Flash Economics

N° 8
July 26th, 2024

ossiam

The risk of a resurgence of inflation in the United States, and the consequences for the yield curve

If we adjust US inflation excluding owners' equivalent rent of residences, we see that inflation is low in the United States, averaging 3% since January 2024 and 2.1% in June 2024.

Long-term interest rates in the United States are now more or less at their equilibrium level, as can be seen when we compare them with the sum of expected long-term inflation (measured by 10-year inflation swaps) and potential growth.

If inflation excluding owners' equivalent rent of residences remains low, which is likely given the weakness of unit labour cost growth, the US yield curve will steepen as a result of a cut in the Federal Reserve's funds rate.

However, if D. Trump is elected President of the United States in November, and if he implements the economic policies he has announced (cancellation of the Inflation Reduction Act, tariffs on all imported products, a halt to immigration), these economic policy choices will be inflationary (through their effect on the prices of imported products and on wages), and the Federal Reserve will have to keep interest rates high; in this scenario, the yield curve would remain inverted.

Patrick Artus
Senior Economic Advisor
patrick.artus-ext@ossiam.com
𝕏 @PatrickArtus

Marketing communication: this document is a marketing presentation. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research; and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

In the United States, inflation is low and long-term interest rates are close to their equilibrium level

If we adjust total US inflation excluding owners' equivalent rent of residences (Chart 1a, 1b, Table 1), we find that adjusted inflation is low and down slightly by 2.1% year-on-year in June 2024.

Chart 1A
United Sates: Inflation and consumer price index owners' equivalent rent of residences

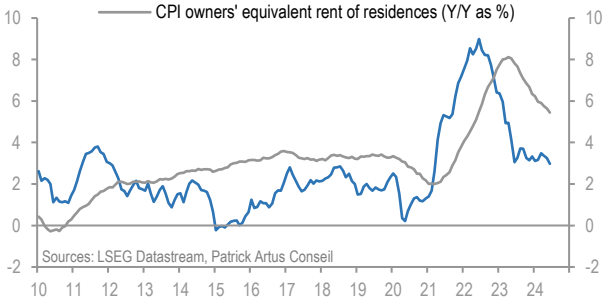


Chart 1B
United States: inflation excluding owners' equivalent rent of residences (CPI, Y/Y as %)

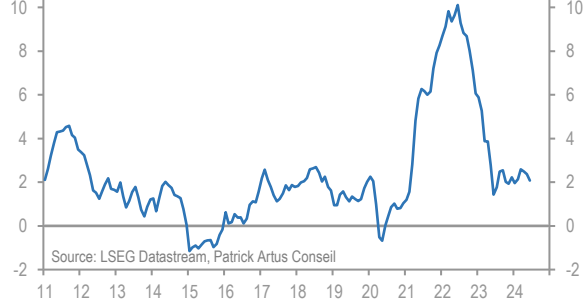


Table 1: United States: Inflation excluding owners' equivalent rent of residences

	CPI all items less owners' equivalent rent of residences (Y/Y as %)
January 2024	2,0
February 2024	2,1
March 2024	2,6
April 2024	2,5
May 2024	2,4
June 2024	2,1

Source: LSEG Datastream, Patrick Artus Conseil

Furthermore, when we add expected long-term inflation measured by 10-year inflation swaps (Chart 2) and potential growth in volume, (Chart 3), we reach a level of 4.5%, which is close to the 10-year interest rate being observed today. (Chart 4).

Chart 2
United States: 10-year inflation swap (as %)



Chart 3
United States : Real GDP

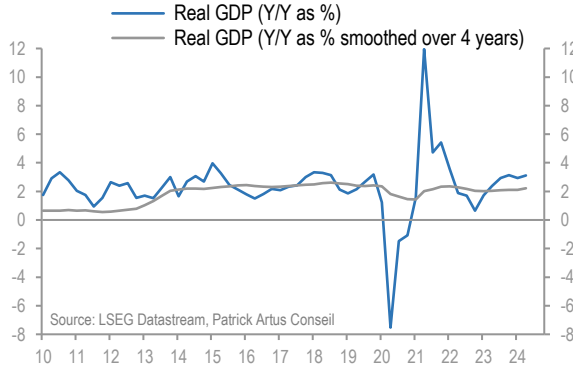


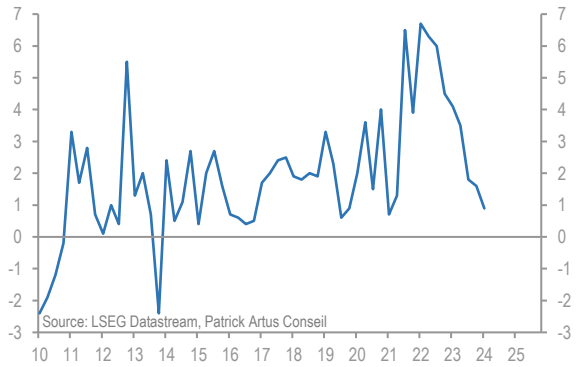
Chart 4
United States : Interest rate on 10-year government bonds (as %)



As a consequence, in the absence of an economic policy shock, the US yield curve will steepen

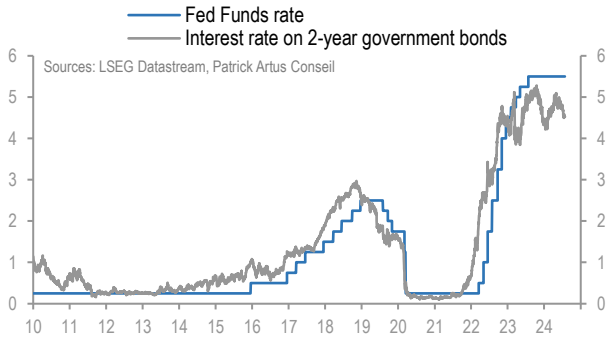
If there is no change in US economic policy in the future, **total inflation will decline** (owners' equivalent rent of residences will slow, **Chart 1a**, **and unit labour costs will rise by less than 2%** as a result of productivity gains, **Chart 5)**.

Chart 5
United States : Unit labour costs (Y/Y as %)



As a consequence, the Federal Reserve will be able to cut interest rates (Chart 6), and the yield curve will steepen as short-term interest rates decline.

Chart 6
United States: Interest rate on 2-year government bonds and Fed Funds rate (as %)



But if D. Trump is elected President of the United States, there will probably be a major change in economic policy

D.Trump has announced:

- **That he would cancel the Inflation Reduction Act,**
- **That he would halt immigration** which reached 3 million in 2023,
- That he would implement **tariffs on US imports from all countries**, at rates (additional to existing tariffs) of 10% on US imports from countries other than China, and 60% on US imports from China.

The effect of this economic policy would be:

- **A decline in growth** (stopping investment in the energy transition, stopping immigration, raising the price of imports),
- **To drive up inflation** (**Chart 1a, 1b**), with the rise in import prices and the increased pressure on the labour market resulting from the halt to immigration (**Chart 7**).

Chart 7
United States: Weekly earnings and ratio between number of job vacancies and number of job seekers



Summary: No steepening of the US yield curve if D. Trump is elected and implements his programme.

If there is no major change in US economic policy, disinflation will enable the Federal Reserve to cut interest rates and **the yield curve will steepen** as short-term interest rates fall.

However, if D. Trump is elected and implements the programme he has announced (cancellation of the Inflation Reduction Act, halt to immigration, increase in tariffs), growth will be reduced and inflation will be stimulated, and the Federal Reserve will not be able to lower its interest rates, which **will keep the interest rate curve inverted.**

Disclaimer

Ossiam, a subsidiary of Natixis Investment Managers, is a French asset manager authorized by the Autorité des Marchés Financiers (Agreement No. GP-10000016). Although information contained herein is from sources believed to be reliable, Ossiam makes no representation or warranty regarding the accuracy of any information of which it is not the source. The information presented in this document is based on market data at a given moment and may change from time to time. This material has been prepared solely for informational purposes only and it is not intended to be and should not be considered as an offer, or a solicitation of an offer, or an invitation or a personal recommendation to buy or sell participating shares in any Ossiam Fund, or any security or financial instrument, or to participate in any investment strategy, directly or indirectly. It is intended for use only by those recipients to whom it is made directly available by Ossiam. Ossiam will not treat recipients of this material as its clients by virtue of their receiving this material. All performance information set forth herein is based on historical data and, in some cases, hypothetical data, and may reflect certain assumptions with respect to fees, expenses, taxes, capital charges, allocations and other factors that affect the computation of the returns. Past performance does not predict future returns. Any opinions expressed herein are statements of our judgment on this date and are subject to change without notice. Ossiam assume no fiduciary responsibility or liability for any consequences, financial or otherwise, arising from, an investment in any security or financial instrument described herein or in any other security, or from the implementation of any investment strategy. This information contained herein is not intended for distribution to, or use by, any person or entity in any country or jurisdiction where to do so would be contrary to law or regulation or which would subject Ossiam to any registration requirements in these jurisdictions. This material may not be distributed, published, or reproduced, in whole or in part.