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Expert Commentary

Michael Gapen, Chief US Economist at Barclays Capital Inc, on US economy and USD

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Michael Gapen
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The US Federal Reserve kept its interest rates unchanged in June and signalled that it still plans two rate hikes in 2016, though six of the 17 Fed officials now see just one rise this year. In your opinion, is it reasonable to expect a rate hike this year at all?

I think it is reasonable, although it is still questionable. The reason for me to say that is the weakness in the US economy that we are seeing right now, which is coming through labour markets, particularly through slower employment growth that historically has been a very key indicator of expansion and contraction in the US economy. Thus, under the assumption that the recent weakness in employment growth is reversible and will rebound along with the forecast that the economy will stay in a modest recovery phase, which is what the Fed is assuming in their base line outlook, one rate hike by the end of this year seems reasonable.

In our own base line forecast, we do have a rate hike in September. However, the weakness in labour markets is worrisome to us, while the Fed will have three labour market reports between now and the time it meets in September. In the meantime, we do not think July is an option at all. Therefore, if these three labour market reports do not show progress and instead show further weakness, meaning that a slowdown in employment is translating into a pick-up in firings or weakness that we would expect to see out of the goods sectors of the economy relating to mining and manufacturing, which would somehow spread into the other services sectors, then the Fed could very well delay its rate hike, but it would not be shifting from September into December, in our mind. Most probably, it would likely take a rate increase for the rest of this year off the table.

Overall, weak labour markets, in our mind, have increased the probability of a recession over the next four quarters. So, under a base line scenario, we think it is reasonable to expect one rate hike by the end of the year, but there is a risk that labour markets are weakening in a way that could cause the Fed to change its entire tightening bias, which would kick a rate hike way out in the future and put the Fed on hold for the foreseeable time period, should labour markets not rebound by the time the Committee meets in September.

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Analysts expect the US economy to expand by 2.4% in the Q2. Do you share this point of view or not? Why?

We do share approximately the same view. We maintain a GDP tracking estimate, meaning that we track the incoming data relative to our expectations. Having said that, our GDP tracking estimate has been ranging between 2.5% and 2.7%, as the data suggests a very strong rebound in consumption in the Q2. We can see that very clearly in auto sales, which rebounded sharply, while the non-auto or services-oriented consumption has also been quite strong. In the meantime, consumption was softer in the Q4 last year and in the Q1 this year, which, in our view, mainly reflected the fact that auto prices were just unsustainably high that consumers were purchasing autos at over an 18 million annualized pace in the Q4, which was just too strong and needed to adjust and calm down; and it did that over the course of the second half of the Q4 and Q1 and seems to have stabilized right now. Furthermore, consumption data looks fine, housing data also looks fine and together those two are suggesting a descent rebound off the soft Q1. Our official forecast remains 2%, but we are tracking above that, closer to 2.5%.

What factors will influence the performance of the Greenback through the rest of the year?

To my mind, it is really about the expected differential in performance of the US economy versus others and the ability of the Federal Reserve to continue on its interest rate tightening path. At the moment, it is obviously much less in favour of a stronger Dollar than it was in the past, in the middle of 2014, when the US economy accelerated quite strongly and the Fed was signalling that it was likely to raise rates in a relatively near future, seeing about four rate hikes per year. At that point, the Greenback had a very strong upward momentum and then at some point in time, when the commodity complex weakened and emerging markets were quite soft, that provided further upward trajectory to the Dollar. Those dynamics are not quite emplace anymore, the US remain in a recovery phase, which is likely to be modest, while the Fed is not signalling that it intends to go much slower. Thus, there will be a modest upward pressure on the US Dollar over time, should the US economy remain in a recovery phase; however, we would not look for the type of appreciation that we saw in previous years.

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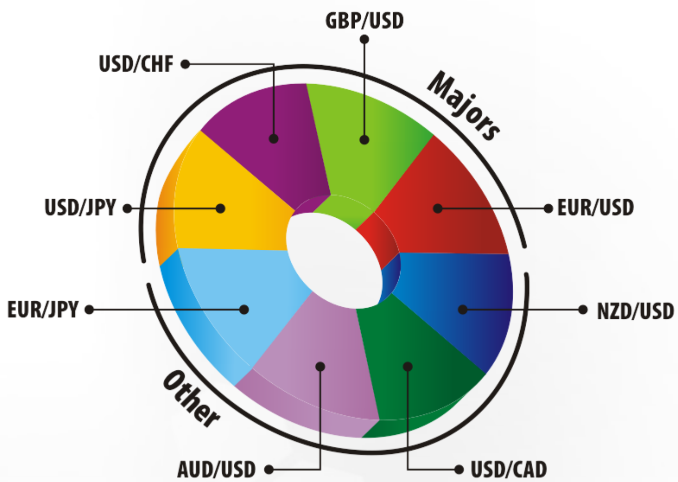

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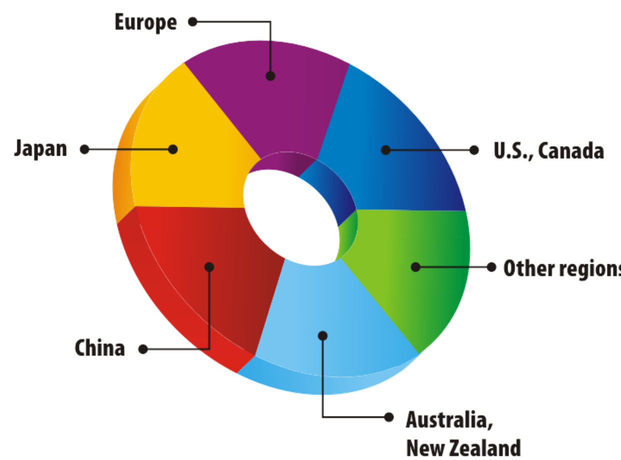

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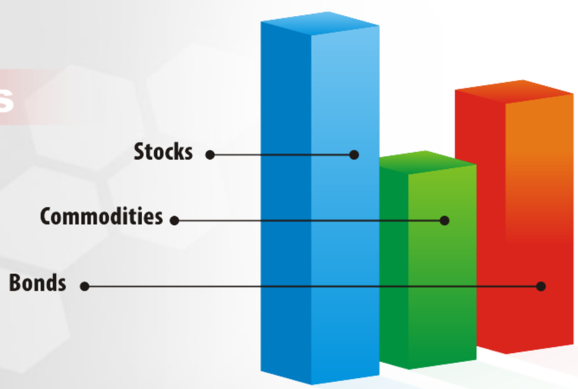

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