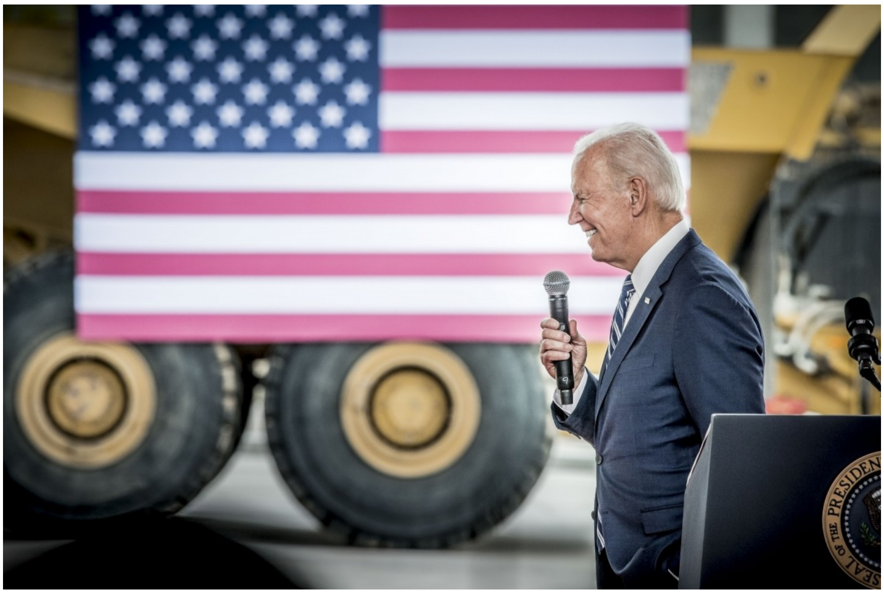
Our 3 calls for the US

We should see a swifter fall in US inflation than anywhere else given the composition of the country's inflation basket. Recession will accelerate inflation's slide and allow the Federal Reserve to respond with rate cuts before 2023 is out



US President Joe Biden at a recent factory visit in an effort to show his economic plans are creating jobs

1 Recession risks mount as businesses pull back

While the household sector is holding up well right now, we are fearful that the story will not be nearly as positive in the first half of 2023. The housing market downturn (triggered by rapid increases in mortgage borrowing costs) will hurt the construction sector, which accounts for around 4% of GDP. This will have a ripple effect on key retail activity such as household furniture, furnishing, household appliances and building supplies.

The slower global backdrop will hit the manufacturing and service sectors, with the Conference Board's US CEO confidence index already at the lowest level since the depths of the global financial crisis 13 years ago. We're therefore likely to see the jobs market and the outlook for business capital expenditure deteriorate markedly over the next couple of quarters. While the US entered a technical recession in the first half of 2022, this was tied to legacy supply chain issues which led to volatility in trade and inventories. A recession will feel much more “real” this time around.

Inflation set to hit 2%

Corporate pricing power already appears to be waning based on survey evidence, especially from the National Federation of Independent Businesses. The deteriorating activity story will help dampen price and wage pressures further. The composition of the US inflation basket, which is heavily skewed toward housing and vehicles – accounting for more than 40% by weight – is also important for our call that inflation will hit 2% by the end of the year.

Given these reflect asset valuations, there is greater scope for these key components to fall in price, which allows inflation to drop far more quickly relative to countries that have inflation baskets more heavily weighted towards services. Inflation will be much stickier for those countries, given that wages account for the bulk of the input cost.

3 The Fed will respond early and fast with rate cuts

Recent falls in Treasury yields and the dollar, coupled with tighter credit spreads, are undermining the Federal Reserve's efforts to control inflation. Consequently, with the Fed continuing to suggest the risk of doing too little outweighs the risk of doing too much, it appears prepared to accept a recession to ensure inflation is defeated. Given this situation, there is some upside risk to our forecast of 100bp of rate hikes from here on. But given the prospect of recession and sharply lower inflation, the Fed will be in a position to cut interest rates in the second half of the year.

Remember as well that the Fed has a dual mandate, which includes maximising employment. This, together with the fact it has an "average" inflation target, offers the US central bank greater flexibility to respond with stimulus versus most other central banks.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Disclaimer