US ECONOMIC UPDATE MARCH 2021

2021 SHOULD BE A YEAR OF STRONG GROWTH

NAB Group Economics

Very strong growth expected in 2021 (6.0%) due to fiscal stimulus and an easing in COVID-19 restrictions. However, COVID-19 risks will remain until vaccinations are far more widespread. Core consumer inflation has been subdued but many indicators point to it rising; we see core PCE inflation settling at around 2% or a little higher. We expect no change in the fed funds rate target range through to end 2023 although by the end of this year the Fed may announce its intention to taper QE, with tapering then commencing in Q1 2022.

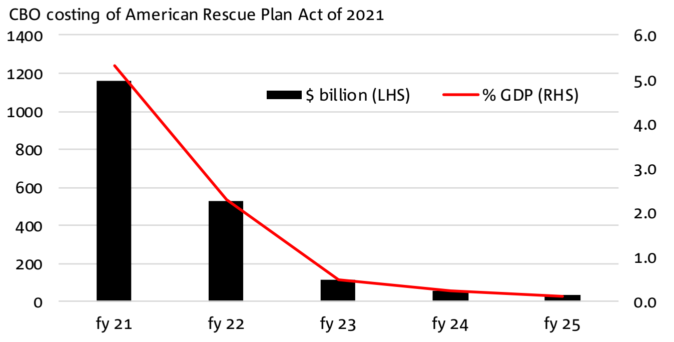
GDP forecast lifted on stimulus

The American Rescue Plan (ARP) was signed into law by the President this month. At a cost of $1.9 trillion over fy 2021 to fy 2025, the stimulus package was almost double what we had pencilled into our forecasts at the start of the year.

Accordingly, in this month's Global Forward View, we raised our forecast for US GDP growth in 2021 to 6.0% from 5.0%. There is already talk of another large fiscal package of up to $3 trillion – centred around infrastructure – but it may be accompanied by tax increases making its net impact unclear.

The bulk of the ARP money will be paid out in fy 2021 (i.e. over the next six months). The largest component (around $400b) are cheques to individuals ($1400, subject to income caps) and families and these are being distributed right now. Other major items include an extension of expiring unemployment benefit provisions (out to September) and payments to the states.

Massive fiscal stimulus

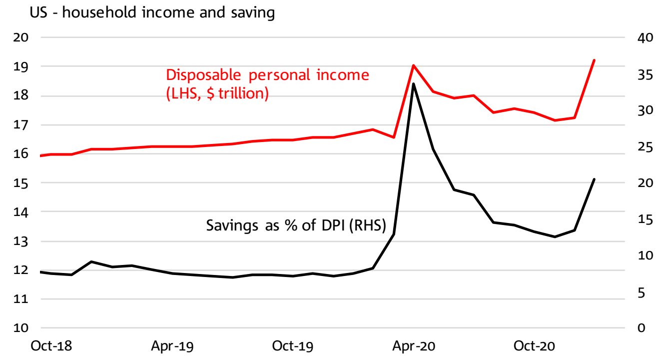


Source: Congressional Budget Office, NAB

With a large fall in the number of new COVID-19 cases since the early January peak, and the on-going rollout of vaccines, a range of states have eased, if not removed, mobility and business restrictions (such as capacity restrictions for restaurants). Even without any stimulus, this would have been expected to have a notable impact on the economy. The combination of a large stimulus and 're-opening' should drive rapid growth over the rest of 2021, although until a much larger number of people have been vaccinated the risk of further COVID-19 waves remains (indeed some states have started to see a rise in cases).

The ARP comes on top of the December stimulus package of $900 billion which also distributed cheques to individuals and re-instated/extended some unemployment benefit provisions. While this came prior to the recent relaxation in COVID-19 related restrictions, it had an immediate impact on household spending which jumped 2% m/m. As the extra payments to households in the month were only partly spent, there was also a substantial rise in the savings rate. There was a similar pattern last year following the initial COVID stimulus packages.

December 20 stimulus – income and savings boost



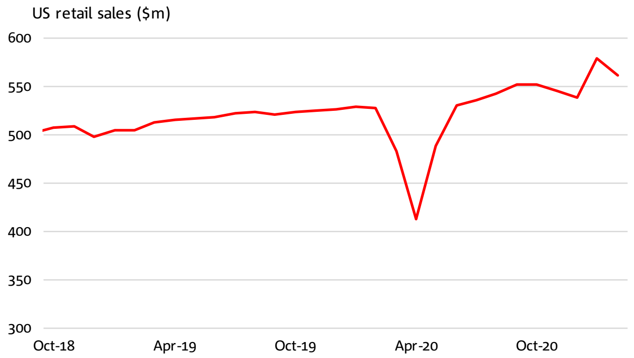
Source: Refinitiv (BEA), NAB

Date **March 2021** | Author Tony Kelly – Senior Economist

As a result, in aggregate, household income has been well supported and there has been an accumulation of savings which will help sustain activity into the future. The recovery in equity markets and growth in house prices also means household wealth has increased, although this would be unevenly distributed.

The increase in retail sales (predominantly goods consumption, which has been less affected by restrictions), was even greater in January at 8.7% m/m (nominal terms). There was, however, a partial correction in February with a fall of 3% m/m. Even so, Q1 is tracking 4.6% higher than Q4.

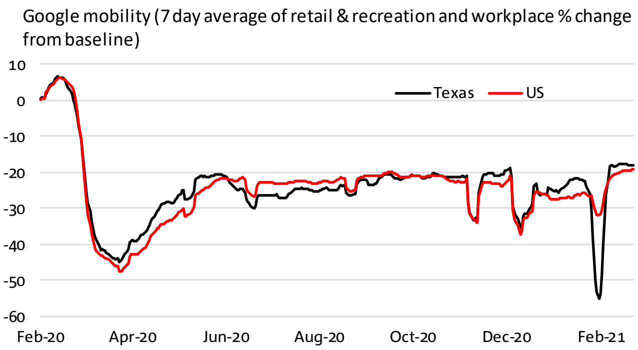
Despite Feb falls, retail sales have lifted



Source: Refinitiv (Census Bureau), NAB

The February decline likely reflected two factors. Firstly, some correction from the spending sparked by stimulus cheques and secondly the impact of winter storms in several states, particularly Texas. Mobility data indicates that Texas shut down to an even larger extent than the initial COVID-19 lockdowns of last year. However, the impact was short lived, and the economic impact will be transitory.

February data affected by winter storms

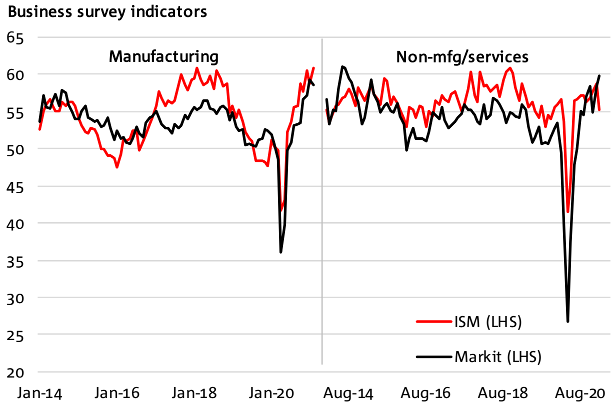


Source: Google, NAB

There has been weakness in other February data as well, industrial production fell 2.2% m/m, and housing starts declined by 10.3% m/m. Again, weather related disruptions were likely part of the story, but other factors are also likely in play. For example, auto sector production is currently being disrupted by shortages of some inputs, leading some plants to (temporarily) close, and rising mortgages rates (albeit still low) may be taking the gloss off the housing market.

While supply shortages may persist for a while yet, national business surveys in February generally remained at solid or better levels, pointing to ongoing growth in the economy. Moreover, available regional manufacturing surveys for March have lifted, including the Philadelphia Fed survey which surged to its highest level since the early 1970s.

Business surveys less affected by Feb weakness

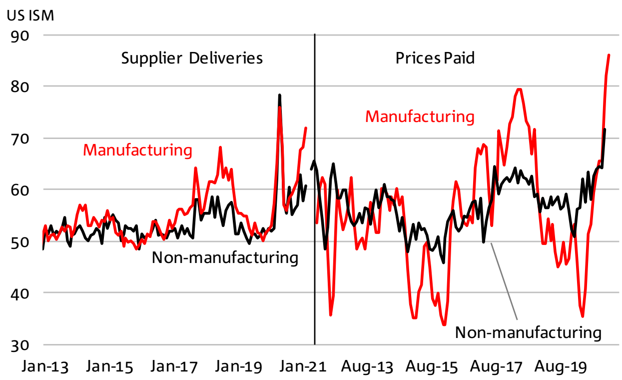


Inflation outlook

The combined value of the December 2020 and March 2021 (ARP) is around 13% of GDP. This contrasts with GDP being 'only' 2.4% down on its pre-COVID-19 level at the end of 2020. The size of the fiscal stimulus relative to the size of the output gap is one factor behind concerns over what will happen to inflation.

To some extent this comparison is over-stated. While the stimulus is heavily concentrated in fy 2021, a substantial part of it (40%) happens in later years. Even within fy 2021 a significant share of the Federal 'spending' are grants to the states, who will likely actually spend it on goods and services over a longer period of time (if not save it to build up rainy day funds, balance the budget etc), while the unemployment benefit provisions are an extension of programs already in place.

Surveys - supply disruptions & prices rising



There are other factors adding to inflation concerns. Commodity prices have been rising – notably oil – as have producer price indices (indicating upstream price pressure). The prices of imported consumer goods are also rising, partly due to the fall in the USD over the last year. As already noted, some sectors are experiencing supply shortages (not just autos but also, for example, shipping) which is evident in survey measures of supplier delivery times. Survey price measures have also risen strongly, in some cases to very high levels.

The clear message is that inflationary pressures are building, with the prospect that March stimulus will add further pressure.

It is also possible that in sectors of the economy where prices fell in response to COVID-19 – such as for air transportation (down 20% y/y in January), hotel/motel accommodation (-14% y/y) – prices will quickly return to something closer to their pre-COVID-19 level (so called 'normalisation') as restrictions ease.

However, selected prices in some sectors rose (above their previous trend) post-COVID 19 – such as autos and health care costs – and normalisation will not just work in one direction.

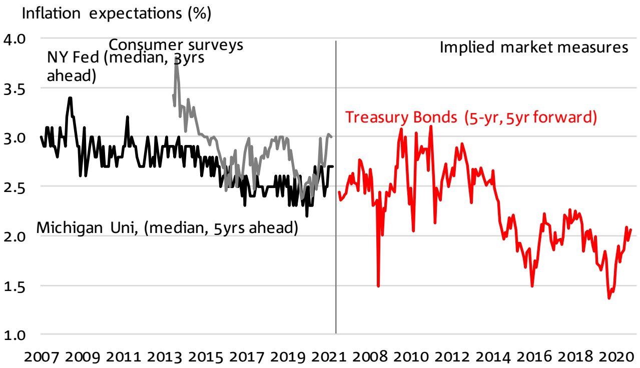
Moreover, even if, as seems likely, such effects (supply issues, price normalisation) added to short-term inflation, it is unclear why they would lead to a permanent increase in inflation.

A closure of the output gap may be expected to lead to more sustained inflationary pressure. The model we use to forecast core (ex-energy and food) US consumer inflation has three main components – an unemployment rate term (to pick up the output gap), import prices (ex oil) and an inflation expectations term.

Empirically the link between GDP growth (which impacts the unemployment term) and inflation is weak. In other words, inflation does not move significantly in response to moves in the economy in either direction.

In terms of inflation expectations, there has been some increase in measures derived from financial markets and household surveys. However, neither are at particularly high levels.

Inflation expectations are up but not high

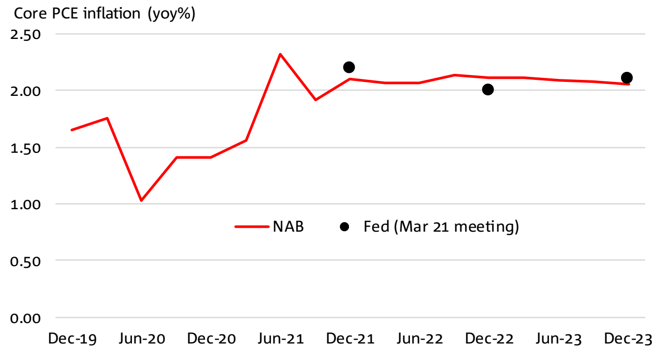


Sources: Bloomberg, Philadelphia & New York Fed. reserves, Thomson Reuters/Michigan Uni.

It is worth noting that any acceleration in inflation will come from a subdued starting point. In January, annual PCE inflation (the Fed's preferred measure) was 1.5% y/y on both a headline and core basis. Looking at the last three months (3mth/3mth basis) price growth has been even weaker.

As a result, while we are expecting very strong growth, our expectations for how much inflation will rise are far more modest.

Expect a modest rise in inflation



Sources: Refinitiv (BEA), Federal Reserve, NAB

Q2 inflation (on an annual basis) is likely to show a strong bounce, as the fall in prices in Q2 last year (due to COVID-19 lockdowns) falls out of the calculation while the (partial) rebound in Q3 2020 remains in it.

Beyond this, however, we expect core PCE inflation to settle at a level around 2% y/y or a little higher. Having said that, the uncertainty around this (and most other forecasts) is high given the unusual nature of this recession, the extraordinary fiscal response, the range of supply issues and widely disparate sectoral impacts.

Monetary policy implications

Based on our central forecast we see no change in the federal funds rate target range (0 to 0.25%) right though our projection period to end 2023.

The criteria set by the Fed before it will increase the funds rate are:

- The labour market needs to be at 'maximum employment'
- inflation needs to have risen to 2% percent and
- inflation needs to be on track to moderately exceed 2% for some time.

While they will consider a range of labour market indicators in assessing 'maximum employment' an unemployment rate of just a bit over 3% would be consistent with satisfying this requirement. Similarly, our forecasts, if realised, would mean the second criterion is met.

While the Fed has not specifically set out what constitutes 'moderately' above 2%, on the face of it our forecast is only a little above. Moreover, the medium Fed member projection for core PCE inflation is similar to ours and most Fed members have not pencilled in a rate hike. The Fed has also indicated that it will look through the expected bump in inflation in Q2 2021 and any (temporary) inflation generated by a ‘normalisation’ in prices.

However, we would expect the Fed to start tapering its asset purchases (currently $80b and $40b per month of Treasury and mortgage backed securities respectively) at some stage in the next year or so.

The Fed’s criterion for scaling back asset purchases (QE) is that substantial further progress has been made toward the Committee's maximum employment and price stability goals. The Fed Chair has been disinclined to explain what would constitute ‘substantial progress’.

That said, with inflation expected to be at or above 2% by end year and the unemployment rate below 5% and falling it is possible that the Fed will deem substantial progress has been made (or will shortly be made) by the end of the year.

The Fed Chair at his March meeting press conference made the point that they want actual progress (not forecasts) and they will say when they are on track for substantial progress to be realised well in advance of any decision to taper.

Overall, this suggests that, if our forecasts are realised, the Fed may announce late in 2021 that it plans to taper QE if the economy continues to evolve as expected. Actual commencement of tapering would then occur in 2022 (we are pencilling in Q1 2022).

Given that what constitutes ‘substantial progress’ is very unclear, there is even more than normal uncertainty around this projection.

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U.S. ECONOMIC & FINANCIAL FORECASTS

						Quarterly Chng %									
						2020		2021				2022			
	2019	2020	2021	2022	2023	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	Year Average Chng %														
Household consumption	2.4	-3.9	7.0	4.8	2.0	9.0	0.6	**1.0**	**2.7**	**2.5**	**1.3**	**0.8**	**0.7**	**0.7**	**0.6**
Private fixed investment	1.9	-1.8	9.7	5.7	3.9	7.1	4.5	**1.9**	**2.0**	**2.1**	**1.6**	**1.3**	**1.1**	**1.0**	**1.0**
Government spending	2.3	1.1	0.2	1.9	1.4	-1.2	-0.3	**0.1**	**0.4**	**0.6**	**0.6**	**0.5**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	-0.7	1.0	-0.1	-0.1	1.6	0.3	**0.0**	**0.4**	**0.1**	**-0.2**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	0.0	-1.5	-0.4	-0.1	-1.4	-0.6	**-0.1**	**-0.2**	**-0.2**	**-0.2**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**-3.5**	**6.0**	**3.9**	**2.1**	**7.5**	**1.0**	**0.9**	**2.4**	**2.0**	**0.9**	**0.7**	**0.7**	**0.6**	**0.6**
Note: GDP (annualised rate)						*33.4*	*4.1*	*3.7*	*9.8*	*8.1*	*3.5*	*2.8*	*2.9*	*2.4*	*2.3*
US Other Key Indicators															
PCE deflator-headline	Dec/Dec % change														
Headline	1.5	1.2	2.7	2.1	2.1	0.9	0.4	**0.9**	**0.7**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
Core	1.6	1.4	2.1	2.1	2.1	0.9	0.3	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
	End of period														
Unemployment rate - qtly average (%)	**3.6**	**6.7**	**4.6**	**3.3**	**3.1**	**8.8**	**6.7**	**6.2**	**5.7**	**5.1**	**4.6**	**4.1**	**3.7**	**3.5**	**3.3**
US Key Interest Rates	End of period														
Fed funds rate (top of target range)	**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**

Source: NAB Group Economics

*Contribution to real GDP growth

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