Short Insight

Group Economics
Financial Markets Research

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What could trigger a Fed pause?

- **Chair Powell's hawkish press conference on Wednesday supports our base case for the Fed to raise rates four more times through to June 2019**
- **While the path of least resistance is for the Fed to keep hiking at a quarterly pace, in this note we explore some of the possible triggers for a pause**
- **The most likely driver of a pause would be a decline in business confidence on the back of trade tensions. There is scant evidence of this as yet**
- **Other potential triggers include renewed and successive undershoots of inflation (à la 2017), an accelerated flattening in the yield curve, or an escalation of EM stress to a broader crisis**

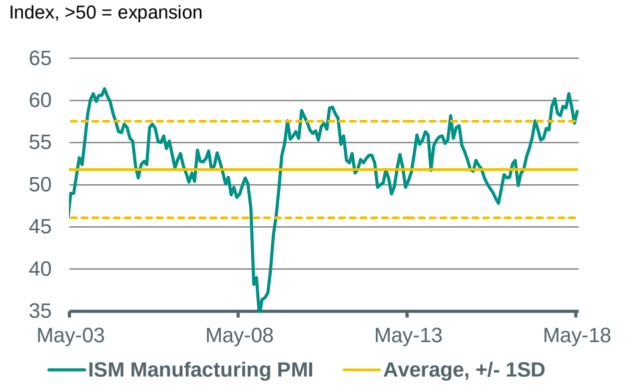
1. Trade tensions yet to impact business confidence (but could)

While our base case is for the Fed to continue hiking at a quarterly pace (see here), a number of factors could trigger a pause in the hiking cycle. Arguably the biggest risk comes from trade, with tensions coming back into focus following President Trump's imposition of steel & aluminium tariffs against the EU, Canada, and Mexico, and the announcement of retaliation measures. So far, the main perceptible impact on business confidence has been in input pricing, with anecdotal reports from the ISM manufacturing survey citing 'panic buying' of steel & aluminium ahead of the implementation of tariffs. Meanwhile, the new orders and production indices remain exceptionally strong. We think it would take a significant fall in the ISM, perhaps to near the longterm average around the low 50s, for the FOMC to pause on the back of this alone.

2. A renewed undershoot in inflation could also drive a pause

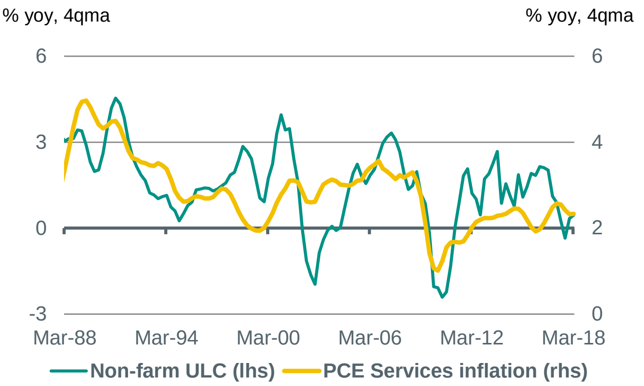
The big headache of 2017 for the Fed was the puzzling weakness in core inflation, and while not our base case, such a scenario could yet materialise in 2018. For the Fed to pause, we think we would need to see core inflation move back below 1.8% yoy, which would require several months of sub-0.1% mom inflation. One possible driver could be wage growth failing to accelerate due to hidden labour market slack, or productivity growth recovering even more than we expect, leading to reduced cost-push inflationary pressure (see *US Watch – Inflation: Not too hot, not too cold* for more on our inflation outlook).

Manufacturing outlook remains exceptionally strong



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Weak unit labour cost growth is weighing on inflation

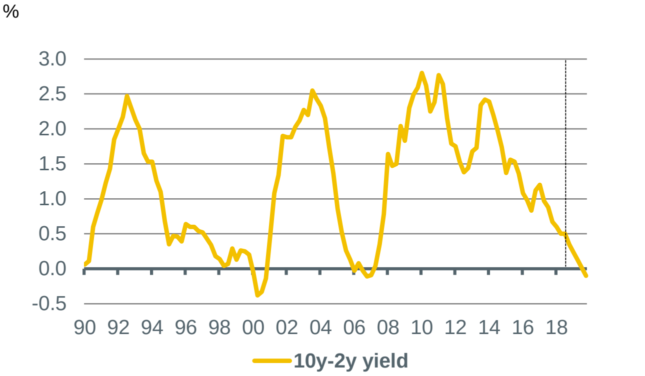


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

3. The yield curve could flatten more quickly than anticipated

The 2s10s yield curve has been on a clear flattening trend since 2014, and we expect that trend to continue – with an outright inversion by end-2019. A number of Fed officials have expressed concern over the flattening yield curve, and in particular what it might say about the market's view of the neutral fed funds rate – i.e. that it may be lower than the Fed thinks, with potentially recessionary consequences from a too-high policy rate (see here). We expect the yield curve to fall to 35bp by end-2018, down from 45bp at present. Should the yield curve flatten more quickly – for instance falling below 10bp before end-2018 – this would raise alarm bells at the Fed, and likely stay the hand of more dovish FOMC members.

We expect the yield curve to invert by end-2019



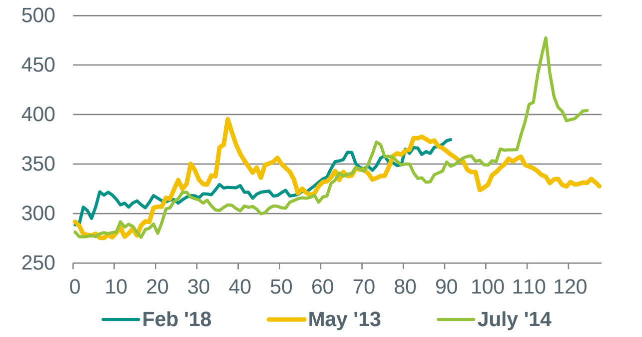
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

4. Emerging market stress could escalate more significantly

In an unusually candid op-ed in the FT last week, Reserve Bank of India Governor Patel called on the Fed to slow its balance sheet reduction temporarily to offset the decline in dollar liquidity coming from higher Treasury issuance. As the chart to the right shows, EM spreads have indeed widened in recent months, though not yet in quite the disorderly manner that they did in the 'taper tantrum' periods of 2013-14. As we discussed in a recent *Global Daily*, we think the Fed is unlikely to slow the pace of monetary tightening – either via the balance sheet or interest rates – unless the stress in emerging markets escalates to a crisis that negatively impacts US growth. At present, the Fed looks unfazed by the stress in emerging markets, but if it were to escalate to a crisis, there is a precedent for the Fed taking global growth into account in its monetary policy considerations (for instance during the China-induced market turbulence of 2015, and ahead of the Brexit referendum in 2016).

EM spreads have widened, but not to crisis levels

JP Morgan EMBI Global Spread, bp (horizontal axis shows number of days)



Source: Bloomberg, ABN AMRO Group Economics