

US ECONOMIC UPDATE 29 OCTOBER 2021

GROWTH SLOWS IN Q3 BUT INFLATION STILL ELEVATED



NAB Group Economics

GDP grew by 0.5% q/q in Q3, a marked slowing on previous quarters. We expect a rebound in growth over coming quarters as some of the headwinds in Q3 fade (supply bottlenecks, COVID-19 and unwinding of fiscal stimulus). We are now expecting GDP growth of 5.5% in 2021 (previously 5.7%) and 3.8% in 2022 (previously 3.9%). Inflation pressures are still evident, but we expect inflation to moderate to a bit over 2% by the end of the forecast period. We now expect that the Fed will start raising the fed funds rate in Q1 2023 (previously Q2 2023).

GDP growth slowed notably in Q3. GDP grew by 0.5% q/q (or 2.0% annualised) well down on 1.6% q/q in Q2. This is around the trend growth rate, implying a pause in catching up lost output, due to supply bottlenecks, the unwinding of fiscal stimulus and COVID-19 headwinds.

Domestic final demand growth was even weaker at around 0.25% q/q reflecting softer consumption, and business investment growth, only modest government demand growth and another fall in residential investment. Exports fell in the quarter, largely due to declines in agricultural and petroleum products. However, there was a strong contribution to growth from inventories.

The strong inventory contribution does not mean an end to the supply issues that have been holding back the economy. Indeed, inventories continued to fall but at a slower pace. As supply bottlenecks ease, businesses will seek to rebuild inventories which should provide a boost to growth.

One of the sectors most affected by supply bottlenecks has been autos – the fall in motor vehicle production in Q3 subtracted more than 0.3% from GDP growth, weighing on consumption (motor vehicle purchases down 18%) and investment in transportation equipment.

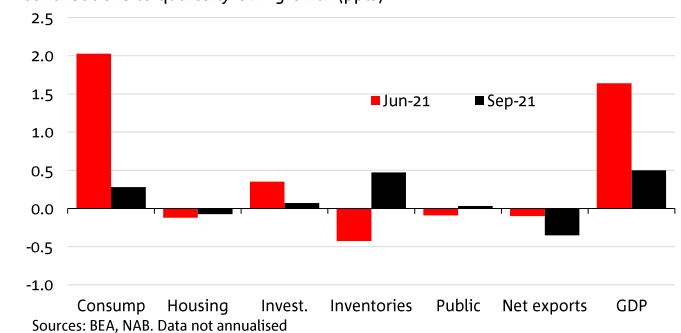
The significant slowdown in consumption growth, from 2.9% q/q in Q2 to 0.4% q/q in Q3 reflects several factors. These include the unwinding of fiscal payments to households since March, higher inflation impacting household budgets, and shortages of some goods (e.g. autos as noted above). The Q3 COVID wave during the quarter may have contributed to slower growth in food services & accommodation, transportation and recreation services consumption; however, growth rates were still strong (particularly

in transportation services) suggesting only a modest impact.

Business fixed investment grew by only 0.4% q/q, well down on recent quarters. Investment in non-residential structures continued to decline and the run of strong growth in machinery & equipment came to an end (-0.8% q/q). This drop-off may in part reflect difficulty in obtaining equipment; notably, there was a fall in motor vehicle sales for investment purposes.

Q3 generally soft across the board

Contributions to quarterly GDP growth (ppts)



Outlook

While a slowdown in growth was expected from the very rapid pace seen in the first half of the year, the Q3 outcome was weaker than we had been expecting.

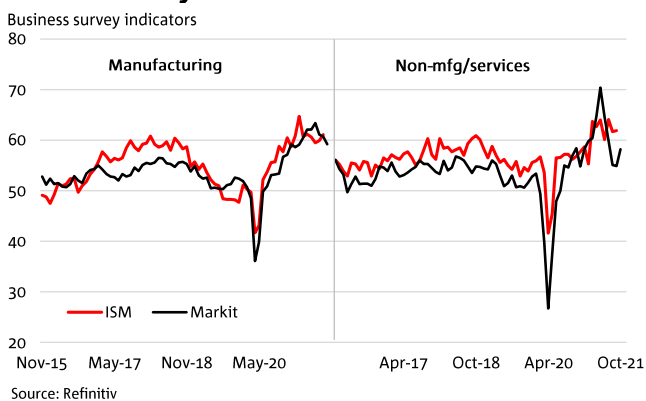
While we still expect to see solid growth going forward, we have marked down our annual growth forecasts due to the Q3 disappointment, the ongoing supply chain drag and resulting spike in prices. We now expect growth of 5.5% in 2021 (from 5.7%) and 3.8% (from 3.9%) in 2022, although now see a slightly stronger 2023 at 2.2% (previously 2.1%).

Our outlook for still solid growth reflects a view that some of the factors that weighed on Q3 growth have or will start to unwind and that the ongoing labour market recovery and strong business investment expectations will continue to underpin growth.

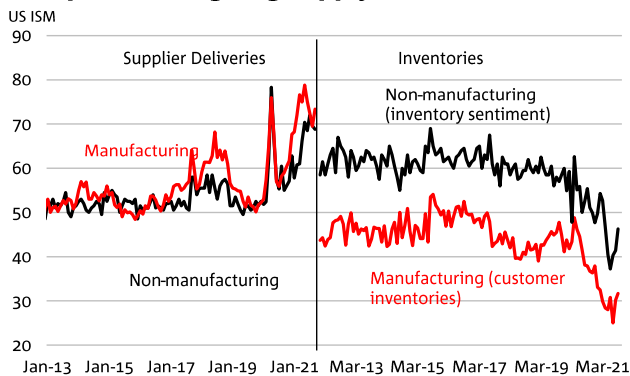
One of the drags has been supply bottlenecks which are limiting production in some industries and holding back consumption and business investment. As these issues unwind, this should provide a boost to GDP, but the timing at which this occurs is highly uncertain and could well happen later than we expect and recover more gradually.

Illustrating these tensions, the latest business survey readings, remain reasonably robust, but at the same time point to ongoing supply bottlenecks. While they may have stabilised they remain significant and are yet to show any signs of material improvement.

Business surveys remain solid...



...but point to ongoing supply bottlenecks



To the extent that the COVID-19 wave in Q3 dragged on growth then, with cases falling over September and into Q4, a rebound can be expected in COVID-19 sensitive sectors (e.g. travel, hospitality). While there remains concern over another 'winter wave', as vaccination rates continue to rise, and treatment options improve, it is expected that COVID-19 will become less disruptive over time.

Much of the drag on consumer incomes from the ending of various fiscal stimulus programs has already occurred, including an end to expanded unemployment benefits in early September. With job openings at high levels, we expect continued employment growth will support incomes from here.

The savings rate remains elevated and households have also accumulated extra savings (over and above their typical pre-COVID level) in the last 1½ years. They have also seen a broader run up in wealth which should also support future consumption.

High inflation is, however, eating into household purchasing power and if it is more persistent than we expect it represents a downside risk.

On the business side, regional Fed surveys of capex intentions continue to point to ongoing solid fixed investment going forward. Inventories remain at low levels and businesses are likely to try and rebuild this as capacity catches up and supply issues recede.

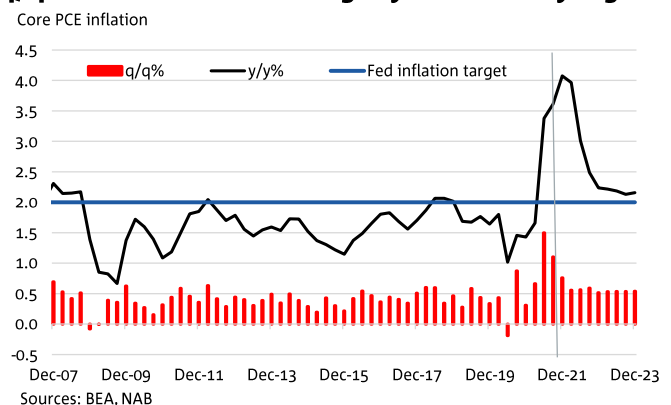
Fiscal policy remains uncertain, with some substantial fiscal spending proposals being discussed by Congress. There has been some winding back of expectations about how large the extra spending may end up being. Any package will also include tax increases, so it is hard to assess what the net fiscal impact will be at this stage. However, there is the prospect of additional net stimulus over the next several years – this would not only represent an upside risk to our growth forecast but also our inflation forecast.

On the inflation front, headline PCE inflation was up 1.3% q/q (4.3% y/y). The core measure (which excludes food and energy prices) was also elevated at 1.1% q/q (3.6% y/y).

The quarterly growth rate implies, absent revisions to prior history, core PCE inflation of only 0.1% m/m in September. This would be the lowest monthly growth rate in the core measure since February 2021.

However, with global supply bottlenecks not yet showing signs of material improvement (and energy prices rising) some pick-up in inflation readings in coming months would not surprise. For example, auto auction prices, which had started to unwind moved higher again in September.

q/q core inflation eased slightly but still very high



That said, our view is that inflation expectations are broadly anchored at around 2% and inflation will ease as supply bottlenecks are addressed. Even so we expect that inflation has shifted modestly above its

pandemic level and expect it to remain above 2% right through our forecast period.

There is considerable uncertainty around the inflation outlook. With supply bottlenecks persisting prices may remain elevated for longer than we expect and feed into broader inflationary pressures.

There is already evidence of a broadening in inflationary pressures and a strengthening in wages growth. The trimmed mean PCE up to August had not moved up much higher on an annual growth basis but recently, the monthly growth rate has lifted. The Employment Cost Index has moved somewhat higher than its pre-pandemic level but not to a worrying degree from an inflation point of view. Q3 data will be released tonight which will give a more up-to-date guide on whether wages growth is accelerating. If this is the case, then this may feed into broader inflation pressures and lead to a further rise in inflation expectations.

On the downside, as supply bottlenecks are addressed there may be large downward moves in some prices, which could see a run of low inflation prints and a reversal of the rise in expected inflation.

Monetary policy

The Q3 GDP report is unlikely to change when the Fed starts to reduce its monthly purchases of Treasury securities and mortgage backed securities (MBS) - 'tapering'. The Fed Chair, in recent remarks, has strongly signalled that this will be announced at next week's meeting.

The Fed currently purchases around \$80 billion of Treasury securities and \$40 billion of agency mortgage-backed securities (MBS) each month. Fed speakers are pointing to the program being wound-up by around mid-2022, which points to a monthly reduction in the size of asset purchases of around \$15b per month (\$10b Treasuries, \$5b MBS).

The Fed's criteria for lifting the fed funds rate is that maximum employment has been achieved and that inflation has risen to 2% and is on track to moderately exceed 2% for some time.

Clearly the inflation criteria have been met.

However, with employment still well below, and the unemployment rate higher than, its pre-pandemic level there is a way to go before the Fed is satisfied that maximum employment has been reached. Fed member projections suggest the majority view is that the maximum employment condition is likely to be reached when the unemployment rate is at 3.8% or lower. This can only be regarded as a rough benchmark given that the Fed will assess a range of indicators in assessing whether employment is at its maximum level.

With that caveat in mind, our forecasts have unemployment rate falling to 3.8% by end 2022 and

moving below this level in early 2023. This points to an earlier 2023 lift-off.

It is worth remembering that the motivation for the Fed seeking to get to a position where inflation is moderately above 2% was to make up for past inflation shortfall against the target and to make sure that inflation expectations were anchored at a level consistent with inflation of around 2% over time. With the recent elevated inflation readings, core PCE inflation has averaged 2.0% over the last six years, and only a little below over a longer window. Inflation expectations have also risen.

As a result, we are making a small change to our fed funds rate track, bringing forward our expectations of the first hike from Q2 2023 to Q1 2023. We still expect that, once lift-off occurs, rates will increase by 25bps a quarter.

There is a risk that rate hikes could come earlier if the unemployment rate continues to fall at its recent rapid rate. We expect to see a rebound in the labour participation rate which will slow progress down but it could be that the pandemic's impact on labour supply is greater or longer lasting than we anticipate.

Alternatively, as already noted, it is possible that the current elevated level of inflation is more persistent and that inflation expectations move even higher. If, as a result, the Fed started to expect that inflation was set to be sustained at a level more than 'moderately above' 2% then it may move on rates even ahead of 'maximum employment' being achieved.

Rate hikes could come later if some of the supply chain issues that have resulted in large price increases for some goods were to rapidly unwind at some point, leading to a series of weak inflation prints. If inflation does indeed settle in 2023 at a little above 2% (as we forecast) then concerns over elevated inflation will likely have receded. The Fed then may be tempted to see how far they can push down unemployment given its focus on ensuring strong labour market conditions not just in aggregate but for various labour market segments (including a reduction racial disparities).

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U.S. ECONOMIC & FINANCIAL FORECASTS

	2019	2020	2021	2022	2023	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	7.9	3.2	2.1	2.7	2.9	0.4	0.7	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4
Private fixed investment	3.2	-2.7	8.1	5.0	4.1	3.1	0.8	-0.2	1.8	1.6	1.3	1.1	1.1	1.0	0.9	0.9	0.8
Government spending	2.2	2.5	0.8	1.7	1.8	1.0	-0.5	0.2	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4	0.4
Inventories*	0.1	-0.6	-0.2	0.9	-0.1	-0.9	-0.4	0.5	0.5	0.4	0.1	0.0	0.0	-0.1	0.0	0.0	0.0
Net exports*	-0.2	-0.2	-1.8	-0.4	-0.1	-0.5	-0.1	-0.3	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	2.3	-3.4	5.5	3.8	2.2	1.5	1.6	0.5	1.2	1.1	0.9	0.7	0.6	0.4	0.5	0.5	0.5
<i>Note: GDP (annualised rate)</i>						6.3	6.7	2.0	4.9	4.4	3.5	2.8	2.3	1.8	1.9	1.9	1.9
US Other Key Indicators	Dec/Dec % change																
PCE deflator-headline	Dec/Dec % change																
Headline	1.5	1.2	4.8	1.9	1.9	0.9	1.6	1.3	0.9	0.6	0.5	0.5	0.4	0.4	0.5	0.5	0.5
Core	1.6	1.4	4.1	2.2	2.2	0.7	1.5	1.1	0.8	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
End of period																	
Unemployment rate - qtly average (%)	3.6	6.7	4.7	3.8	3.6	6.2	5.9	5.1	4.7	4.4	4.2	4.0	3.8	3.7	3.6	3.6	3.6
US Key Interest Rates	End of period																
Fed funds rate (top of target range)	1.75	0.25	0.25	0.25	1.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25

Source: NAB Group Economics

*Contribution to real GDP growth

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