Higher for longer means more headwinds for US growth

With Treasury yields up at 5% and the dollar holding firm, financial conditions have undoubtedly tightened, reducing the need for another Fed rate hike. Consumer borrowing costs are moving rapidly higher, savings are being exhausted, and real household disposable incomes are falling. That means the risks to growth in 2024 remain to the downside

Federal Reserve Chair Jerome Powell

The US continues to confound expectations

Twelve months ago, the consensus view was that rapid and aggressive monetary policy tightening coupled with a growing reluctance of the banks to lend would inevitably take its toll on the economy. Recession was the consensus call. Yet, in the third quarter, the economy expanded at a 4.9% annualised rate, unemployment was just 3.8%, and inflation remained closer to 4% than the 2% target.

Having confounded expectations, financial markets have embraced the Fed's higher-for-longer narrative on interest rates with 10Y Treasury yields up at 5% and the dollar strengthening to 12M highs on a trade-weighted basis. This is leading to a significant tightening of financial conditions in the US economy, helping to push mortgage and car loan interest rates above 8% and credit card interest rates to all-time highs. Given all that, Federal Reserve officials increasingly acknowledge that we are close to the end of the tightening cycle with policy widely regarded as restrictive. In our view, interest rates have peaked.

Nonetheless, with inflation still well above target, officials are refusing to close the door on possible extra rate hikes, if only to ensure the market doesn't move to the mindset that the next move is inevitably a cut and traders should start to price for that. We expect 10Y treasury yields to remain near 5% through the current quarter.

Recent market moves intensify the challenges for 2024

The Federal Reserve wants to see clear evidence of slowing activity to be confident that inflation will return to 2% sustainably. We are now doubtful that there will be enough evidence for this to prompt an interest rate cut in 1Q 2024 and have subsequently pushed back the start point for Fed rate cuts to the second quarter. Recent upward revisions to income data suggest that households may have more residual savings than previously thought, and this can keep positive growth momentum throughout 4Q and into early Q1.

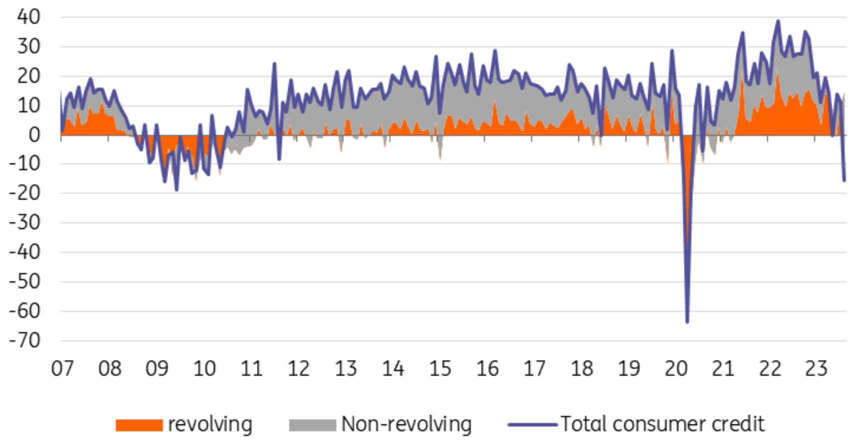
However, we remain more cautious about 2024's growth prospects relative to the consensus view, which should help to dampen inflation pressures more significantly than the Fed currently expects. In turn, we believe that this offers policymakers the room to cut interest rates more significantly than is currently priced by markets.

Consumer spending is key and fundamentals are weakening

Consumer spending is key for the outlook given it is 70% of economic activity. Real household disposable incomes have fallen in each of the past four months, savings have been run down, and the suspicion is many households have exhausted them, while consumer credit has turned negative with households repaying student loans. As such, the drivers of consumer spending are looking much less supportive. With loan delinquencies on the rise and banks' reluctance to lend pointing to credit growth turning negative in the coming months, the stresses in the household sector are becoming more apparent.

Consumer credit has turned negative

Monthly change in consumer credit (US$bn)



Source: Macrobond, ING

Commercial real estate is another area of potential stress. There are lingering fears that low office occupancy, falling property prices and upwards of $1.5tn of debt needing to be refinanced over the next couple of years could see landlords increasingly handing back the keys to lenders. This could see loan losses mount, particularly for small and regional banks which are responsible for two-thirds of the lending to the sector, compounding the problems for an economy where credit flow is so critical.

Given this situation, we need to see consumer fundamentals improve quickly. Real household disposable incomes are critical to the economy's prospects, and if they don't recover, we fear that the economy will experience a contraction in the middle quarters of 2024.

The one consolation is that inflation is slowing and we expect that process to continue as the housing rents slowdown story becomes more apparent in the data. This should give the Federal Reserve the opportunity to respond to economic weakness, with the Fed funds rate forecasted to end the year at 4% with the 10Y Treasury yield down at 3.5%.

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