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CIO Office Viewpoint

Can the US consumer fight the Fed?

Investment Solutions

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Can the American consumer derail US monetary policy? So far, 2023 has defied expectations that higher borrowing costs would undermine Americans' willingness to spend. At the annual Jackson Hole meeting of central bankers, Federal Reserve Chair Jerome Powell stressed that strong demand may reignite inflation pressures, requiring even higher interest rates. The US economic outlook now seems to hinge on the impact of already-restrictive monetary policy on consumer demand.

US growth since the second quarter appears unique in a slowing global environment. That put Mr Powell in a difficult position as he delivered his keynote speech in Jackson Hole, Wyoming on 25 August. For now, resilient US growth is not prompting a Fed policy rethink as restrictive monetary and financial conditions continue to work their way through the economy. Still, should the Fed feel confident that rebounding consumer spending will not undermine the impact of higher interest rates?

Personal savings, which reached a high through the pandemic, coupled with falling unemployment through 2023 and rising incomes in real terms, have all boosted US consumption since April this year. Real wages are still rising, helped by declining inflation and new wage settlements.

If consumer spending remains strong, we may see demand-led, secondary effects on inflation. That would challenge the Fed's 'peak and plateau' monetary policy strategy as it may demand yet higher interest rates. After taking interest rates to 5.5%, their most restrictive in more than two decades, the Fed plans to keep borrowing costs high to slow economic growth and wage increases. The Atlanta Fed estimates that US gross domestic product (GDP) is still accelerating and may reach an annualised 5.8%, compared with 5% in mid-August. Third-quarter personal consumption expenditure and private domestic investment growth are also set to rise, it says.

Supply-side disinflationary forces are behind us

The most important factors pushing supply-side disinflation are now behind us. Easing supply chain pressures and falling commodity and energy costs have reduced core inflation from a high of 6.6% in September 2022 to 4.7% in July 2023.

"Two months of good data are only the beginning of what it will take," said Jerome Powell, Federal Reserve Chair, speaking at the annual meeting of central bankers at Jackson Hole, Wyoming on 25 August. "The economy may not be cooling as expected," he added, reiterating his July message that more rate rises may be necessary to generate a period of 'below-trend' growth and fewer job openings in order to stabilise prices.

Key takeaways

- Resilient US demand is putting disinflation progress at risk, raising the need for either additional interest rates hikes, or a sustained period of high rates
- Interest rate sensitive sectors including credit, manufacturing, and trade remain weak as restrictive monetary conditions take effect
- The US Federal Reserve remains committed to its 'peak and plateau' interest rate policy, with an unchanged 2% inflation target, Chairman Powell said in a speech at Jackson Hole
- The outlook for US growth depends on whether disinflation continues, creating the conditions for a soft landing, or robust domestic spending drives higher rates and a more severe recession.

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With core inflation measures slowing in June and July, and benchmark interest rates now higher than inflation, the Fed can justify keeping rates unchanged in September 2023. Clearly, the Fed's job is not yet done, and it plans to keep rates high until inflation reaches the average policy target of 2%.

Even if the Fed's 25 basis point hike in July turns out to be the last of this monetary policy cycle, that does not mean we are close to the central bank's first rate cut. If the Fed leaves rates on hold in September and November, we do not expect a first cut any earlier than March 2024 - at the earliest.

Looking beyond some consumption indicators, other economic data continues to suggest that the economy will weaken as inflation declines more slowly, without a setting off a deep recession. Several factors continue to suggest that we cannot yet rule out a deceleration, including a global slowing from China to Europe that inevitably weakens US trade.

Higher borrowing costs have already slowed interest-rate sensitive parts of the US economy, in other words, everything that is unrelated to consumption. Business activity indicators anticipate further deceleration after US manufacturing contracted every month since March 2023, with loan and credit card delinquencies rising (see chart 1). Second, the yield curve remains inverted, a classic precursor to a downturn. That is visible in commercial lending standards, which are still tight enough that historically, they indicate a recession. Finally, housing market activity has slowed as mortgage rates have hit two-decade highs, even though a physical shortage of homes continues to support house prices, according to Freddie Mac, a government-sponsored mortgage business.

'Excess' savings running dry

Nevertheless, some pressures support the prospect of slower consumer spending. The Federal Reserve of San Francisco calculates that less than 10% of consumers' excess savings built up through the Covid pandemic remained by June 2023 (see chart 2). Adding to the forces that may drive down spending, student loan repayments will resume in October. There are 46 million holders of outstanding US student debt, totalling USD 1.77 trillion, of which around USD 217 billion falls due annually. While much of this student debt is held by higher income earners able to make repayments, we estimate that it may reduce spending growth by the end of 2023, shaving as much as 0.2% from real GDP growth in the last three months of the year.

Our central scenario is for US inflation to settle under 3%, with annualised economic growth of around 1% allowing the Fed to keep its benchmark rates at 5.5%, before beginning a series of cuts starting no earlier than March 2024. This would clearly qualify as a 'soft landing.'

Slightly less likely, we believe, is a 'hard landing' where the US economy sees inflation settle at levels far above the 2% target, prompting the Fed to stifle growth with additional rate hikes.

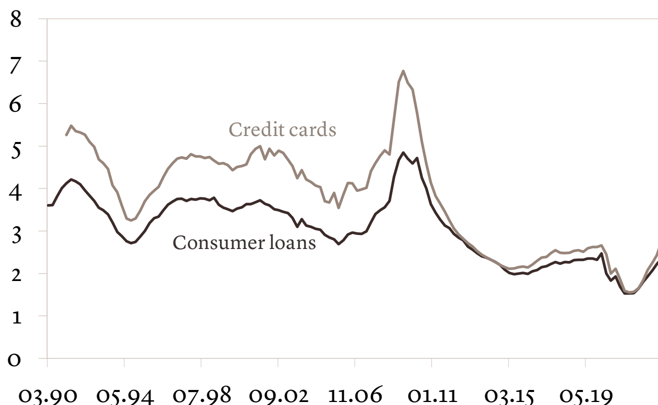
Finally, we cannot completely exclude the intermediate possibility that the Fed keeps its policy rate stable as inflation settles at levels slightly higher than target. In a presidential election year, the Fed may indeed prefer to leave economic growth running above its long-term trend in order to avoid triggering a deeper contraction, despite the risk that consumers re-set their expectations to higher-for-longer inflation.

Whichever of these three scenarios plays out, 2023 may be remembered as the year in which the only force capable of dismissing the old investment adage 'don't fight the Fed,' turns out to be the US consumer.

Samy Chaar
Chief Economist

1. Consumer loans delinquencies

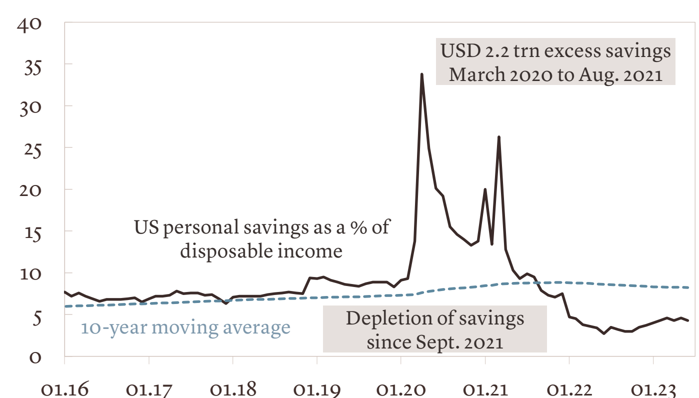
Delinquency rates highest since 2012



Source: Bloomberg, Lombard Odier calculations

2. US households personal savings rate

As a % of disposable income



Source: Bloomberg, Lombard Odier calculations

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