US ECONOMIC UPDATE JULY 2021
Q2 GDP GROWTH BELOW EXPECATIONS BUT STILL STRONG

National Australia Bank

NAB Group Economics

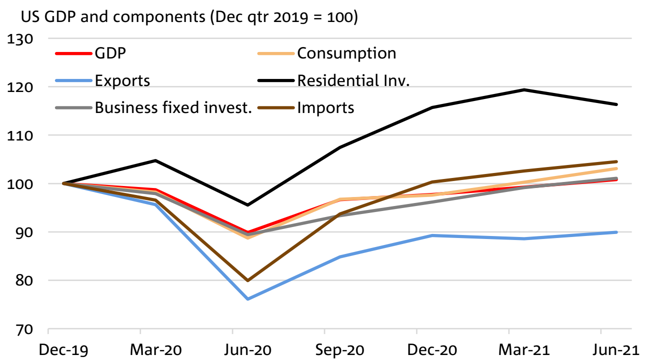
The economy grew strongly in Q2 2021 even if the pace was below expectations. Key drivers were consumption and business investment. While inventories were a headwind, they should turn into a tailwind as supply bottlenecks are addressed. GDP is now above its pre-Covid-19 level, and we expect strong growth over H2 2021, although Covid-19 remains a risk with cases currently rising. Quarterly PCE inflation was also very high, but we expect it to moderate from here and eventually settle at around 2.1-2.2% in 2023. We still expect QE tapering to be announced later this year and to commence in early 2022. We don't expect to see a start to Fed rate rises until mid-2023.

Q2 GDP

US GDP rose 1.6% q/q or 6.5% on an annualised basis in Q2 2021. This was well below market expectations of around 8-8.5% (and the 10% forecasts of a month or two ago). However, the disappointment relative to expectations largely reflected inventories, net exports and government spending; the key drivers of our forecasts (consumption and business investment) were broadly as expected.

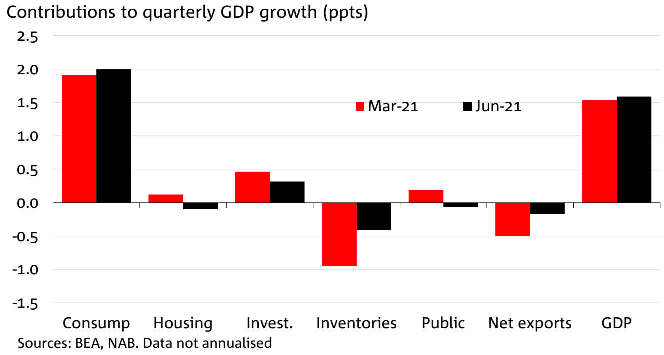
Growth of 1.6% q/q is the second strongest quarterly outcome since 2003 (the strongest was Q2 last year in the initial rebound from lockdown). GDP is now above its pre-COVID-19 (Q4 2019) level. However, it is still well below where it would have been if it had kept growing at its pre-pandemic rate, so there is still a material output gap. This can be seen in the labour market; the unemployment rate was 5.9% in June, well above the 3.4% February 2020 level, while non-farm employment is 6.8m lower than its pre-pandemic level.

GDP moved above pre-pandemic level in Q2



The key drivers of Q2 GDP growth printed largely as expected. Private consumption grew by 2.8% q/q, boosted by the re-opening of the economy and Federal government fiscal stimulus. Business fixed investment also grew by a robust 1.9% q/q, supported by strong growth in machinery & equipment investment and intellectual property products, although non-residential construction again fell. Another area of weakness was housing; residential investment rebounded strongly earlier in the recovery but has since come off the boil although it is still well above its pre-pandemic level.

Consumption & business invest. key drivers in Q2



There was a large run down in inventories again in Q2, which subtracted 0.4%ppts from quarterly growth. The inventory run-down reflects strong demand in the economy while, at the same time, there are number of supply chain disruptions (both in the US and abroad). The decline in inventories was widespread across sectors, although particularly notable for motor vehicle dealers, a sector facing global production issues.

The strength of the US economy in the first half of 2021, relative to other economies, as well as a

Date 30 July 2021 | Author Tony Kelly – Senior Economist

consumer switch towards goods consumption, has led to strong growth in imports, while exports are still yet to fully recover. As a result, net exports continued to see a negative contribution to growth.

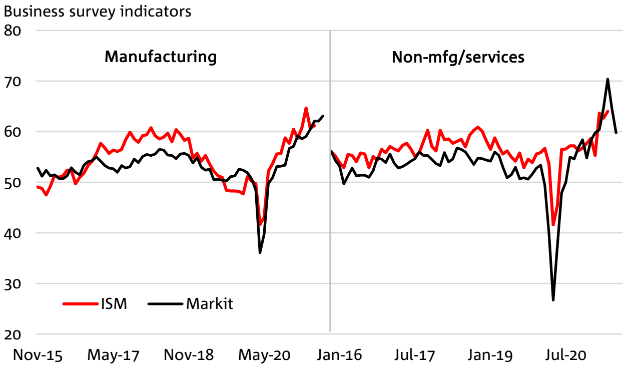
Government spending was also weak, falling 0.4% q/q, largely due to a fall in processing and administration costs of the Paycheck Protection Program. However, even outside of this, Federal spending was soft, while growth at state and local level (0.2% q/q) modest – no sign yet of Federal government stimulus payments to the states.

Growth Outlook

While headline growth disappointed in Q2, the major surprise was in the inventory contribution which should turn into a tailwind over coming quarters as supply bottlenecks are resolved. Growth will also be supported by low interest rates and the recovery in the labour market, which should offset some pull back in fiscal support.

Supporting this view, business surveys remain at high levels. While, the preliminary Markit services PMI has moved well off its May high, it may simply reflect a fading boost from re-opening and fiscal support. Regional services indicators for July have held up better; we may get a clearer picture with the release of the ISM services PMI for July.

Business surveys – still high but may have peaked



Source: Refinitiv

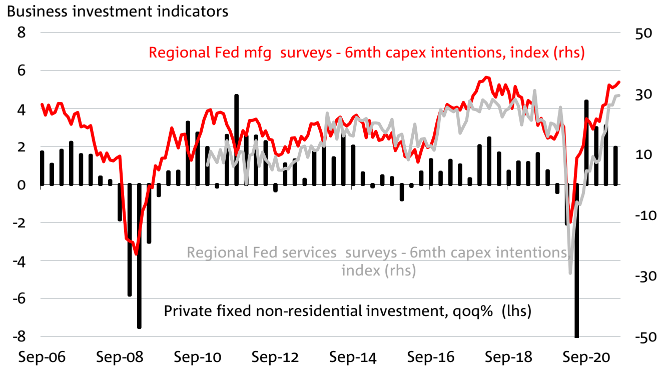
Following the very strong spike in March, monthly consumption data flattened out over April and May. This raised the prospect of a soft trajectory into Q3. However, the outcome for Q2, indicates growth was strong in June or the earlier months data has been revised upwards, allaying this concern somewhat.

The March consumption spike reflected re-opening but also stimulus cheques which were sent out in the second half of the month. Disposable personal income rose 13% q/q in Q1 then declined 7% in Q2, and high inflation also took a bite out of household purchasing power. Excluding Federal Covid support payments, disposable income increased in Q2, consistent with reported growth in jobs and hourly earnings, which will help offset the winding down in other fiscal support measures to households. The boost to unemployment benefits will end by September and has already been wound back in some states.

Moreover, the household savings rate is well above its pre-pandemic level, household balance sheets are in good shape, and interest rates low. This will support solid consumption growth, although we expect it to soften from the heady pace seen in H1 2021. Indicators for restaurant bookings airline travel for much of July are above their Q2 average (although the former is now levelling off), suggesting that the recovery in the service sectors most affected by Covid-19 remained on track early in Q3.

Moreover, business surveys also point to the strong growth in business investment continuing into the second half of 2021.

Business investment intentions elevated



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

Net exports are likely to be held back by restocking (which will partly occur through higher imports), but easing production constraints within the US and the continued recovery overseas (particularly Europe, where growth in Europe started to pick up during Q2) should support export growth.

Overall, we expect growth of 6.2% in 2021 (previously 6.7%) and 4.3% in 2022 (previously 4.1%), reflecting the weaker than expected Q2 outcome, but with growth over subsequent quarters now projected to be a bit stronger (in large part due to the expected rebound in inventories).

A risk to the outlook remains COVID-19. The number of new COVID-19 cases has been rising since early July. Some restrictions – such as masks – have been re-imposed in some jurisdictions, although these will have little impact on economic activity. Apart from the possibility of restrictions with larger economic impacts being imposed down the track, the rise in cases may also make consumers more cautious.

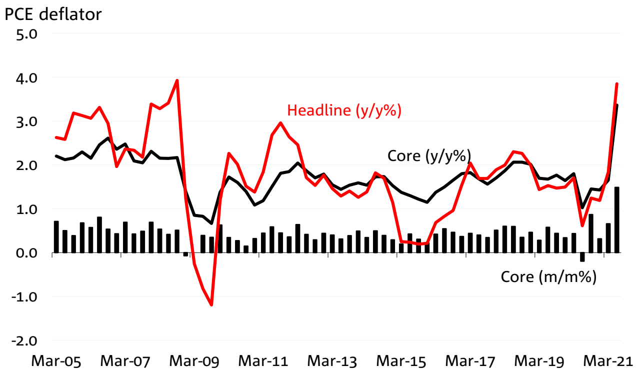
Our forecasts assume that there will be no material re-imposition of restrictions although there remains a high degree of uncertainty about this, particularly given the emergence of more transmissible variants such as the Delta strain. With vaccines more effective at preventing serious illness rather than transmission, rising cases will likely only cause a major reaction if it leads to a significant enough rise in people needing treatment to trigger concerns that the hospital system will be overwhelmed.

An upside risk to our forecasts is fiscal policy, with the administration trying to gain passage of multi-trillion spending plans in Congress.

Inflation

Inflation was extremely high in Q2 2021. Headline PCE inflation (the Fed's preferred measure) increased by 1.6% q/q and is up 3.8% over the year. The core measure, which strips out food and energy, also grew very strongly (1.5% q/q, 3.4% y/y). This represents the strongest quarterly inflation print since the 1980s.

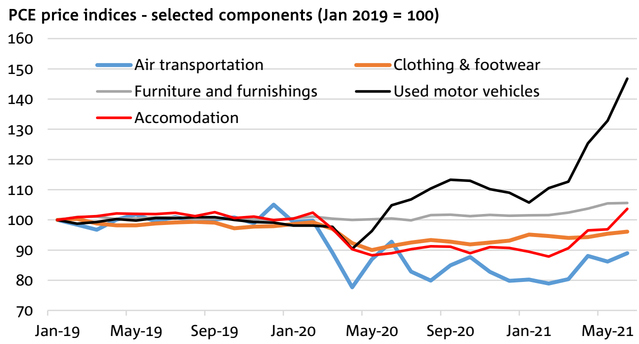
Inflation spiked in Q2



Sources: BEA, NAB

The spike in prices reflects a combination of factors. The prices of some items have accelerated rapidly due to strong demand alongside supply disruptions. A prime example of this is in the auto sector where problems sourcing components has seen production decline by 14% since January while over Q1 and Q2 motor vehicle (and parts) consumption increased 16%. As a result, motor vehicle prices have risen at a particularly rapid rate. Other goods such as recreational items, sporting goods and furniture and furnishings have also risen strongly.

Supply shortages & price normalisation at play



Sources; BEA, NAB. June 2021 estimated by NAB

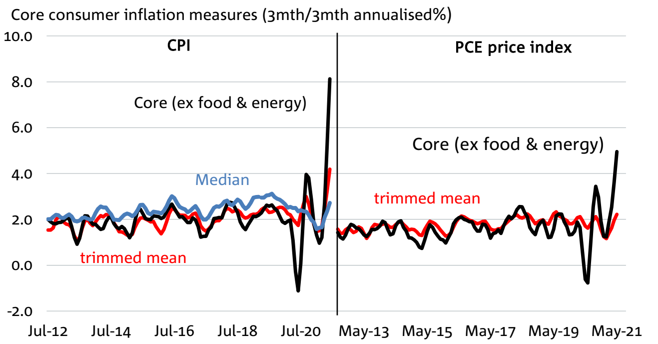
At the same time prices in sectors badly affected by Covid-19, which fell as the pandemic took hold last year, have been moving back towards their pre-pandemic level or 'normalising'.

At some stage these effects will wane, if not unwind. In particular, motor vehicle pricing is likely to fall when production ramps up – indeed, second-hand vehicle auction prices have already started to fall. If this were to occur rapidly in conjunction with more normal price growth for sectors where prices have been normalising, then some weak, if not negative, monthly inflation readings would be possible.

Of course, it is unclear whether prices in all these cases will return back to their pre-Covid levels, perhaps because of a more generalised lift in prices (and future inflation) due to the boost to incomes and wealth from the Covid-19 policy response (more money chasing fewer goods) or because there has been a more permanent shift in sector specific costs, impacting production margins. Higher commodity prices, such as for oil, and shipping costs, are also likely to take a while to fully work their way through the economy wide prices.

Other measures of core inflation also indicate inflation has picked up but point to a more moderate pick up than indicated by headline or core PCE or CPI inflation. This is particularly the case for trimmed-mean core PCE inflation which hasn't moved above the range of recent years. However, research by the Dallas Federal Reserve suggests that trimmed-mean inflation tends to move higher in the future when it is below current headline inflation.

Measures of underlying inflation



Sources: Cleveland Federal Reserve (trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. Monthly data to May 2021.

Other measures of price pressures in the economy – such as producer prices for consumer goods and services, as well as business equipment and intermediate goods, are also elevated. The same is true of survey measures of business prices and costs. Surveys also indicate supply problems are still a major issue, indicating that a large reversal of some of the recent price spikes is unlikely in the near term. It is, however, the case that some of these measures do appear to have peaked – consistent with our view that we are unlikely to see quarterly inflation at Q2 levels again.

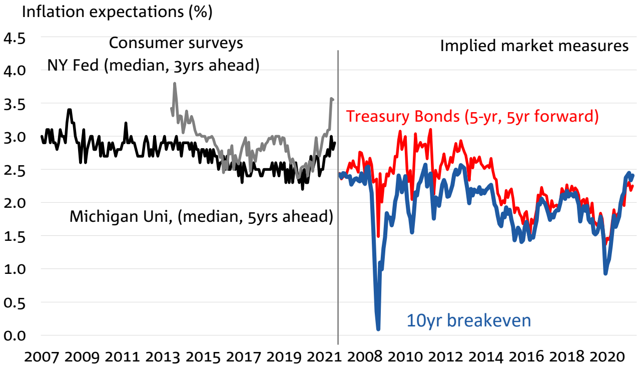
The lift in inflation that we have experienced, even if it proves to be transitory, can lead to higher future inflation if it were to permanently lift inflation expectations. This can because it can change such things as business pricing practices and wage claims.

There is some evidence that wages growth is (or will) strengthening. While unemployment remains relatively high, employers are finding it difficult to fill many vacancies. The NFIB small business survey indicator of increases in compensation over the last 3-6 months is at a record high (data available from the mid-1980s) and the hourly earnings data from the monthly employment report has also grown strongly in recent months. However, the Atlanta Fed's wage growth tracker, which tries to adjust for compositional shifts, is not showing any pick-up yet.

The best indicator of wage growth – the Employment Cost Index – grew at a solid rate in Q1 (0.9% q/q) and a bit above the range of recent years. Tonight's Q2 reading will provide an important guide as to whether wage growth is moving higher. As with recent price increases, however, the issue is not just whether growth is higher but whether it is going to be sustained at a higher level (and is not just a response to temporary labour supply issues or a catch-up due to delayed wages increases).

While hard to measure with any precision, a range of indicators point to a lift in inflation expectations above their pre-Covid levels. However, they are not at a level that would signal risk of a significant move away from the Fed's 2% target.

Inflation expectations have lifted



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

Pulling together these cross-currents makes forecasting inflation even more difficult than normal. Our central view remains that once some of the current 'noise' dies down that inflation will settle at a higher level than before Covid-19. However, we are mindful of the possibility that inflation may stay robust in the near term due to continuing supply issues but that there may also be patches of weak inflation readings as these issues are resolved. While we have marked down our PCE inflation forecasts a little over the next year, we still expect it to settle at above the Fed's 2% target by 2023 (around 2.1-2.2%).

Monetary policy

The Fed's FOMC meeting statement this week noted that there had been progress towards its maximum employment and price stability goals. However, the bar for tapering of its current purchases of Treasury and mortgage backed securities (MBS), of \$80b and \$40b a month respectively, is that 'substantial' progress be achieved.

The Fed's statement also stated that it would assess progress towards its goals in "coming meetings". As such, we see no reason to change our view that the Fed will announce a decision to taper towards the end of this year (November/December most likely) with tapering to commence in Q1 2022. This will of course depend on incoming data being broadly consistent with our (and the Fed's) expectations – particularly in the labour market, although the high level of unfilled jobs strongly points to a continuation of robust jobs growth. This view also assumes no material economic impact from the current rise in Covid-19 cases.

The Fed Chair also indicated that when tapering does occur, it will be most likely through a reduction in the monthly purchases of both Treasury and MBS securities. He did, however, leave open the option that MBS purchases will be wound back at a faster pace.

The bar for raising the fed funds rate is much higher and rate increases are not on the immediate horizon. As the Fed Chair said in this week's press conference "We're clearly a ways away from considering raising interest rates. It's not something that is on our radar screen right now". He also indicated that 'ideally' they wouldn't be raising rates while still purchasing assets, which even if tapering were to start in early 2022, could still be happening over much of 2022. Our view is still that the most likely timing for an increase in the federal funds rate is around mid-2023.

CONTACT THE AUTHOR

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

U.S. ECONOMIC & FINANCIAL FORECASTS

						Quarterly Chng %											
						2021				2022				2023			
	2019	2020	2021	2022	2023	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	Year Average Chng %																
Household consumption	2.2	-3.8	8.5	4.3	2.0	2.7	2.8	1.5	1.3	0.8	0.7	0.7	0.6	0.5	0.4	0.4	0.4
Private fixed investment	3.2	-2.7	8.7	5.1	4.0	3.1	0.7	1.3	1.4	1.4	1.2	1.1	1.0	1.0	0.9	0.9	0.8
Government spending	2.2	2.5	1.0	1.9	1.8	1.0	-0.4	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Inventories*	0.1	-0.6	0.1	0.7	-0.2	-0.9	-0.4	1.0	0.5	0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Net exports*	-0.2	-0.2	-2.0	-0.5	-0.1	-0.5	-0.2	-0.5	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.3**	**-3.4**	**6.2**	**4.3**	**2.1**	**1.5**	**1.6**	**1.8**	**1.4**	**0.9**	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*6.3*	*6.5*	*7.3*	*5.8*	*3.8*	*2.9*	*2.3*	*2.1*	*2.1*	*1.9*	*1.8*	*1.8*
US Other Key Indicators																	
PCE deflator-headline	Dec/Dec % change																
Headline	1.5	1.2	3.9	1.9	2.1	0.9	1.6	0.9	0.4	0.4	0.4	0.5	0.5	0.5	0.6	0.5	0.5
Core	1.6	1.4	3.4	2.0	2.2	0.7	1.5	0.8	0.4	0.4	0.5	0.5	0.6	0.5	0.6	0.5	0.5
	End of period																
Unemployment rate - qtly average (%)	3.6	6.7	4.9	3.7	3.2	6.2	5.9	5.5	4.9	4.4	4.1	3.8	3.7	3.5	3.4	3.3	3.2
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