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FINANCIAL MARKET UPDATE

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Inflation concerns rising, while downside risks to growth persist

It's a tough time to be a central banker because the upside risks to the inflation outlook and signs of a pick-up in inflation expectations are presenting a strong case for policy to become less accommodative at a time when such a move would risk choking off economic growth. The Fed has become more vocal about worrying signs of a pick-up in inflation, pointing to the persistent rise in energy prices.

However, worries about the economy also persist, with the U.S. housing recession in full swing, consumer confidence deteriorating and the unemployment rate at its highest level in 3-1/2 years. The U.S. housing market slump and financial market turbulence are keeping the U.S. economy vulnerable to slipping into recession.

Our view is that the strong headwinds facing the economy will be enough to keep the Fed on the sidelines this year, especially if energy prices start to decline as we expect and take some of the heat off headline inflation rates. Short-term interest rates are likely to remain range-bound as the cross-currents in the economic data keep the policy outlook uncertain. Longer-term yields, however, are likely to continue to drift higher as headline inflation rates stay elevated.

Fed talks tough but likely to keep policy steady

▲ The Fed has become more vocal regarding their concerns about the inflation outlook and has stated that while downside risks to the economy still exist, they are starting to diminish somewhat.

▲ Elevated energy and food prices propped up prices for U.S. consumers, with the headline inflation rate rising to 4.2% in May. Even the underlying core inflation rate, at 2.4%, was above the range that is considered within the Fed's comfort zone. More worrying for policymakers is the recent pick-up in inflation expectations.

▲ However, the downside risks to growth are expected to keep the Fed holding interest rates unchanged through the remainder of this year even in face of mounting inflation worries in the hope that weak economic growth will help counter the inflation pressures emanating from higher commodity prices.

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