US: Feeling the squeeze

Evidence is mounting that while demand is booming, the pandemic has led to damaging scarring of the economy. Supply bottlenecks will be slow to ease, which will negatively impact economic activity and prompt more inflation. The result is we now expect the Federal Reserve to raise interest rates in 2022

Industrial worker people inside warehouse, USA

Source: Shutterstock

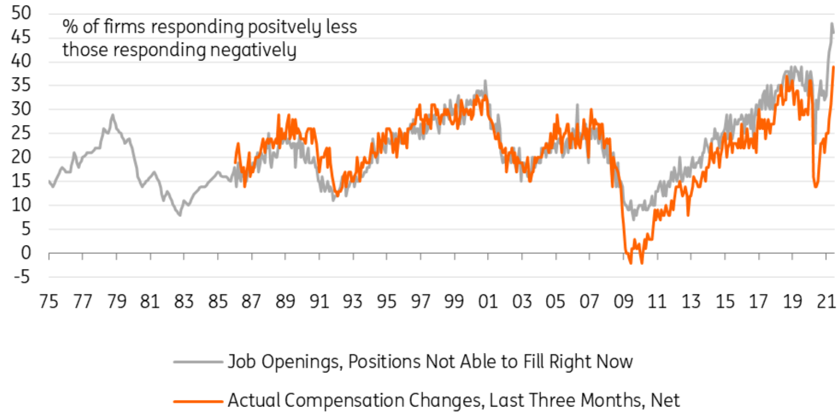
Demand is outpacing supply

Our long-held views of strong growth, elevated inflation and early Federal Reserve interest rate increases in the US are all still valid, but we have decided to add a few tweaks this month. We are revising down growth a touch, revising inflation upwards and bringing the Fed rate hike call into 2022, as evidence mounts that the supply capacity of the economy is struggling to keep pace with demand.

It is clear from a majority of business surveys that corporate America is facing bottlenecks in supply chains while also suffering from a lack of suitable workers. These capacity constraints mean that output is unlikely to be quite as strong as we had thought likely with 2Q GDP coming in closer to 10% annualised and full-year 2021 growth revised down to 6.7%.

It is important to emphasise this is not a demand issue. Companies are seeing rising order backlogs at a time when their customers are becoming increasingly desperate with record low inventory levels. The implication is that corporates have got more pricing power than they have had for years, meaning that companies facing higher costs have the ability to pass some (or all) onto customers.

NFIB survey 1974-2021: Businesses can't find workers and are raising compensation at a record pace



Source: Macrobond, ING

Persistent inflation to force the Fed's hand

The rhetoric from Fed officials surrounding the "transitory" nature of inflation has shown clear signs of cracking with the "dot plot" from their June FOMC forecast update now indicating a majority of officials expect interest rates to be increased at least twice in 2023.

> *Rising worker compensation is set to be a key story for 2H21, to both recruit and retain staff and coupled with surging housing costs, this means inflation looks set to linger in a 3.5-4.5% range well into next year.*

We are even less confident that inflation will fade quickly. The narrative that workers would flood back into the jobs market once childcare issues fade and uprated unemployment benefits cease is being challenged by evidence that retirement rates have surged through the pandemic, fuelled by booming stock valuations in 401k plans.

Rising worker compensation is set to be a key story for 2H21, to both recruit and retain staff and coupled with surging housing costs, this means inflation looks set to linger in a 3.5-4.5% range well into next year. We suspect the Fed will start tapering its QE asset purchases before the end of this year, with the potential for two 25bp interest rate rises next year.

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