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Kunal Kumar Kundu: US Fed's dovish outlook

The release of the advance estimate of US gross domestic product (GDP) for the second quarter of 2014 and the subsequent [Federal Open Market Committee](#) (FOMC) statement last Wednesday could lead to a twist in the tale as to when one can expect rates to rise in the US.

For starters, the [GDP](#) figures came up with a number of positive surprises. Not only was the preliminary estimate of [Q2](#) growth better than expected at a four per cent annualised rate, it also came with a positive revision of Q1 GDP growth. The latter now stands at -2.1 per cent against the previously reported -2.9 per cent. This means growth averaged 0.5 per cent in the first half of the year. While this does not look great *per se*, it is far better than the flat growth that was expected. Moreover, 2013 growth was revised up by 0.5 per cent. Though this came at the expense of a weaker 2012, it nonetheless puts the US on a better momentum.

A closer look at the disaggregated data reveals that nearly all sectors contributed to that outcome. The biggest surprise in Q2 came from consumer spending, which expanded by 2.5 per cent. Trade also turned out to be less of a drag, shaving only 0.6 per cent from the growth. Other sectors performed broadly in line with expectations. Business investment was up 5.5 per cent, with broad-based gains in equipment, structures and intellectual property. Residential investment expanded by 7.5 per cent, marking the first positive contribution since last summer. Even government spending was a positive for growth, posting its best performance since third quarter of 2012, consistent with fading fiscal drag. The only jarring tone in the note was made by the inventory data, which boosted Q2 GDP by 1.5 per cent. However, given that this has materialised on the back of a 1.2 per cent drag from inventories in Q1, this essentially reflects a catch-up after winter destocking. What is also worth noting is that net of inventories, real final sales expanded by 2.3 per cent in Q2 following a -1 per cent contraction in Q1. Thus, the positive momentum is driven by broad-based improvements in final demand and is not solely an inventory story.

If one looks at the price components of the GDP report, it turns out to be firm (two per cent annualised gain in core personal consumption expenditure, or PCE, deflator), though in line with expectations. Year-on-year, core [PCE inflation](#) was running at 1.5 per cent as of Q2, which, according to Fed Chairperson Janet Yellen, is broadly in line with the Fed's forecast. We do expect core inflation to continue marching higher, possibly forcing an upward revision in the FOMC's year-end forecast.

While the rupee reacted immediately to the better than expected US GDP growth data as a potential harbinger of an early rate action by Fed, we do not think this to be a game-changer for the Fed. At least, not as yet. Most Fed officials were already discounting the weak Q1 outturn as an outlier and expected growth to average in excess of three per cent in the second half of the year. More importantly, the new information has no bearing on the outlook for employment,

which was already decoupled from GDP figures.

We believe that the outlook for the Fed and for rates will be determined more by inflation data, and less so by growth data. As the unemployment rate crosses six per cent and begins to approach NAIRU (non-accelerating inflation rate of unemployment, which is around 5.5 per cent), the debate on slack and inflationary potential of the US economy will become shriller. While Yellen's view about "shadow unemployment" has so far been supported by benign wage data, we expect wage growth to accelerate notably in the second half of the year. Should this forecast materialise, we believe this will be a game-changer for the Fed policy and interest rates.

The subsequent release of the [FOMC](#) statement also brings forward the view that the Fed is aware of the risk. The statement was on expected lines. The Fed tapered asset purchases by another \$10 billion and the forward guidance on rates remained unchanged. However, the committee made a few seemingly modest tweaks to its assessment of labour markets and inflation. It is no longer claiming that the unemployment rate "remains elevated" and instead is referring to "significant underutilisation of labour resources". The statement also acknowledged that inflation has moved "somewhat closer" to the Fed's target, and added that the risk of inflation running persistently below two per cent has "diminished somewhat".

While the overall message continues to be dovish, this could be the Fed's attempt to manage expectations ahead of further data improvements. There is a distinct possibility that the unemployment rate reaches NAIRU and core PCE deflator reaches two per cent earlier than expected. In this context, the Fed might find it difficult to keep rate rise expectations contained.

While our baseline scenario is of the Fed raising rates during the second half of 2015, there could well be rising clamour for an earlier increase. Such an eventuality would test the ability of the rupee to withstand the depreciation pressure. However, whenever the hike materialises, we do not expect the severity of last year's correction to be repeated.

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