US ECONOMIC UPDATE SEPTEMBER 2020
RECOVERY CONTINUES, BUT RISKS REMAIN

NAB Group Economics

The recovery from the collapse in activity over March and April continues. However, it has slowed. The inability of Congress to agree on further fiscal support and the recent uptick in COVID-19 case numbers are a source of concern. Changes to Fed forward guidance reinforces the view that the feds fund rate will be on hold for a long time.

The recovery from the massive falls in economic activity seen over March and April is continuing. While a large bounce in GDP is expected in Q3, the pace of the recovery has slowed.

Most monthly indicators of activity are well above their June quarter average. Some indicators are even above their pre-COVID-19 level, including retail sales and home sales, while core capital goods orders are not far off. While housing starts dipped a little in August, these data are volatile at the best of times; the National Association of Home Builders Home Activity index moved to its highest ever level in September, indicating underlying improvement in the housing sector.

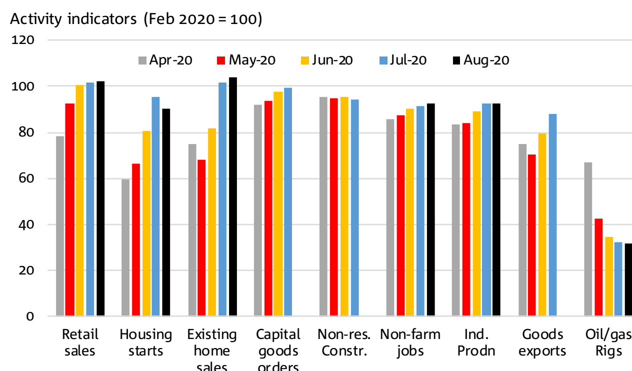
That said, the speed of improvement across a range of indicators, such as retail sales, industrial production and employment, has slowed. At the same time, non-residential construction and mining sector investment indicators have continued to fall, although the latter looks like it might have reached its trough, supported by a stabilisation in oil prices.

Several factors are behind this moderation in growth. As restrictions were eased from late April (in some states) a large initial bounce in activity was always likely, due in part to temporary pent-up demand. Household incomes also increased substantially due to massive Federal Government fiscal support, but with no new fiscal stimulus since April this support has been declining as some programmes have either expired or as funds have been run down.

Moreover, there was a rise in COVID-19 cases over June & July. This led many states to pause their 'reopening' or reintroduce some restrictions. It also likely induced more caution by individuals and businesses.

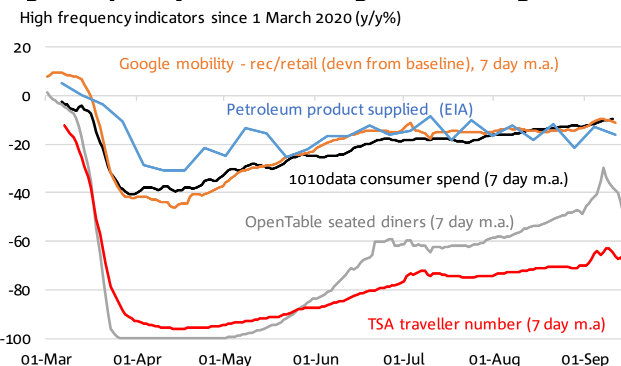
Many high frequency indicators pointed to a pause in the recovery at around this time. However, some of

Recovery continuing but at a slower pace



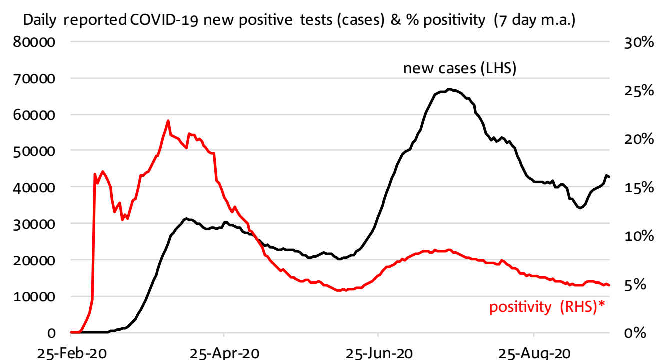
Source: Refinitiv. Capital goods orders are ex transport & defence ('core')

High frequency data showing some life again



Sources: Google, US EIA, TSA, 1010data, OpenTable

Recent case pick up a concern, but so far due to more tests



Source: Covidtracking.com * % of tests with positive COVID-19 results

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these indicators have moved higher in recent weeks, indicating that the recovery remains on track.

This improvement follows a decline in the number new COVID-19 cases. That said, since around mid-September the number of COVID-19 cases has started rising again. It is too early to say another upswing has begun. The number of cases dipped around the time of the labour day holiday (7 September) likely due to reporting delays, and the unwinding of this exaggerates the apparent upwards trend. Moreover, unlike the resurgence in cases over June/July, the increase in cases can be accounted for by an increase in testing, with the percentage of tests producing positive results little changed.

Nevertheless, the spread of COVID-19, and Government and community reaction to any changes, remains a key risk to the outlook.

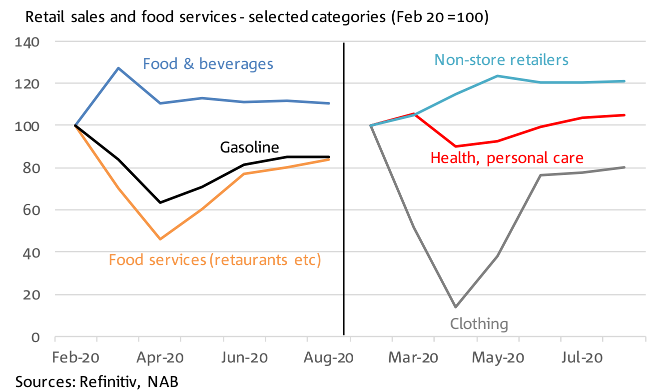
As noted above retail sales are now a little above their pre-COVID-19 level. However, this is not a uniform outcome across the component spending categories. Spending on some categories increased because of COVID-19 and, while easing a little since, remains well above their pre-COVID-19 level. This includes spending on food & beverages (maybe due to hoarding initially but also people spending more time at home) and on-line retailers (the major part of 'non-store retailers').

Other categories such as clothing & footwear and food services (cafes, restaurants etc) experienced massive falls, and by August were still well below their February level (by around 20%). Importantly, as these are the categories where further gains are most likely to come in, they continued to recover over July/August. Growth in food services was 4.7% m/m in August alone even with bars/indoor dining being popular targets for renewed restrictions by authorities. In contrast, after an initial bounce, gasoline sales have tracked sideways.

The varying performance of the different retail sales categories also points to possible longer-lasting structural changes. It is possible that the proportion of work done from home has permanently shifted higher, which will reduce travel (gasoline) and lead to more home consumption (less use of food services). Possibly significant structural shifts may also play out in other (non-retail) areas as well, such as the demand for commercial property space. Adjustment to such shifts in an economy take time.

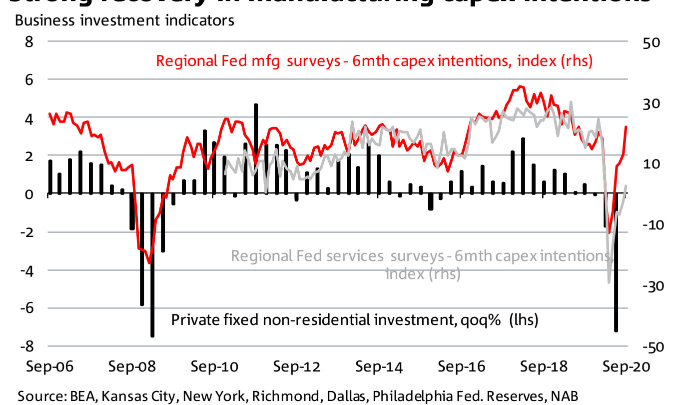
This is one reason why we expect a full recovery to be protracted. Other factors include the slow pace at which state restrictions on activity are being eased, ongoing consumer and business caution, a tightening in lending conditions, likely cutbacks in state/local government spending, and a large number of permanent business closures. The rise in the number unemployed who are not on temporary lay-off, even as the overall unemployment rate moves down, is illustrative of the longer-term damage that has occurred.

Huge variation across retail sales categories



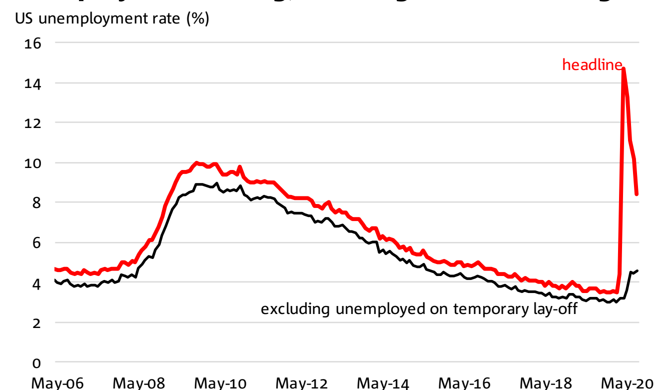
Sources: Refinitiv, NAB

Strong recovery in manufacturing capex intentions



Source: BEA, Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Unemployment falling, but longer-term scarring



That said, data on new business openings have been positive, and business surveys indicate that manufacturing sector capital expenditure intentions have bounced back strongly. While service sector investment intentions have not fully recovered, their operations tend to be less capital intensive.

Overall, we expect GDP to decline by 4.1% in 2020 and then grow by 3.4% in 2021. This is unchanged from our previous forecasts, although we have marginally revised up growth expectations for Q3 2020, but revised Q4 down by a similar amount.

Fiscal developments and the path of the virus will remain major factors influencing how strongly the economy recovers. While there continues to be intermittent talk of a further fiscal package there are

few, if any, concrete signs one will soon emerge. We have long considered premature withdrawal of fiscal support a risk to the recovery.

That said, the end July finish to the Pandemic Unemployment Compensation programme has not notably affected available indicators. It may be that the large run up in household savings earlier in the year (due to fiscal support) is providing a buffer, thus giving policy makers more time to reach agreement. Of course, there is no certainty this will happen.

Hanging over all of this are November's Presidential and Congressional elections, adding another layer of uncertainty for households and businesses to deal with.

Monetary Policy

At its September FOMC meeting the Fed adjusted its forward guidance for monetary policy. This follows the move to flexible average inflation targeting in August. The key parts of September FOMC meeting statement were:

> *"…the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time… The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved.*
>
> *"…it will be appropriate to maintain [the current fed funds rate] target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time.*

In other words, there will not be an increase in the Fed funds rate until inflation has reached 2% (and looks like being above that level for a while) and the labour market is very strong. This contrasts with the first increase in the fed funds rate post-GFC in December 2015. At that time, personal consumption expenditure price index (PCE) inflation was 0.4% y/y or (1.2% on a core, ex food and energy, basis) but there was an expectation that inflation would move back to target.

Even when the Fed does start to raise rates, it is promising to keep rates below their neutral level (so that they are supportive of above trend growth) until inflation has been above 2% for 'some time'.

In effect it's a promise to keep rates at low levels for a long-time, even as the economy recovers and monetary policy rules used in the past (such as the Taylor rule) would normally point to policy rate increases.

The Fed's preferred measure of inflation is core PCE inflation. It has been below 2% for most of the last 8 years (although it was at 2% or a bit higher for part of 2018). Hence there is a need for above 2% inflation to meet an average 2% target. Following the collapse in activity over March/April, core PCE inflation fell significantly although it clawed back some of its losses in July (and a further increase in August is likely based on the CPI report for the month).

There has been some debate whether the combination of supply disruptions, loose monetary policy and fiscal expansion would generate higher inflation or whether the likely persistent weakness in the economy would be deflationary. We lean towards the latter view and do not have core PCE inflation moving to 2% on a sustained basis over our forecast horizon (which is to end 2022). (It is possible that it might briefly move above 2% mid -next year as the price falls in April/May come out, but the subsequent rebound is still part of, the annual calculation.)

As a result, the change in forward guidance does not change our view that the fed funds rate target range will remain unchanged at 0 to 0.25% at least through to end 2022. The majority of Fed members are not projecting any increase in rates by end-2023. Bottom line is that rates are likely on hold for a long time, barring a much quicker recovery in the economy and inflation.

The Fed, at its September meeting, also expanded the rationale for its ongoing purchases of Treasury securities and agency mortgage-backed securities. Now, in addition to supporting market functioning, they are also intended to 'help foster accommodative financial conditions'. This is more akin to the thinking behind the post-GFC QE programmes (although they were more targeted at longer dated securities).

While the Fed did not change the pace of purchases, with market stresses notably diminished from what was experienced early in the downturn, this signals that the asset purchases will continue.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %											
						2020				2021				2022			
	2018	2019	2020	2021	2022	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components																	
Household consumption	2.7	2.4	-4.4	3.7	2.5	-1.8	-9.9	8.5	0.5	0.9	0.7	0.7	0.6	0.6	0.6	0.6	0.6
Private fixed investment	5.2	1.9	-5.0	3.2	4.8	-0.3	-8.2	2.0	0.5	1.6	1.7	1.5	1.3	1.1	1.0	0.9	0.9
Government spending	1.8	2.3	1.4	0.8	1.9	0.3	0.7	-1.0	0.2	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Inventories*	0.2	0.0	-0.8	0.8	0.0	-0.4	-1.1	1.4	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.3	-0.2	0.5	-0.4	-0.1	0.4	0.1	-0.5	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**3.0**	**2.2**	**-4.1**	**3.4**	**2.7**	**-1.3**	**-9.1**	**6.6**	**0.7**	**0.9**	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**	**0.6**
Note: GDP (annualised rate)						*-5.0*	*-31.7*	*28.9*	*2.9*	*3.7*	*3.3*	*3.0*	*2.8*	*2.7*	*2.5*	*2.4*	*2.4*
US Other Key Indicators (end of period)																	
PCE deflator-headline																	
Headline	2.0	1.5	1.1	1.9	1.9	0.3	-0.4	1.0	0.3	0.4	0.5	0.5	0.5	0.4	0.5	0.5	0.5
Core	2.0	1.6	1.4	1.6	1.8	0.4	-0.2	0.8	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.4
Unemployment rate - qtly average (%)	3.8	3.5	7.8	6.5	6.1	3.8	13.0	8.9	7.8	7.4	6.7	6.6	6.5	6.4	6.4	6.3	6.1
US Key Interest Rates (end of period)																	
Fed funds rate (top of target range)	2.50	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

Source: NAB Group Economics

*Contribution to real GDP growth

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