US ECONOMIC UPDATE 4 OCTOBER 2021

THE FED IS SET TO TAPER – BUT RATE HIKES ARE STILL A WAY OFF

NAB Group Economics

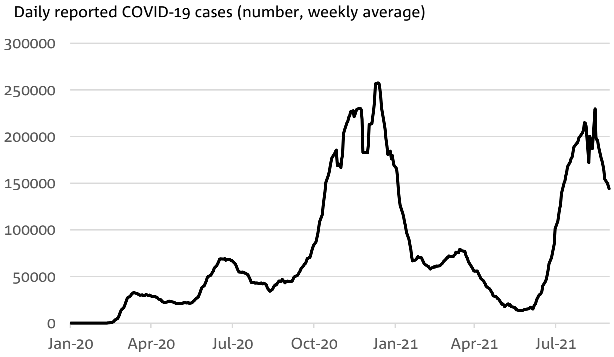
We have downgraded our forecast for 2021 and 2022 GDP growth as Q3 GDP is not looking as strong as had been expected. Supply disruptions – both in product and labour markets – remain major issues. We expect the Fed will start tapering its monthly asset purchase program in November, with it to come to an end by mid-2022. We still don't see any rate hikes until Q2-2023.

Incoming data for Q3 continue to be mixed. While pointing to solid growth for the quarter, expectations (including ours) for another quarter of very strong growth have been unwound.

Consumption growth has clearly moderated since the fiscal stimulus induced spike in March this year. In August, consumption rose 0.4% m/m but there was a large downward revision to the July estimate, leaving the monthly average level of consumption over these two months similar to that seen in Q2. This likely reflects an easing in household income (as stimulus measures unwound), the impact of high inflation on real spending power, and supply issues (which, for example, have contributed to a large fall in motor vehicle sales).

Another headwind was the summer COVID wave. The recovery in services, which require a high degree of in-person activity, such as food services (restaurants, cafes), accommodation and public transport, has slowed in recent months.

Any COVID-19 headwind likely fading (for now)

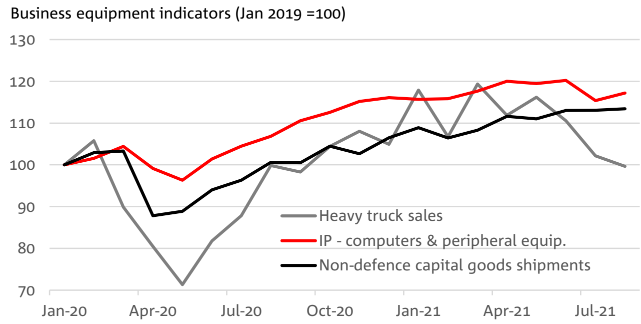


Source: Refinitiv

However, new case numbers have fallen over September which will be a positive for Q4. Savings rates remain high, household balance sheets are in good condition and households also accumulated a stockpile of savings over the COVID period. With jobs growth also likely to be strong in the near term, we expect some strengthening in consumption growth in coming quarters.

We now expect a soft outcome in Q3 for business fixed investment growth, although we anticipate there will be a rebound in Q4 and into next year. Non-residential structures investment (outside of mining) remains a drag and supply disruptions appear to be an issue as well. Heavy truck sales have fallen sharply in recent months, likely reflecting auto manufacturing issues, and supply constraints may also be behind the recent fall off in computer and peripheral equipment production. However, businesses capex plans (based on regional Fed surveys) remaining elevated and continuing growth in capital goods shipments and orders suggest a more positive outlook beyond Q3.

Supply issues holding back business investment?

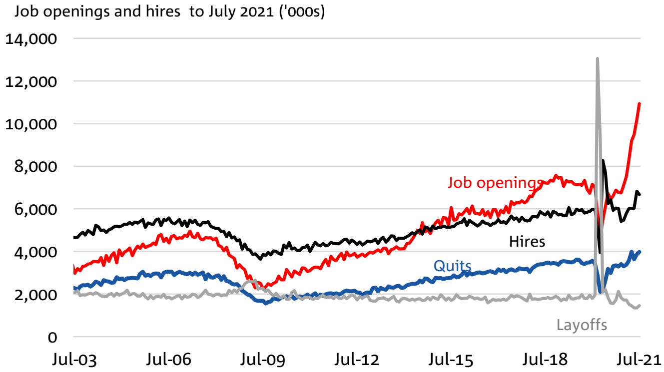


Source: NAB, BEA, Federal Reserve, Census Bureau, Refinitiv

Continuing supply disruptions (both in the US and abroad) will also impact the ability of businesses to rebuild inventories from their current low levels. We have moderated our expectation of the inventory contribution to Q3 GDP growth, pushing some of it into the following two quarters. That said, there remains a high degree of uncertainty about the timing and speed at which supply issues, as well as inventories, will be addressed.

Supply issues are not just occurring in product markets but are also evident in the labour market. Businesses report difficulties in finding labour and this is reflected in a growing discrepancy between job openings and new hires.

Employers finding it difficult to fill positions



Sources: BLS, NAB

However, demand factors also continue to play a role in the labour market. There was a disappointing increase in non-farm employment in August of 235,000 (the lowest monthly increase since January and down from 1 million in July). The major shift down (from the July pace) was in leisure and hospitality (where COVID may have stalled new hires) and public education, which continues to suffer on-going disruption.

Indicators for residential investment are also mixed. Sales activity has rebounded somewhat, but new construction spending fell in August. Coupled with the fall in building permits seen this year, this suggests that the strong growth in new construction spending since mid-2020 is drawing to an end.

Reflecting these factors, we have marked down our expectation for Q3 GDP to 3.7% q/q annualised (from 6.5% q/q). As a result, we now expect GDP growth of 5.7% in 2021 (6.0%) previously, 3.9% in 2022 (previously 4.1%) while the forecast for 2023 is unchanged at 2.1%

The main risks – upside and downside – around this outlook remain broadly unchanged.

There is considerable uncertainty around how long supply chain disruptions will act as a headwind to the recovery. COVID-19 is also likely to remains a disruptive factor as the US vaccination rate is not particularly high by advanced economy standards, and there is a risk of another winter wave.

Fiscal policy currently poses downside and upside risks. On the downside, there are near term risks around a government shutdown and, less likely but potentially far more consequentially, that Congress fails to raise (or suspend) the debt ceiling in time. The immediate threat of a shutdown was averted last week by a continuing resolution which extended funding to 3 December. However, it did not address the debt ceiling; the Treasury Secretary has stated this may become a binding constraint by 18 October, although the Congressional Budget Office thinks late October/early November is more likely.

On the upside, Congress is also considering a $1 trillion infrastructure bill (but less than half is new money) and a separate and potentially much larger spending bill (within the range of $1.5 to 3.5 trillion). However, these bills also contain revenue offsets (spread out over 10 years) which means the net stimulus will be smaller.

Congressional debate around the spending bills, government funding and the debt ceiling is intertwined, meaning there is a risk of something go wrong as legislators wait for someone else to blink. With a Democrat President, and Democrat control of both the House of Representatives and Senate, it is difficult to conceive that there could be anything other than a very brief Government shutdown and that the debt ceiling will be addressed in-time.

Monetary policy – tapering to start soon

The Fed is very likely to decide to start 'tapering' its monthly asset purchase programme at its November meeting.

The Fed currently purchases around $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities (MBS) each month. Tapering is the reduction of these monthly purchases over time in a series of steps.

The Fed's criteria for tapering has been that 'substantial progress' be made towards its maximum employment and inflation goals. Its September meeting statement said that if progress towards these goals 'continues broadly as expected' then a reduction in the monthly purchase amount 'may soon be warranted'. The Fed Chair, in his press conference, was even clearer, stating that the substantial progress test has already been met for inflation and all but met for employment. He indicated that it would not need a very strong September jobs report for it to go from 'all but met' to 'met'.

While there is a risk that the next employment report will again be soft, we expect to see a solid (if not better) outcome, which would mean a November taper start. The other caveat worth noting would be if some of the fiscal risks noted above (shutdown/debt ceiling) were seen as being in play (or had been realised) then this might cause the Fed to delay.

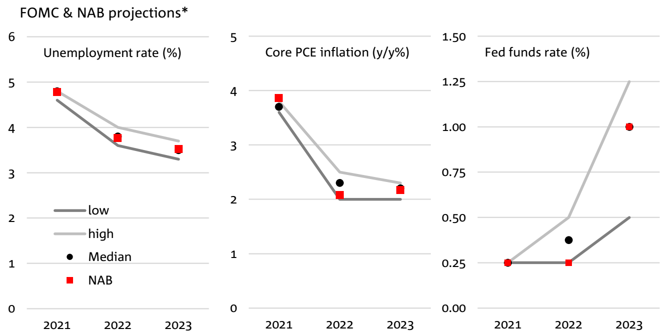
The Fed Chair also indicated that a gradual tapering that finishes around the middle of next year is likely to be appropriate. This points to a monthly reduction in the size of the asset purchases of around $15b per month ($10b Treasuries, $5b MBS).

The Fed's criteria for lifting the fed funds rate is a higher bar than it is for tapering. The Fed has indicated that the target range will remain unchanged until maximum employment has been achieved and inflation has risen to 2% and is on track to moderately exceed 2% for some time.

While imperfect, the Fed member projections – which were updated at the September meeting – provide a guide to what level indicators such as the unemployment rate and core PCE inflation will need to be at for the Fed to consider these criteria to have been met.

For 2022, the eighteen Fed members were evenly split as to whether the fed funds rate should be unchanged or increased, with a median projection of the unemployment rate of 3.8% and core PCE inflation of 2.3y/y%. Even though the median projection of PCE inflation eased marginally in 2023, with the unemployment rate projected to fall further, rate hikes were projected for that year.

FOMC and NAB projections broadly similar



* Low/high FOMC range based on central tendency. FOMC Fed funds rate projections adjust to show top of target range.

While other indicators will also be considered in assessing whether maximum employment has been achieved, this broadly suggests that when the unemployment rate falls to 3.8% or a bit lower, and (core) inflation is around 2.2% y/y, then the conditions for lift-off will likely have been met.

Our current projections for these variables are not significantly different to those of the Fed. As a result, we see no need to change our view that the first fed funds rate increase (of 0.25bps) will occur in Q2 2023, with 25bp hikes in each of the following two quarters. This would result in a fed funds target range of 0.75 to 1.00% by end 2023. However, if anything, the risk is that rate increases start a bit earlier than we expect if our inflation and unemployment forecasts were realised.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	2019	2020	2021	2022	2023	2021 Q1	Q2	Q3	Q4	2022 Q1	Q2	Q3	Q4	2023 Q1	Q2	Q3	Q4
	Year Average Chng %					Quarterly Chng %											
US GDP and Components																	
Household consumption	2.2	-3.8	7.8	3.3	2.1	2.7	2.9	0.1	0.9	0.8	0.7	0.7	0.6	0.5	0.4	0.4	0.4
Private fixed investment	3.2	-2.7	8.3	5.3	4.0	3.1	0.8	0.2	2.0	1.7	1.3	1.1	1.0	1.0	0.9	0.9	0.8
Government spending	2.2	2.5	0.8	1.9	1.8	1.0	-0.5	0.3	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.4	0.4
Inventories*	0.1	-0.6	0.0	0.8	-0.2	-0.9	-0.4	0.8	0.4	0.3	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0
Net exports*	-0.2	-0.2	-1.7	-0.3	-0.1	-0.5	-0.1	-0.1	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.3**	**-3.4**	**5.7**	**3.9**	**2.1**	**1.5**	**1.6**	**0.9**	**1.3**	**1.1**	**0.8**	**0.6**	**0.5**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*6.3*	*6.7*	*3.7*	*5.1*	*4.4*	*3.1*	*2.5*	*2.0*	*2.2*	*2.0*	*1.8*	*1.8*
US Other Key Indicators																	
PCE deflator-headline	Dec/Dec % change																
Headline	1.5	1.2	4.5	2.0	2.1	0.9	1.6	1.3	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.5
Core	1.6	1.4	3.9	2.1	2.2	0.7	1.5	1.1	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.5
	End of period																
Unemployment rate - qtly average (%)	3.6	6.7	4.8	3.8	3.5	6.2	5.9	5.2	4.8	4.5	4.1	3.9	3.8	3.7	3.6	3.6	3.5
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

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