US ECONOMIC UPDATE JUNE 2021

FED – STILL DOVISH BUT LESS THAN PREVIOUSLY THOUGHT

NAB Group Economics

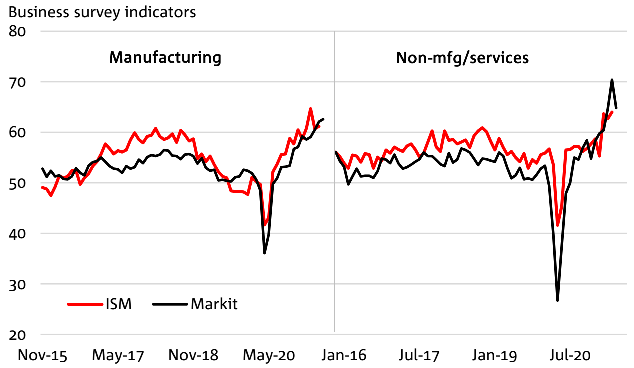
We still expect to see very strong Q2 GDP growth supporting further labour market improvement, although progress has been held up by labour supply issues. Inflation pressures remain elevated; while partly due to supply shortages or to prices in some sectors recovering from depressed levels, there has also been a broader pick-up in inflation. We still expect a QE tapering announcement later this year, with tapering to commence in early 2022, but have changed our federal funds rate call – we now forecast quarterly (25bp) rate rises starting in Q2 2023.

Rapid growth despite supply problems

We continue to expect very strong Q2 GDP growth reflecting the combined impact of a removal of many COVID-19 related restrictions and the substantial fiscal stimulus that has been put in place. Household balance sheets are also strong, and the larger than normal savings accumulated last year may also help sustain activity, as will continued loose monetary policy settings. Supply issues in some sectors are a constraint, although these should diminish over time.

The current rapid growth underway is illustrated by business surveys. Both the Markit (preliminary data to June) and ISM (data to May) are tracking at very high levels. This is particularly the case for the services sector, which is benefiting the most from the easing in COVID restrictions.

Business surveys point to very strong growth

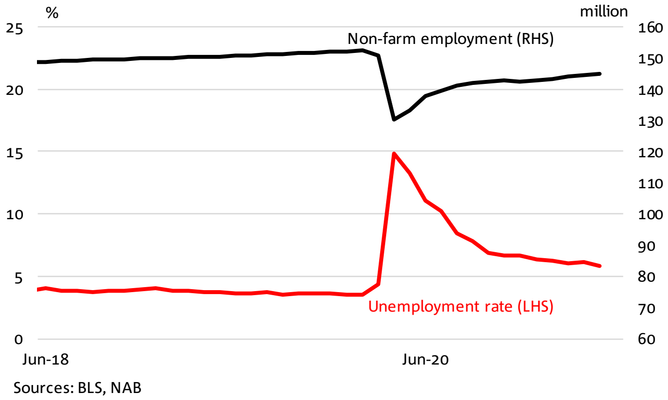


Source: Refinitiv

We expect growth of over 9% q/q (annualised) in Q2, slightly lower than before, but still very strong. But our forecast for 2021 GDP growth is unchanged at 6.7%, followed by 4.1% in 2022 and 2.1% in 2023.

Consistent with the strong pace of growth, the labour market continues to show improvement. After somewhat of a lull in April, the pace of net job growth picked up in May to 559k. The unemployment rate also fell to 5.8% from 6.1%. However, a full recovery remains a long way off – total employment is still 7.6m below its pre-pandemic level, and the unemployment rate is 2.3ppts above its early 2020 level. Moreover, workforce participation has only recovered half of its fall, and has not improved since August 2020.

Labour market healing but still a long way to go



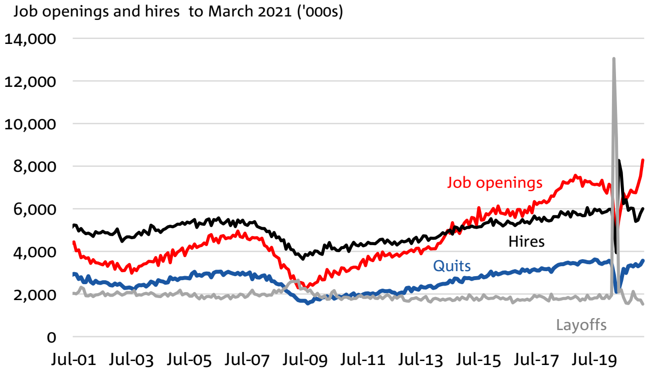
Sources: BLS, NAB

Supply side issues in the labour market are holding back the recovery. There has been a surge in job openings, but this has not been matched by actual hiring. Issues around childcare access, in-person schooling, continuing COVID related health concerns and elevated unemployment benefits may be factors behind the slow supply side response, although these should ease with time.

While job vacancies have picked up rapidly, the ratio of job openings to unemployment remains below its pre-pandemic level, so even on this metric the labour market recovery has further to go.

Date 28 **June 2021** | Author Tony Kelly – Senior Economist

Hiring not keeping up with climb in vacancies

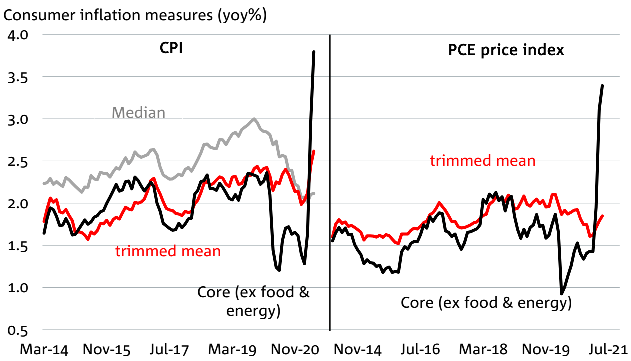


Sources: BLS, NAB

Moreover, unlike in countries where job subsidy schemes kept most people attached to a specific job (even if they were not doing any work), the large number of people who left their previous position in the US means it will take time to match them to a new one. This is particularly so given that the downturn was spread unevenly across sectors and there is likely to be some permanent changes (e.g. more work from home) and therefore changed sources of employment.

Supply issues are also evident in other markets, particularly manufacturing – e.g. auto production has been constrained by a shortage of semiconductors. This is contributing to a surge in inflation in recent months; the CPI measures of used car prices rose 20% over the three months to May, and car rental costs by 46%. Moreover, prices in some of those sectors worst affected by the downturn – and which are now benefiting most from re-opening – have risen strongly. Over the last three months, lodging prices have increased 12% and airline fares 27%, recovering much of the decline since early 2020.

Underlying inflation measures

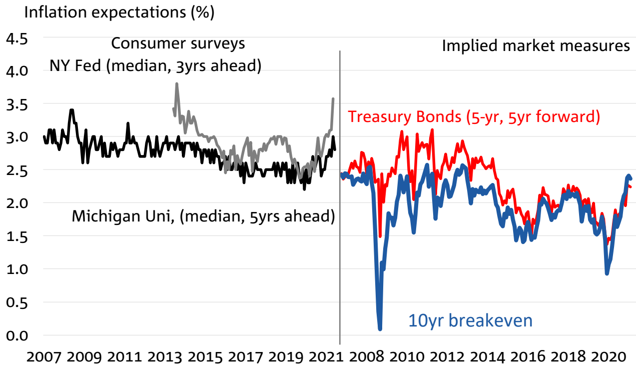


Sources: Cleveland Federal Reserve (median, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. CPI data to May, PCE data to April 2020.

After rising 0.9% m/m in April, core CPI (all items ex food and energy) inflation was again very high in May, up 0.7% m/m. As a result, the annual inflation rate was up to 3.8% – a rate not seen since 1992. Other measures of underlying inflation have not risen anywhere to the same degree. Trimmed mean CPI increased 0.4% m/m in both April and May suggesting that there has been a broader pick up in inflationary pressure, although the rise in trimmed mean core PCE inflation is more modest again.

Inflation expectations have also lifted and are now at above pre-pandemic levels. The Fed's general view, prior to COVID-19, was that inflation expectations were at the low end of the range consistent with its 2% inflation target. However, in his post June meeting press conference, the Fed Chair indicated that he now views expectations as 'broadly consistent' with the Fed's inflation target.

Inflation expectations also up



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

Monetary policy – change to Fed call

The most immediate policy decision for the Fed is when to start reducing ('taper'), and eventually end, its QE program. Currently the Fed is increasing its holdings of Treasury and mortgage backed securities by $80b and $40b a month respectively.

The Fed has stated that for tapering to start it will need to have achieved 'substantial further progress' towards its maximum employment and inflation goals. After the June FOMC meeting the Chair noted that 'in coming meetings' the Fed will discuss progress against their goals and that they would provide advance notice of any decision to taper.

Our view has been, and remains, that the Fed would announce a decision to taper towards the end of this year, with tapering to commence in Q1 2022. Some recent comments suggest that the tapering announcement could be made as early as September. Depending on how much advance notice is considered necessary, this raises the possibility that tapering starts in late 2021, a bit earlier than we currently project.

How long the tapering runs before QE purchases stop completely is unclear. The 2013/2014 taper took a bit under a year, although a somewhat shorter timeframe is also possible. We expect at the end of the QE program the Fed will continue to maintain the stock of purchases (i.e. they will reinvest any principal payments securities) as they did post the end of the 2014 taper.

How long the QE tapering takes may have implications for the fed funds rate, as the Fed is unlikely to move on the latter until some period after QE purchases have ended.

The Fed member projections (the 'dots') released following the June FOMC meeting attracted considerable interest as the median view for 2023 changed from indicating no change in the fed funds rate to indicating a 50bp increase.

As the Fed Chair noted, the forecasts released are not a committee consensus (but pre-meeting individual projections) and they do not have a good track record of predicting future rate moves.

However, the dot plots have led us to change our projection for the federal funds rate because of what they tell us about how fed members are interpreting current Fed guidance around its policy stance and therefore what economic conditions are needed for it to lift rates.

To recap, Fed guidance is that the fed funds rate will remain unchanged 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." While inflation is well above this benchmark right now, the Fed has been discounting it on the basis that it will (largely) prove temporary; moreover, the US is far from being at full employment.

The Fed has not defined 'moderately exceed' but we had assumed it would be around 2¼%. On this basis, with our expectation for core inflation over 2022 and 2023 largely around the 2.1-2.2% mark we had projected an unchanged fed funds rate through to end 2023 but noting that it was a line-ball call.

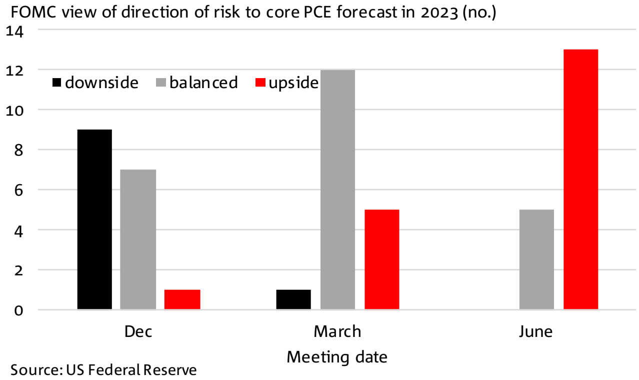
The change in fed member projections for 2023 to include a 50bp increase in the fed funds rate is noteworthy as, for that year, there is no change (from the March meeting) in the median forecast for either unemployment or core inflation. For core inflation the forecast is 2.1% – lower than what we had assumed 'moderately exceed 2%' would be.

There are several possible explanations for why the fed funds rate projections shifted even as other variables remained unchanged (in 2023).

The current forward guidance was based around lifting inflation expectations and meeting the Fed's average inflation target approach (where, if inflation is below 2% for a period, the Fed will aim for above 2% for some period). While the Fed has left unspecified the period of time over which it hopes to average 2% inflation, the recent higher than expected inflation means that the average inflation rate over any recent period one might choose to specify has lifted. The other motivation behind the current guidance was to lift inflation expectations but this has already happened.

Another possibility is that the shift reflects changing risk perceptions. While the median forecast has not changed for 2023, perceptions of the risk around the forecasts has shifted considerably; with most members now seeing upside risk. While the Fed has been emphasising that it will act based on realised outcomes, the "on track to moderately exceed 2% for some time" benchmark has a forward-looking element to it, so perceptions of upside risk are relevant.

Fed view of 2023 inflation risk has shifted



Source: US Federal Reserve

The other element of the Fed guidance around the timing of rate hikes is the need for maximum employment. The Fed will assess a range of indicators to determine when this point is reached but using a rough benchmark of the unemployment rate needing to be 3.5% (its previous cycle low) or perhaps a bit lower for this condition to be satisfied, our forecasts have this being achieved in Q4 2022/Q1 2023.

As a result, we are now pencilling in quarterly 25bp rate rises starting in mid-2023 (Q2 2023). Risks around this are dual sided – a quicker (say 6 months) tapering combined with a more robust economy (and inflation) than expected could bring this forward. A reversal of some the of the recent price increases (which leads to a decline in inflation expectations), more moderate than expected growth and inflation, or the Fed Chair and other key FOMC members having a more dovish view than other members (which could mean we are over-interpreting the significance of the change in the median voter projection) could delay rate hikes.

CONTACT THE AUTHOR

Tony Kelly
Senior Economist
Antony.Kelly@nab.com.au

U.S. ECONOMIC & FINANCIAL FORECASTS

	2019	2020	2021	2022	2023	Quarterly Chng % 2021 Q1	Q2	Q3	Q4	2022 Q1	Q2	Q3	Q4	2023 Q1	Q2	Q3	Q4
US GDP and Components		Year Average Chng %															
Household consumption	2.4	-3.9	8.4	4.4	2.0	2.7	2.5	2.1	1.2	0.8	0.7	0.7	0.6	0.5	0.4	0.4	0.4
Private fixed investment	1.9	-1.8	10.5	5.8	3.9	2.9	1.8	2.0	1.6	1.4	1.2	1.1	1.0	0.9	0.9	0.9	0.8
Government spending	2.3	1.1	2.0	2.4	1.8	1.4	1.0	0.7	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Inventories*	0.0	-0.7	0.5	0.4	-0.1	-0.8	0.4	0.4	0.1	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.2	0.0	-2.0	-0.5	-0.1	-0.5	-0.2	-0.3	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.2**	**-3.5**	**6.7**	**4.1**	**2.1**	**1.6**	**2.3**	**1.9**	**1.0**	**0.8**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*6.4*	*9.4*	*8.0*	*4.1*	*3.4*	*2.8*	*2.3*	*2.2*	*2.0*	*1.9*	*1.8*	*1.7*
US Other Key Indicators																	
PCE deflator-headline		Dec/Dec % change															
Headline	1.5	1.2	3.9	2.1	2.1	0.9	1.6	0.8	0.6	0.6	0.5	0.5	0.5	0.6	0.6	0.5	0.5
Core	1.6	1.4	3.5	2.2	2.1	0.6	1.5	0.8	0.5	0.5	0.6	0.5	0.6	0.6	0.5	0.5	0.5
		End of period															
Unemployment rate - qtly average (%)	**3.6**	**6.7**	**4.5**	**3.4**	**3.1**	**6.2**	**5.8**	**5.2**	**4.5**	**4.0**	**3.8**	**3.6**	**3.4**	**3.3**	**3.2**	**3.1**	**3.1**
US Key Interest Rates		End of period															
Fed funds rate (top of target range)	1.75	0.25	0.25	0.25	1.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00

Source: NAB Group Economics

*Contribution to real GDP growth

Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

Jacqui Brand
Personal Assistant
+(61 0) 477 716 540

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0)436 606 175

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

International Economics

Tony Kelly
Senior Economist
+61 (0)477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

Global Markets Research

Ivan Colhoun
Global Head of Research
+(61 2) 9237 1836