UNITED STATES: "IT AIN'T OVER TILL IT'S OVER"

In the United States, it seems that the expansion phase of the business cycle, the period of elevated inflation, the monetary tightening cycle and the 'risk-on' mindset in markets are all far from over. Ongoing relatively strong growth increases the risk that inflation would stop declining. Market commentators have started referring to such an outcome as the 'no landing' scenario. However, judging by the latest data, a 'delayed landing' seems the more likely one. Markets now expect a higher terminal rate whereby the policy easing would come later as well. The higher the terminal rate, the bigger the likelihood that the landing would be bumpy after all.

Back in 1973, the American baseball legend Yogi Berra, whose team was behind in the National League competition, noted that *"it ain't over till it's over"*[1]. He meant to say that the race for the title was far from over and that everything was still possible.

The phrase fits the purpose when describing the US economic and market environment: it seems that the expansion phase of the business cycle, the period of elevated inflation, the monetary tightening cycle and the 'risk-on' mindset in markets are all far from over.

Starting with the first, some recent data for the month of January have been particularly strong -job creations were impressive, retail sales increased a surprisingly strong 3% after declining in November and December-, and, more generally, the Federal Reserve Bank of Atlanta nowcast[2] shows an annualized increase of real GDP of 2.5% in the current quarter versus the previous one.

Ongoing relatively strong growth increases the risk that inflation would stop declining or decline much less rapidly than expected. The labour market would remain tight and underpin strong wage growth and companies facing sustained demand would be able to maintain their profit margins. Market commentators have started referring to such an outcome as the 'no landing' scenario, which is very different from the traditional alternatives of a soft or a hard landing because the central bank would be forced to keep on hiking rates[3].

From this perspective, the latest consumer price inflation data have somewhat disappointed. The headline number -on a monthly seasonally adjusted basis- increased from an upwardly revised +0.1% in December to +0.5% in January and core inflation was stable at +0.4%.

Although both numbers were in line with the Bloomberg consensus, the stability of core inflation raises concern about the pace of disinflation. To explore this further, chart 1 shows quarterly averages[4] of monthly changes in consumer prices for a large number of expenditure categories.

To shed light on the distribution, for each period the results are ranked in ascending order. After the spectacular improvement in the third quarter of 2022 -the entire distribution shifted down, the right tail flattened and many categories recorded very negative inflation numbers-, the data since the start of the fourth quarter of 2022 show a stabilization: its distribution overlaps with that of the previous quarter albeit with less extreme negative readings.

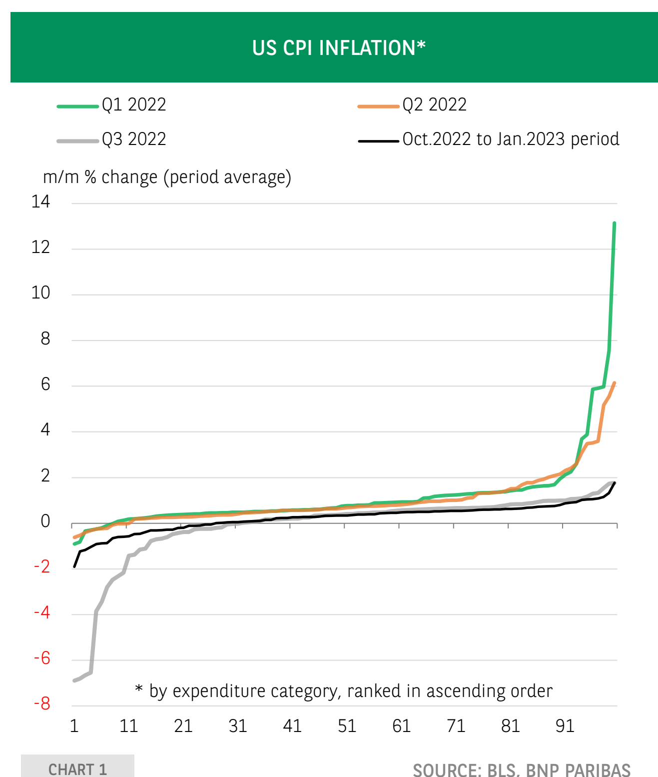

CHART 1 SOURCE: BLS, BNP PARIBAS

Moreover, in this chart, the median inflation is still at 0.34% on a monthly basis, which admittedly is significantly better than in the first and second quarter of last year -respectively 0.75% and 0.65%- but hardly lower than in the third quarter (0.38%). 63% (60%) of the consumer price index components have a monthly inflation rate that corresponds with an annual inflation higher than 2.0% (3.0%).

1 Source: How people started saying 'It ain't over till it's over', BBC website, 23 September 2015.
2 The nowcast is a real-time model-based estimate of real GDP growth based on the historical relationship between data releases and GDP.
3 In case of a soft landing, the Federal Reserve succeeds in bringing inflation back to target without triggering a recession. In case of a hard landing, reaching the inflation target comes with the cost of a recession.
4 The January 2023 data have been added to those of Q4 of last year.

EDITORIAL

Against this background of slowing and slow disinflation, the Federal Reserve will have to continue its tightening policy. In reaction to the latest data, markets now expect a higher terminal rate whereby the policy easing would come later as well (*chart 2*). This has weighed on equity markets, but only slightly so. The S&P 500 index is up more than 6% year-to-date and, despite the recent increase in Treasury yields, is only 2.5% below its high for this year. It reflects a tendency of investors to look beyond the peak in interest rates whilst adopting a sanguine view about the impact of rising labour costs and monetary tightening on company profits.

Going back to Yogi Berra's aphorism, much like in sports, where eventually there is a winner, there is an endgame when the central bank is raising rates. The Federal Reserve will stop doing so when it is convinced that, without further action, inflation will converge sufficiently quickly to target. What this means for the growth cycle and the market cycle will depend on the economic environment which by then we will have reached. Judging by the latest data, rather than a 'no landing' scenario, a 'delayed landing' seems the more likely one. The higher the terminal rate, the bigger the likelihood of it being bumpy after all.

EXPECTED FED FUNDS RATES

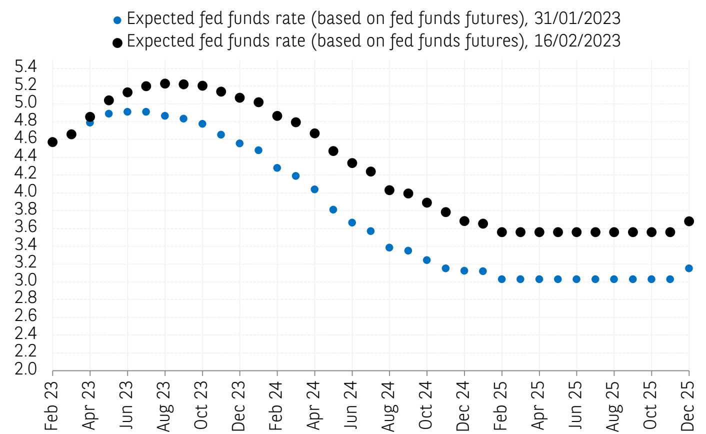

CHART 2

SOURCE: REFINITV, BNP PARIBAS

William De Vijlder

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