. However, over the last six months, price growth and core inflation dropped to lower than the Fed's target of 2%.



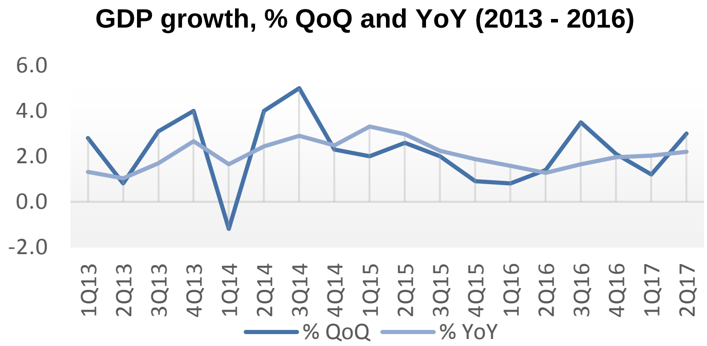


Source: US Bureau of Labor Statistics, Bloomberg, Samruk-Kazyna

Unemployment rate rose slightly to 4.4% in August 2017 vs. 4.3% reading reported in July, remaining well below 4.9% seen in September 2016. Since the beginning of 2017, the unemployment rate has declined by 0.4%. The number of long-term unemployed (those jobless for 27 weeks or more) was essentially unchanged in August at 1.7 million and accounted for 24.7% of the unemployed.

Strengthening of the US labor market and wage growth did not result in an acceleration of inflation. Price growth has been slowing down in the recent months, from record-high since reaching 2.7% YoY seen in February 2017 to 1.9% YoY in August. Meanwhile, core inflation, which excludes volatile energy and food prices and is used by the Fed as the primary gauge for prices growth, has remained at 1.7% YoY in August vs. 2.3% in January 2017.

Nevertheless, economic growth has accelerated in 2Q17 to 3.0% QoQ and 2.2% YoY, driven by growing personal consumption, which offset slightly lower government spending. Growth in 3Q17 is estimated at 2.2% YoY. Consequently, full year GDP growth is forecasted at 2.2% in 2017 and 2.3% in 2018.



Source: US Bureau of Economic Analysis, Samruk-Kazyna

Implications for global financial and commodity markets

The Fed's stance is contradictory with central banks elsewhere. The Bank of Japan decided to maintain its interest rates steady at 0.1% in an attempt to stimulate inflation. Meanwhile, the European Central Bank also indicated that its medium-term policy will remain relatively unchanged.

Markets have appeared largely unconcerned by the prospect of the Fed's retreat from quantitative easing; two increases in short-term rates this year coupled with signals of a reduced balance sheet have done little to tighten financial conditions in the US thus far.

Currency

In light of the Fed's decision, the dollar rose to a two-month high against the yen and extended its gains against the euro. The dollar index, which measures the US currency against a basket of its peers, swung from a loss to be up 0.7% after the statement.

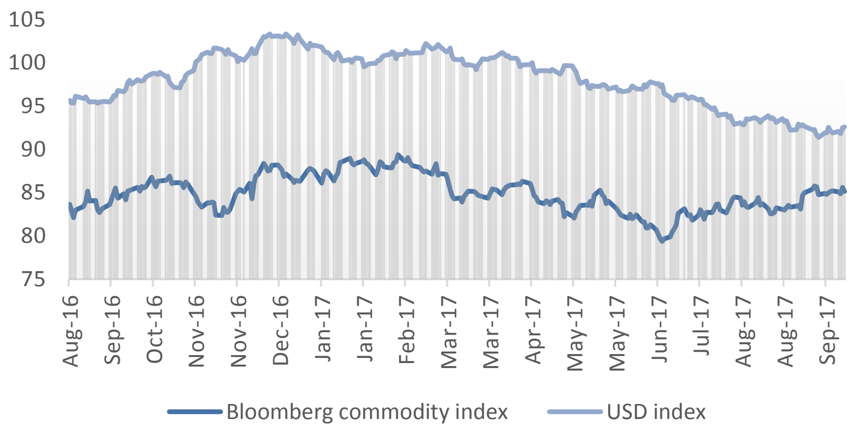
Capital markets

The yield on the 10-year Treasury also climbed from about 2.24% immediately preceding the announcement to 2.27% soon afterwards, while the policy-sensitive 2-year yield jumped from 1.38 per cent to 1.43%.

Commodities

Prices for most commodities moved in different directions despite the strengthening of US currency, but the effect of the Fed's decision was quite limited. Oil prices settled higher despite the increase in US supplies, as market participants expect that OPEC will decide to extend its agreement to cut oil output. Meanwhile, gold prices dropped to their lowest level in over three weeks as increasing prospects of a December rate hike curbed the demand for the metal.

Bloomberg commodity index (August 2016 - September 2017)

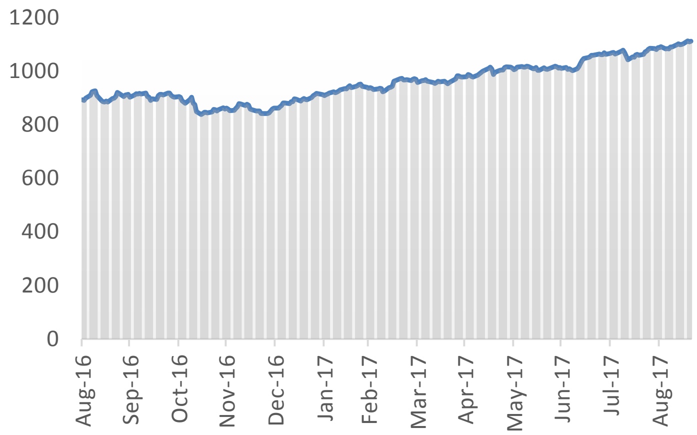


Source: Bloomberg, Samruk-Kazyna

Capital outflows

In the long-term, appreciation of the dollar and rising interest rates in the US pose a threat for emerging markets, since investors would be more inclined to invest in the US economy. Consequently, emerging markets might experience capital outflows and disinvestments. Outflow of capital may cause additional pressure on emerging market currencies and international reserves. However, moderate pace of the US monetary tightening is not likely to be accompanied by bouts of heightened risk aversion and financial stress, which in the past have led to slowing international capital flows with damaging consequences for activity and employment in developing countries.

MSCI emerging markets index (August 2016 - September 2017)



Source: Bloomberg, Samruk-Kazyna

Higher borrowing costs

Fed's policy changes would also have an effect on interest rates on international capital markets. Consequently, external borrowing might become more expensive for some companies, including those in emerging markets. The risk of higher funding costs is also relevant for governments that rely on external borrowing. On the other hand, Fed's rate hikes would raise the yields on US treasury bonds, a common low-risk instrument for international investors.

Our commentary

The US policymakers have carried out two out of three rate hikes anticipated in 2017, with one additional rate hike highly probable towards the end of the year given relatively solid economic growth momentum and a strong labor market. The US Fed has a dual mandate i.e. stable prices as well as full employment, and that a tighter labor market could help firm prices toward the target eventually. The unemployment rate currently stands at 4.4%, with the level of full employment rate estimated at 4.8%. Even so, with the inflation still below official target of 2%, there is no reason for the Fed to abandon its gradual normalization policy approach. As such, most Fed policymakers expect for three rate increases in 2018, two in 2019 and one in 2020, reflecting anticipation of moderate and sustainable economic growth momentum.

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