# US ECONOMIC UPDATE MAY 2021

## Q2 GROWTH STILL LOOKING STRONG; APRIL INFLATION SURPRISE

NAB Group Economics

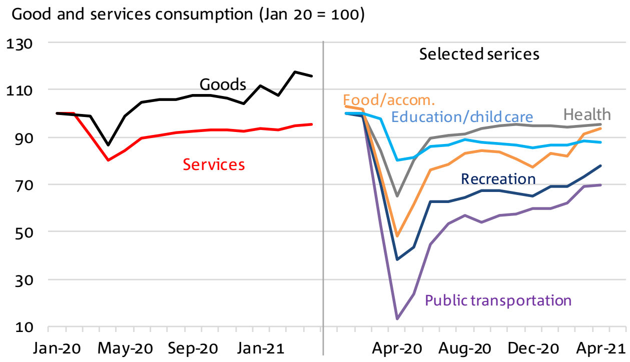
**April activity data have been mixed, but still point to very strong growth in Q2 GDP. There was a major upside surprise to inflation in April. While this largely reflects some temporary factors that should wane over coming months, how long current elevated price pressures persist is a major uncertainty. We still expect tapering of asset purchases to begin in Q1 2022, with the Fed signalling this towards the end of this year. We also expect the fed funds rate to remain unchanged through to end 2023, but note that this call is line ball, with a risk of rate hikes in 2023.**

### April data mixed, but Q2 growth will still be very strong

After very strong growth in activity in March, news for April has been more mixed. On top of this, inflation surged in April, even as the rate of job gains moderated significantly.

Household consumption fell by 0.1% m/m in April. This was well down on the 4.1% m/m growth in March which was boosted by the $1400 stimulus cheques. The April level of consumption was still up 2.2% on the Q1 average monthly level, so we still expect very strong consumption growth in Q2.

**April consumption largely held onto March gains, as service recovery continued**

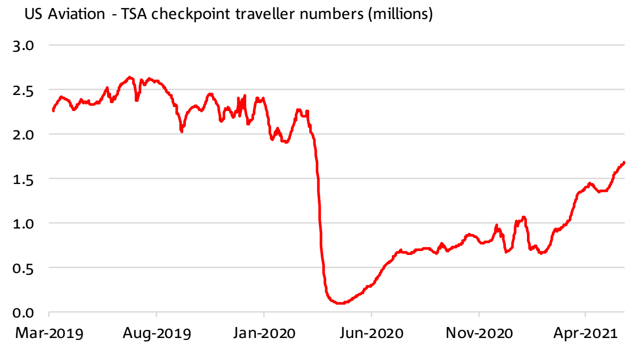



Sources: BEA, NAB

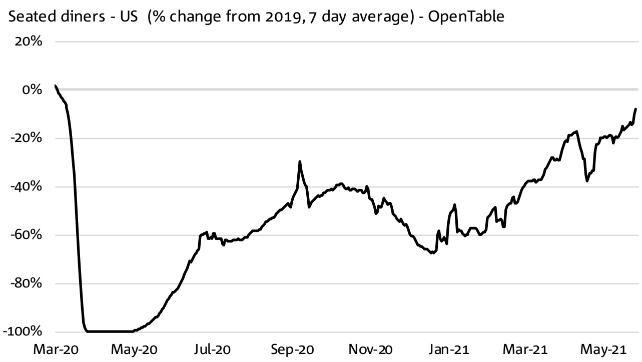
There was some retracement in goods consumption in April – from very high levels – possibly reflecting some waning of the stimulus from cheques sent to households in March, some reallocation of spending from goods to services (food purchases fell while eating out increased) and the absence of a rebound from poor February weather.

However, some of the service sectors of the economy most affected by COVID-19 related restrictions – such as recreation, travel, restaurants and hotel accommodation – saw further improvement. High frequency measures of activity in these sectors, such TSA traveller numbers and seated dining data from OpenTable, point to this continuing into May.

**Service sector rebound continued into May**




Source: Refinitiv (TSA)




Other activity indicators have been a bit more mixed. Even as new private residential construction spending has continued to grow, home sales have fallen back. On the investment side, non-residential construction

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continues to fall, but this will likely be offset by gains in mining investment (measured by rigs) and equipment investment (given growing core capital goods shipments and orders). Exports are also growing and will be supported by the global recovery, but imports have also been rising rapidly as not all the post re-opening/stimulus spike in demand is directed at domestic producers.

Manufacturing industrial production also increased in April but only modestly and it has not yet fully recovered from the weather induced dip in February. Clearly shortages of inputs are impacting the sector, notably in autos where production is down 14% since January (widely attributed to a shortage of semiconductor chips). In time, these supply issues will be addressed which will provide a boost to growth down the track.

At the risk of placing too much emphasis on a single report, supply issues are also evident in the labour market.

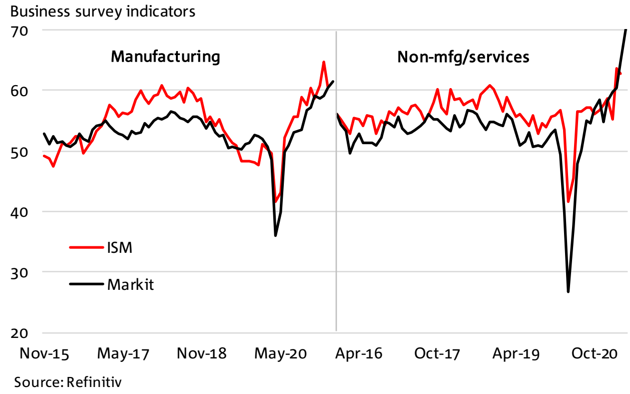
After total employment increased by 1.3 million over February and March, only 266,000 (net) new jobs were created in April and the unemployment rate edged up. This was despite the trend down in jobless claims (consistent with a fall in lay-offs) and a very high level of job openings. This suggests employers are having trouble filling positions despite employment still being 8 million below its pre-COVID-19 level. Average hours worked have also moved to a high level by the standards of the last couple of decades, indicating that, faced with difficulty hiring new staff, existing staff are filling in the gap.

There are several possibilities for why job openings are not actually being translated into more people in employment. While the US is 're-opening', the availability of in person schooling and, reportedly, childcare remains an issue. As already noted, the recovery has not been even across sectors so there may also be an issue of mismatch between the skills of potential employees and the needs of open positions. Higher unemployment benefits may also be a disincentive to returning to work.

Some of these issues should be worked out over coming months. As restrictions continue to be wound back, in-person schooling will become more common. Over twenty states have already announced that they intend to modify or opt out of the Federal government's expanded unemployment benefits and they are due to expire in September in any event. Skill mismatches may take longer to address, although on-going recovery in the worst affected sectors should help.

Despite the mixed April data, business surveys paint an overwhelming positive picture of how the economy is tracking. It is the case that the 'supplier deliveries' component of the ISM surveys is at historically high levels (indicating supply issues) but the other components such as production/activity and orders are also at elevated.

**Business surveys point to robust growth**



Source: Refinitiv

With parts of the recent fiscal stimulus package still working its way through the economy, household balance sheets strong (with savings elevated), monetary policy very supportive and the winding back of COVID-19 restrictions continuing, we continue to expect rapid growth in Q2 and over the rest of 2021. For 2021 we are still expecting growth of 6.7%. Growth is then expected to moderate in 2022 but to a still well above typical 4.1%.

There remains some potential upside risk to our forecasts from fiscal policy. The President's American Jobs Plan (AJP) and American Families Plan (AFP), proposed further spending increases and tax credits worth over $4 trillion spread over many years. While there will also be tax increases, if enacted the plans would still represent a net stimulus over a ten-year window. The President's proposed fy22 Budget also includes large increases in non-defence discretionary spending (around 0.5% of GDP).

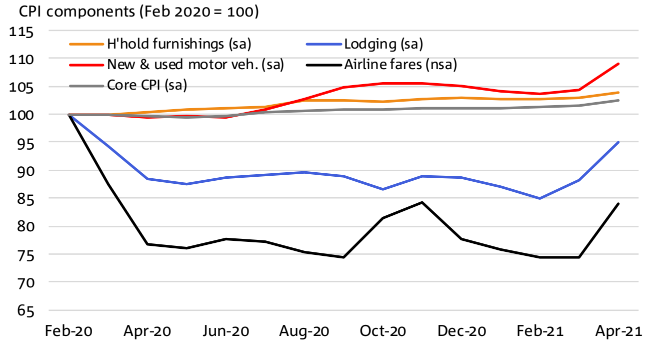
At this stage, it is unclear what will ultimately be passed by Congress. Already the President appears prepared to scale back the AJP to try and get more Congressional support. Moreover, the timing of the planned expenditure (and higher tax revenue) will also be crucial in assessing any impact on the economy over the next few years.

## April inflation spike

There was a big jump in consumer inflation in April, which was significantly above what was expected (and much higher than what was implicit in our quarterly inflation forecast). Core (all groups ex food and energy) prices rose by 0.9% m/m in April, a monthly growth rate not seen since the 1980s when annual inflation was around the 10% mark. Similarly, core PCE inflation (the Fed's preferred measure), increased by 0.7% m/m, its highest in 2001.

The increase in CPI was heavily concentrated in a few categories – lodging, airline fares and motor vehicles. This accords with much of the commentary around price pressures – they reflect either heavily impacted sectors which had earlier slashed prices and are now rebuilding their margins or sectors where there are supply issues (and strong demand) such as autos. On a trimmed mean basis (which excludes the strongest and weakest performers) growth was more moderate, but still robust at 0.4% m/m. Trimmed mean PCE inflation was even more moderate at 0.2% m/m.

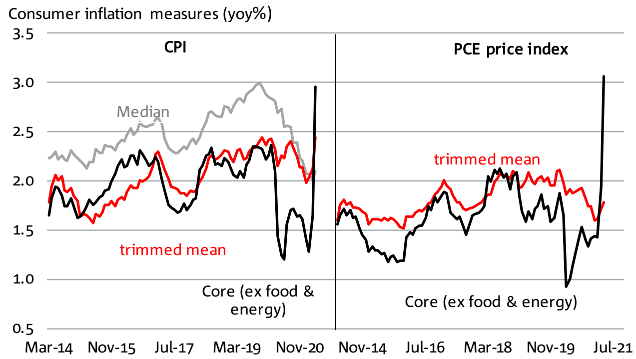
**April CPI surge (partly) driven by a few categories**




Sources: Refinitiv, NAB

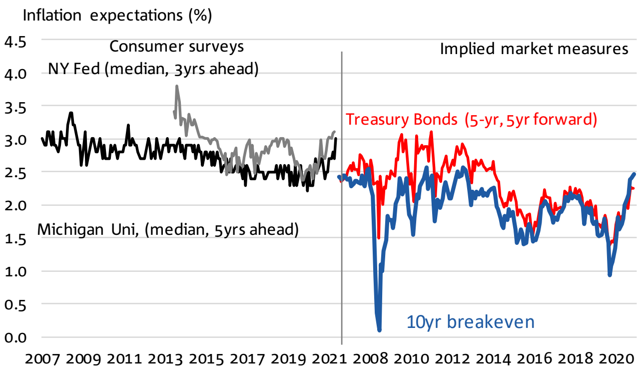
As a result, annual core inflation has spiked to 3%y/y on a CPI basis and 3.1% y/y on a PCE basis. This in part reflects base effects from last year – prices fell in March and April last year and these are now out of the annual correction but the (partial) correction in prices mid-last year remains in.

**April jump in core inflation jumps – but less so in other measures of underlying inflation**




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.

**Inflation expectations at multi-year highs**




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

There has also been an increase in various measures of inflation expectations, which are now running at levels well above that seen before COVID-19. It is worth noting, however, that the Fed's view prior to COVID-19 was that inflation expectations were at the low end of the range consistent with its 2% inflation target. However, some inflation expectation measures are also tracking at around levels seen pre-GFC (a period when measured inflation was consistently above the Fed's (now) target of 2%).

## Monetary policy

The April FOMC minutes noted that 'a number of' participants indicated it might be appropriate to start talking about when the Fed might taper its $120b monthly asset purchase program (i.e. reducing amount of monthly purchase over time). Following the subsequent April inflation reports there now appears to be a general shift in Fed members towards this view

The Fed's criterion for scaling back asset purchases (tapering) is for 'substantial further progress' to have been made toward its maximum employment and inflation goals. Vice Chair Quarles, in a speech last week, indicated that his view is that "...the rise in inflation—even after discounting temporary factors—and inflation expectations since December will prove sufficient to satisfy the standard for inflation in the guidance around asset purchases later this year...". However, he also noted that labour market gains have been weaker than hoped for.

Our expectation remains that towards the end of this year, the Fed will signal that, if conditions continue to evolve as expected, 'substantial progress' on its goals will soon be achieved. This would then lead to tapering starting in Q1 2022.

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

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

The first two criteria are both likely to be satisfied, on our forecasts, by late 2022/early 2023. There is less clarity around the third criteria – inflation on track to be moderately above 2% inflation for some time.

Of course, inflation is already above 2% but for now the Fed is sticking with its view the current spike will prove temporary. We also expect inflation to moderate over the course of the year and into next year, and then to sit a bit above 2%.

We noted in last's month Update that our inflation forecasts were even then probably not far off the level that may justify rate hikes. Our inflation forecasts incorporate an adaptive inflation expectations term. This is a fancy way of saying expected inflation is affected by past inflation. As a result, large surprise upside results, such as in April, increase inflation expectations and lead to a (small) upwards shift in our 2022/2023 forecasts.

The Fed has not defined what 'moderately' above 2% means but our guess would be that annual inflation of at least 2¼% would satisfy this criterion and our forecasts are close to (if not sometimes on) this mark over 2022 and into 2023.

Therefore, while our forecasts still see no change in the federal funds rate target range (0 to 0.25%) right though our projection period to end-2023, this call is increasingly line-ball. There is a definite risk, if our other forecasts for growth and inflation were realised, that the Fed would start raising rates in 2023.

The more immediate risk around the projections is what happens if the April inflation surprise is repeated in coming months. If this is accompanied by a return to rapid jobs growth, then the timing of asset purchase tapering could be brought forward into Q4 2021. However, there is a limit to how much it can bring tapering forward. The Fed has yet to discuss tapering in any depth (at this stage Fed members are just talking about have a discussion) and then they would need to publicly flag that they are on track for a taper, with a delay to actual implementation (given promises of plenty of notice).

For the fed funds rate, the Fed's view and policy stance is predicated on inflation only moving sustainably higher (and moderately above 2%) when there is a tight labour market. While not our projection, if the monthly inflation readings (on an annualised basis) were to remain persistently – and by more than a moderate amount – above 2% even as employment remained well below its pre-COVID-19 level, they would be faced with a difficult choice.

The Fed Chair was asked in the April meeting press conference what they would do if inflation expectations moved higher even before a return to full employment. The Chair referred to the Fed's *Statement on Longer-Run Goals and Monetary Policy Strategy* which states that if its employment and inflation objectives are in conflict that it will take "…into account the employment shortfalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate." This is not particularly informative, but in practice would probably mean some tightening in policy with the aim of allowing still some labour market gains (albeit slower) while containing inflation.

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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 | 8.3 | 4.4 | 2.0 | 9.0 | 0.6 | 2.7 | 2.5 | 2.1 | 1.2 | 0.8 | 0.7 | 0.7 | 0.6 |
| Private fixed investment | 1.9 | -1.8 | 10.8 | 5.9 | 4.0 | 7.1 | 4.3 | 2.7 | 2.5 | 1.9 | 1.6 | 1.4 | 1.2 | 1.1 | 1.0 |
| Government spending | 2.3 | 1.1 | 1.8 | 2.3 | 1.8 | -1.2 | -0.2 | 1.4 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 |
| Inventories* | 0.0 | -0.7 | 0.5 | 0.4 | -0.1 | 1.6 | 0.4 | -0.8 | 0.5 | 0.3 | 0.1 | 0.1 | 0.0 | -0.1 | 0.0 |
| Net exports* | -0.2 | 0.0 | -1.9 | -0.5 | -0.1 | -1.4 | -0.6 | -0.4 | -0.2 | -0.3 | -0.2 | -0.1 | 0.0 | 0.0 | 0.0 |
| **Real GDP** | **2.2** | **-3.5** | **6.7** | **4.1** | **2.1** | **7.5** | **1.1** | **1.6** | **2.4** | **1.8** | **1.0** | **0.9** | **0.7** | **0.6** | **0.6** |
| *Note: GDP (annualised rate)* | | | | | | *33.4* | *4.3* | *6.4* | *10.0* | *7.6* | *4.1* | *3.4* | *2.9* | *2.3* | *2.2* |
| **US Other Key Indicators** | | | | | | | | | | | | | | | |
| PCE deflator-headline | | Dec/Dec % change | | | | | | | | | | | | | |
| Headline | 1.5 | 1.2 | 3.5 | 2.2 | 2.1 | 0.9 | 0.4 | 0.9 | 1.3 | 0.6 | 0.6 | 0.6 | 0.5 | 0.6 | 0.5 |
| Core | 1.6 | 1.4 | 3.0 | 2.2 | 2.2 | 0.9 | 0.3 | 0.6 | 1.2 | 0.6 | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 |
| | | End of period | | | | | | | | | | | | | |
| **Unemployment rate - qtly average (%)** | **3.6** | **6.7** | **4.6** | **3.4** | **3.0** | **8.8** | **6.7** | **6.2** | **5.9** | **5.3** | **4.6** | **4.1** | **3.9** | **3.6** | **3.4** |
| **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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