

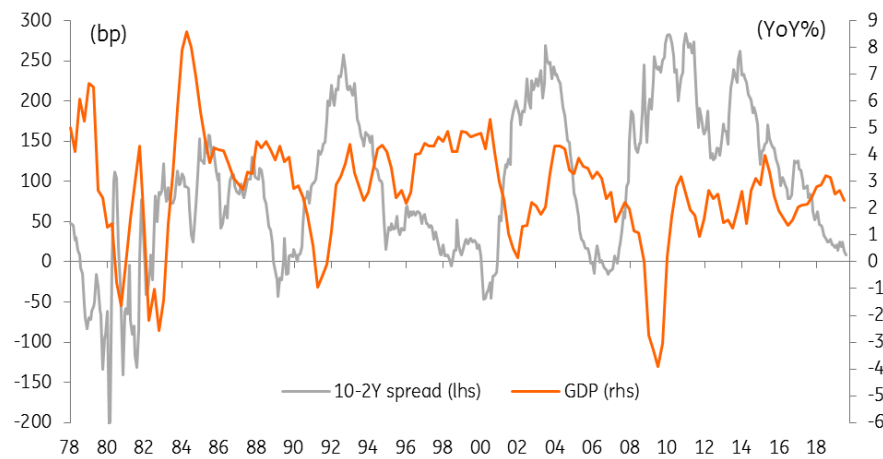
A test for the Fed

The combination of rising borrowing costs, trade tensions and geopolitical threats are stressing financial markets, but with US growth looking strong and inflation heading higher will the Federal Reserve ease back?



Source: Shutterstock

It wasn't long ago when the big story in bond markets was the potential for an inverted yield curve. However, a 40 basis point rise in the 10-year Treasury yield over the past six weeks has put pay to that for now. The strong US growth and jobs story, combined with rising inflation has led the Federal Reserve to take a bolder position on the likely path for interest rates with officials clearly signalling a strong likelihood for four more rate rises over the next 15 months.



Source: Macrobond

However, this hasn't gone down well with equity markets who are deep in the red again today. There is a sense that higher borrowing costs combined with escalating trade tensions, (which disrupt supply chains and increase costs) and ongoing external events such as emerging market problems and Italian budget woes, could exacerbate the downside risks for US activity. An equity market correction could then in turn compound the problems by hurting consumer and business sentiment and result in slower spending growth more broadly in the economy.

The S&P 500 is down “only”138 points versus the 291 point drop seen in January/February this year. Until there are clear signs that the economy is weakening, the Fed will probably continue raising interest rates “gradually”

We will have to wait and see whether these issues start feeding back into the Fed's thinking. If so, this could point to a slower path of rate hikes than the Fed are currently signalling. Certainly, today's US inflation numbers were softer than expected with the annual rate of consumer price inflation slowing to 2.3% from 2.7% while the core (ex-food and energy) remained at 2.2% rather than rise to 2.3% as was expected. The problem though is that pipeline wage pressures, the effects of tariffs and higher energy costs are likely to push inflation higher in coming quarters.

4.2%

Atlanta Fed GDPNOW 3Q18

Annualised growth forecast

At the same time, economic activity is very strong with the Atlanta Federal Reserve's GDPNow model suggesting the economy expanded at a 4.2% annualised rate in 3Q18. We see little reason to see a significant slowing in the fourth quarter, given the ongoing support from fiscal stimulus and the strength of the US jobs market.

Furthermore, the S&P 500 is down “only” 138 points versus the 291 point drop seen in January/February this year. Until there are clear signs that the economy is weakening, the Federal Reserve will probably continue raising interest rates “gradually”. As such, we continue to predict a December rate rise with three more hikes next year.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.