US: How far can the Fed go?

With inflation above 8% and the unemployment rate below 4% the Federal Reserve is finally in policy tightening mode, just when the growth story is showing signs of wobbling and recession fears are on the rise

Source: Shutterstock

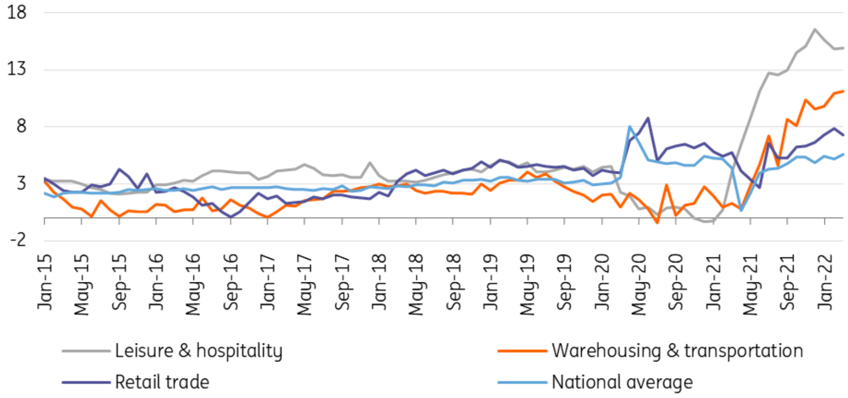
Growth fears mount as the Fed hits the brakes

With the Federal Reserve acknowledging that it needs to make monetary policy restrictive to get inflation under control, the surprise 1Q GDP contraction wasn't helpful going into the May FOMC meeting. The 1.4% annualised decline in output was primarily due to a big drag from net trade (weak external demand while the US continued to suck in imports) and an inventory run down. The underlying story on business and consumer spending wasn't nearly as bad. Yet a negative GDP reading inevitably adds to a sense of nervousness about the economic outlook. It also creates doubts over how far and how fast the Fed will end up raising interest rates.

But wage growth and employment remain strong

However, it didn't deter the Fed from hiking 50bp on 4 May with Chair Jay Powell signalling that additional 50bp hikes are "on the table" for June and July. Business investment indicators look healthy and employment is rising strongly while wages continue to be bid higher. Significantly, low wage sectors are seeing most of the gains, with pay in the leisure and hospitality industry rising 15% year-on-year while retail, warehousing and transportation workers are also seeing strong, inflation-busting increases.

Low wage workers getting the biggest pay rises



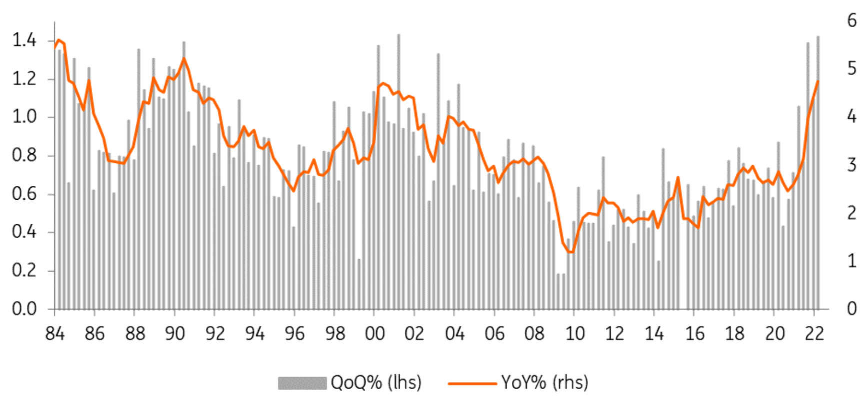
Source: Macrobond, ING

While white collar workers are, by and large, not seeing the same sorts of pay increases, they are more likely to have built up savings balances through the pandemic that can be utilised to maintain spending patterns. This all points to continued solid domestic demand growth. The trade and inventory drag should unwind over coming quarters and we look for 2.5%+ GDP growth in 2Q and 3Q 2022.

Fed focused on inflation

Meanwhile, inflation may be close to a peak at 8.5% but there is little to suggest it will drop back to the 2% target anytime soon. Surging employment costs in an environment where businesses continue to feel they have enough pricing power to pass higher costs onto customers will keep inflation sticky. At the same time, ongoing supply chain strains and geopolitical tensions will limit the downside for commodity, energy and freight/component costs.

Employment costs are rising at a rapid rate



Source: Macrobond, ING

Before the May FOMC meeting, we had seriously contemplated putting a 75bp hike for June as our base case forecast. However, the bar to achieving such an outcome has certainly been raised by Chair Powell's comments where he suggested that 50bp steps are the favoured option while 75bp is “not something that the committee is actively considering”. Of course, this doesn't rule it out, but it makes it more likely that based on our growth and inflation views the Fed will hike by 50bp at June, July and September rather than 75bp, 50bp and 25bp, respectively. We expect the Bank to switch to 25bp increments in the final meetings of 2022 when quantitative tightening is fully up to speed and contributes to the tighter monetary conditions.

Rate hikes means a slowdown is inevitable

By front loading interest rate increases, the Federal Reserve may be hoping to quickly get a grip on domestically generated inflation pressures and inflation expectations. But faster, sharper interest rate increases obviously come with a greater risk of an adverse reaction than would slower, more gradual moves. There are early signs of this already happening in the housing market where mortgage rates have jumped by more than 200bp in the space of four months and mortgage applications are clearly on the slide.

We are not formally forecasting a recession, but it could be a close-run thing in 2023. Already we are in an environment where consumer confidence is being hit by inflation fears, geopolitical worries and equity market volatility. Upcoming mid-term elections are unlikely to be helpful either as political animosity increases. The strong dollar is also set to weigh on the economy.

Fed to follow with rate cuts in late 2023

The best outcome would be an easing of geopolitical tensions, supply chains and a return of the missing workers from the labour force, which would dampen inflation pressures while expanding the productive potential for the US. This does not seem likely anytime soon.

Consequently, we expect the Fed to move interest rates into restrictive territory, growth will slow markedly and inflation heads towards target after which we will see the Fed reverse course and move policy to a more neutral footing. Between 1970 and 2000 the average length of time between the last rate hike in a cycle and the first rate cut was only three months. Over the past 20 years, it has been three quarters. History would suggest a 1Q 2023 peak in the Fed funds rate would be followed by a rate cut in 4Q 2023 and this is indeed what we forecast.

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