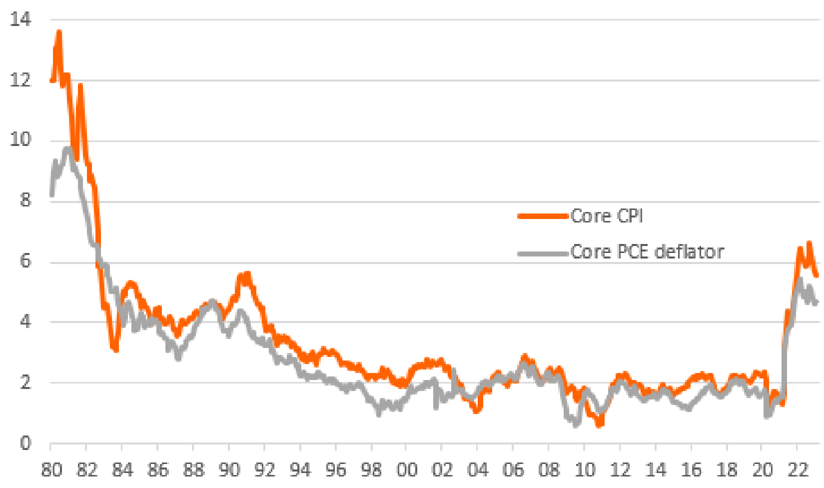
US: Fed inflation fears keeps the pressure on for rate hikes

The Fed's favoured measure of inflation accelerated in January with markets now fully pricing 25bp moves in March, May and June. We agree that this is the most likely path ahead, but it will be painful for the household sector, coming at a time when real incomes are squeezed by inflation, borrowing costs continue to rise and lending conditions are tightening

Inflation shows little sign of slowing

The acceleration in the Federal Reserve's favoured measure of inflation, the core personal consumer expenditure deflator, is a big story. It rose 0.6% month-on-month versus expectations of a 0.4% print and is also above the 0.4% increase reported by the core CPI report. There were upside revisions too, which means the year-on-year rate has ticked up to 4.7% from 4.6%, above the 4.3% rate expected. This will ensure the Federal Reserve mantra of ongoing hikes continues with 25bp moves in March, May and June fully priced by markets. Talk of a potential 50bp move at the March Federal Open Market Committee meeting can't be completely discounted, although we don't think they will carry through with it.

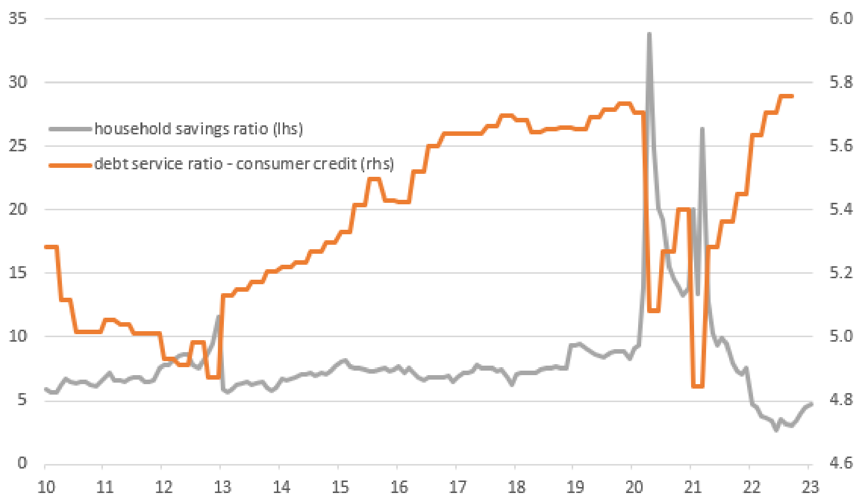
US inflation measures (ex food and energy (YoY%))



Source: Macrobond, ING

Meanwhile, personal incomes didn't rise quite as much as expected, up 0.6% month-on-month. The consensus was for a 1% gain because of the annual uprating of social security benefits by 9%, but there was a 2.7% MoM drop in farm income while “other benefits” fell 15.5%. Real personal spending rose 1.1% MoM as expected. We will see weaker prints in February and March, but consumer spending is still likely to grow in the 3.5-4% annualised range in the first quarter of this year.

Household savings ratio and debt service ratio (% of household disposable income)



Source: Macrobond, ING

Household finances are under pressure though

The combination of decent income growth, rising spending and robust inflation means March and May rate hikes are very likely and we have to accept that a further move in June is more likely than not. Our caution centres on the combination of squeezed real incomes, rising interest rates and tightening lending conditions all happening at the same time. Household saving ratios are now well below pre-pandemic levels while the proportion of income spent on servicing the debts on consumer loans is at the highest since 2009 (the chart above measures them as a percentage of household disposable income).

This hints at financial pressures on the household sector and this will increasingly bite as we go through the year. It will only get worse if those lay-off announcements keep coming, which could lead to the economy slowing sharply in coming quarters, opening the door for a path to lower interest rates from the fourth quarter.

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