James Knightley: Risks skewed towards higher-for-longer US interest rates

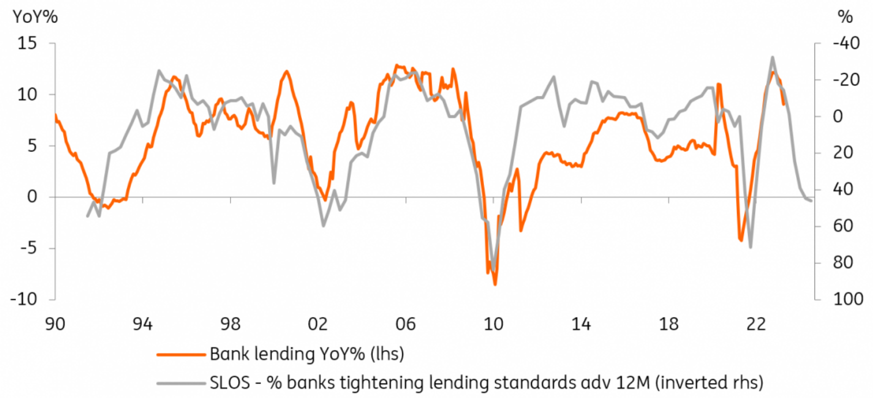
Uncertainty over inflation, the labour market, the health of banks and Supreme Court deliberations means our forecasts are subject to a lot of risks. With the Fed focused on inflation, interest rates could rise more than we expect, but economic threats may mean that the Fed ends up having to ease policy even more aggressively

Our US view

After the most rapid and aggressive tightening of monetary policy for more than 40 years, we expected financial and economic stresses to appear sooner rather than later. The small and regional banks are where this is most evident, but even before recent failures, banks were changing their attitudes and becoming more restrictive in terms of who they lend to, how much they lend and at what rate.

This combination of rapidly tightening lending conditions and significantly higher borrowing costs points to outstanding lending turning negative by the end of this year. For the US economy, where credit is such an important driver of economic activity, this outcome has in the past always meant recession. At the same time, corporate pricing plan intentions are softening and the high weighting of shelter and vehicles in the CPI basket means inflation should drop below 3% before year-end.

Tighter lending standards points to credit contraction and recession



Source: Macrobond, ING

Where we stand relative to the market

Compared with the consensus, we are forecasting a slightly more V-shaped profile for GDP growth of 1.2% for 2023, 0% for 2024 and 2.2% for 2025 – consensus is 1.1%, 0.8% and 2.0%, respectively. For inflation, we are broadly in line with the consensus for 2023 and 2025 at 4.1% and 2.3%, respectively, but for 2024 our more pessimistic growth view means we forecast inflation at 2% versus market expectations of 2.6%.

We are earlier and more aggressive in looking for Fed rate cuts, expecting a 50bp rate cut at both the November and December policy meetings with 3% rates by the end of the second quarter of 2024. The consensus is for no rate change this year before rates drop to 3.5% in 2024 and 2.75% in 2025. The market is, however, pricing modest interest rate cuts before the end of this year.

Where we could be wrong... inflation is stickier and the Fed tightens further

We see three key areas where our forecasts look vulnerable. First, we may be too optimistic that inflation falls rapidly. The unemployment rate is just 3.4% and labour market resilience could result in stickier wage pressures that keep service sector pricing more robust, especially if consumer spending remains firm. There are several hawks on the Federal Open Market Committee who want to see clear evidence that inflation is on a clear path to 2% before they are prepared to call time on hikes. If we see month-on-month inflation prints continuing to come in at 0.3% or 0.4%, rather than averaging 0.2%, and jobs numbers remain firm, we will probably see interest rates rise further with a Fed funds rate perhaps at 5.5% or even 5.75%.

Or we are too early in our downturn expectations

The second risk relates to the timing of events. Our long-held thesis is that the combination of higher borrowing costs and less credit availability weighs heavily on business and consumer spending in an environment where sentiment is already at recession levels.

Historically, credit growth lags movements in lending conditions by 12 months and unemployment responds similarly. Given lending conditions started tightening rapidly more than

12 months ago and interest rates have risen by 500bp since March 2022, our best guess has been that the economy will be showing the effects in the second half of this year.

However, strong household and corporate balance sheets may mitigate some of these effects and the downturn story could happen later than we are predicting. Therefore, Fed rate cuts may come later and possibly be less aggressive than we are predicting.

But things could get even worse

There are risks in the other direction though. We are hopeful we are almost through the debt ceiling crisis that has been unsettling for financial markets, but we can't rule out an intensification of stresses elsewhere. These could certainly resurface in the small and regional banks, most probably through their heavy exposure to the commercial real estate sector. Significant losses here could weaken balance sheets, resulting in a further tightening of lending conditions and a potential mini-credit crunch.

Also, we need to keep an eye on the Supreme Court deliberations regarding President Joe Biden's $20,000 student debt forgiveness plan. Then there is the resumption of student loan repayments that were paused during the Covid-19 pandemic. As part of the debt ceiling deal between House Republicans and the president, it appears that interest will be charged again from September with repayments resuming from October. According to Federal Reserve data, $1.6tr is owed by more than 43 million Americans, so from the fourth quarter onward these households could end up needing to divert hundreds of dollars each month towards loan repayments. This has the potential to weigh very heavily on consumer spending.

A worst-case scenario of a return of banking strife and the resumption of student loan repayments amid a housing market downturn and weaker general activity would heighten the chances of a recession and an even swifter, sharper response from the Federal Reserve than we are forecasting.

Author

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