US ECONOMIC UPDATE DECEMBER 2021
Q4 GDP LOOKING STRONG; FED TURNING MORE HAWKISH

NAB Group Economics

Expectations for Q4 GDP growth revised up on the back of very strong October data. The unemployment rate and other labour market indicators point to an increasingly tight labour market, while inflation remains elevated. A broadening out of inflation pressures has contributed to a hawkish turn by the Fed; we now expect the Fed to announce a faster taper at its December meeting and to start lifting the fed funds rate from Q2 2022.

Q4 GDP – looking strong

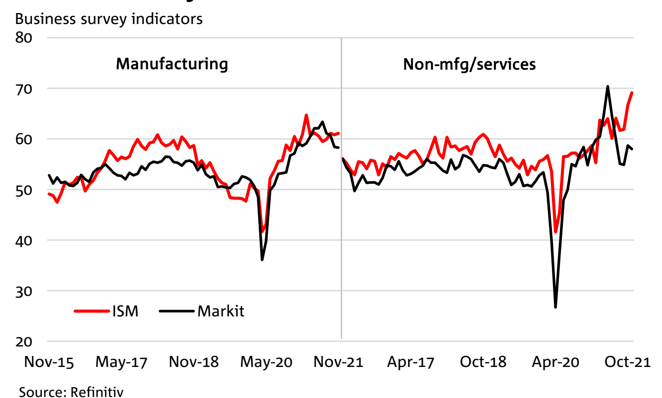
Data early in Q4 suggest GDP growth will be very strong in the quarter. In particular, October household consumption increased 0.7% m/m and real goods exports increased over 9.0% m/m. With goods imports down in the same month this points to a large net trade contribution.

At the same time, core capital goods orders continue to rise while some of the headwinds that held back total equipment investment in Q3 look to have faded. House sales have continued their recent recovery and while residential construction expenditure again fell in October, building permits (a leading indicator) have stabilised recently.

Business surveys point to continued momentum in November 2021. This is despite a rise in the number of new COVID cases in the second half of November and the risk that this may trigger a more cautious approach to in-person activity. The Omicron variant is an additional source of risk, but until there is more clarity around how more transmissible it is, its virulence and how effective existing vaccines are against it, it is hard to assess the degree of risk. At this stage, mobility indicators do not point to any large, obvious, change in household behaviour.

Coupled together with our expectation that inventories will make a strong contribution to growth in the quarter, these developments have led us to revise up our Q4 forecast to 1.7% q/q or 7.1% annualised (previously 1.2% q/q). If anything, there is upside risk to this new forecast – the Atlanta Fed's GDP tracking estimate is at 8.6% q/q annualised, but we expect some of the October strength – particularly in the volatile trade data will be reversed over the rest of the quarter.

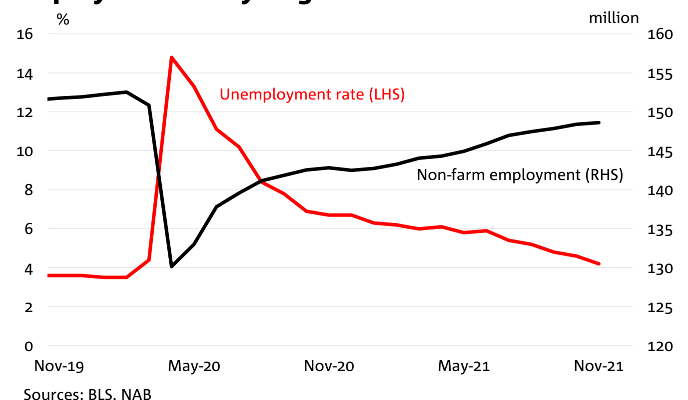
Business surveys remain robust



Source: Refinitiv

There were mixed signals from November labour market data but the large fall in the unemployment rate adds to the evidence of a tight labour market. A disappointment was non-farm jobs which only increased by 210,000, the weakest result since end 2020. However, there was a welcome (albeit modest) rise in the participation rate and, due to a large increase in the household survey measure of employment, the unemployment rate fell 0.4 pts to 4.2%.

Unemployment closing on pre-COVID level, employment a way to go



Sources: BLS, NAB

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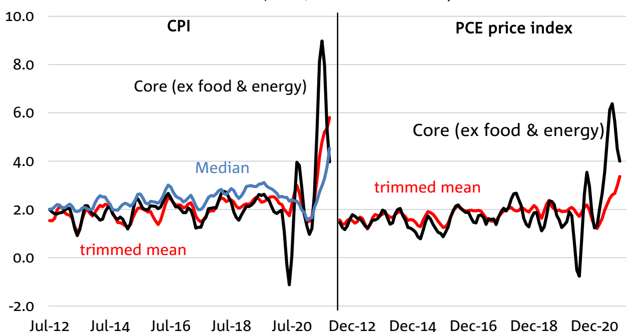
The unemployment rate has fallen by 1.0ppts over the last 3 months. While we don't expect it to continue declining at this pace, the recent steep fall means that the pre-COVID unemployment rate of 3.5% – which was a multi-decade low at the time – is now within sight. While non-farm employment remains almost 4 million below its pre-pandemic level, jobs are plentiful and it is the supply of labour that is holding back employment growth more than demand.

On inflation, monthly growth in the core (ex. energy and food) CPI and PCE measures jumped higher in October although they remained below their peak growth rates seen earlier in the year. In contrast, the trimmed mean measures have clearly lifted in recent months, signalling a broadening out in inflation pressures. Concerns around the Omicron variant saw a large fall in oil prices, which will rein in headline inflation measures in the short-term; however, if Omicron concerns are realised experience suggests that due to flow-on impacts on global supply chains (and a switch to goods demand), the end result can be inflationary.

Trimmed mean inflation indicators rising – signalling a broadening out in inflation



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

Rising wage costs (in the absence of matching productivity gains) are one factor that could contribute to broader inflation pressures. As we noted last month there was a striking increase in the Employment Cost Index (ECI) in Q3 2021 (1.3% q/q). In contrast, the hourly average earning series has moderated over the last couple of months; the 0.3% m/m growth in November was the weakest growth rate since March. That said, this measure is affected by compositional changes in employment so does not provide a clean guide as to what is happening to wages, and the tight labour market should support wage growth.

Monetary policy implications

Fed rhetoric has turned more hawkish of late. This was highlighted by the Fed Chair's recent congressional testimony. In particular, the Chair:

- Appeared to indicate that the first part of the Fed's criteria for raising the fed funds rate (inflation has risen to 2%) has been met.
- Acknowledged that price pressures had broadened out and that the risk of higher inflation had increased.
- Said that it was appropriate to consider, at the December meeting, speeding up the QE taper so that the program ends a few months earlier.

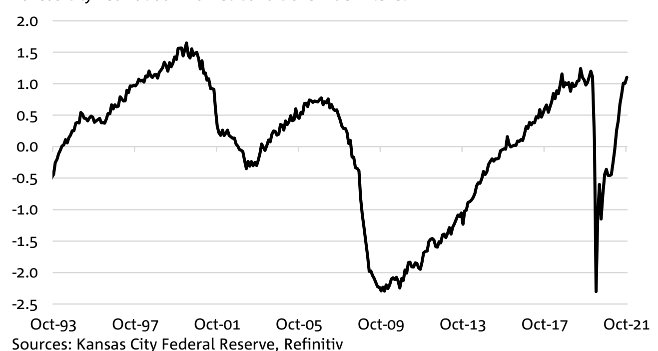
In line with this latter comment, we now expect the Fed to announce a faster taper of its QE at next week's FOMC meeting (to take effect in January). Until recently, the Fed had been purchasing around $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities (MBS) each month ('QE'). At its November meeting, it decided that each month it would reduce these purchases by $10 billion for Treasury securities and $5 billion for MBS. We now expect that from January the Fed will reduce Treasury security purchases and MBS by $20b and $10b per month respectively. This revised pace would see QE end in March.

Given the Fed's clear preference for not lifting the fed funds rate while undertaking asset purchases, this opens up the possibility of earlier rate hikes.

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.

In our view – and now the Fed Chair's – the first of the inflation criteria have already been met. While we also expect inflation to moderate over 2022, it is likely to remain above 2% – consistent with the broadening out in inflation pressures seen recently, stronger wage growth and an increasingly tight labour market.

When will Fed declare 'full employment?'



Sources: Kansas City Federal Reserve, Refinitiv

The last criterion for a rate increase is achievement of full employment. The Fed has stated that it will consider a wide range of indicators in assessing what constitutes maximum employment. The Labor Market Conditions Index (LMCI) produced by the Kansas City Fed distils over 20 labour market indicators into a single measure of the level of activity (there is also a 'momentum' index). It suggests that the labour market in October was operating at a level around

that seen pre-pandemic, which was regarded as being a time where the market was very healthy.

Given the ambiguity around what full employment means in practice, the Fed has wide discretion around how strong various indicators need to be before declaring it has been achieved.

While the LCMI is a useful tool, we doubt the Fed would declare 'full employment' while the two key labour market indicators – the unemployment rate the level of non-farm employment – were still well away from their pre-pandemic level. However, the rapid fall in the unemployment rate means that it will fall below 4% in the near future. As we have noted previously, in the September meeting Fed member projections, an unemployment rate of 3.8% or lower appears to be the point at which a majority of Fed members will consider a rate rise. This can of course change, particularly given the still large shortfall in the level of employment (and participation rate) – and updated projections next week will provide an update on the Fed's 'reaction function'.

However, the upside risks to inflation suggest to us that the Fed will not push for an ambitious definition of full employment. Interestingly, in his Senate testimony, in talking about getting the participation rate (and when improvement can be expected), the Chair noted "…in a sense, the risk of persistent high inflation is also a major risk to getting back to such a labor market." While not spelt out, this indicates the Fed is conscious that getting behind on the inflation front – and the rapid rate rises that it would need to bring it under control – is also a threat to its full employment objective.

As a result, we expect that the Fed will now start to raise the Fed funds rate in Q2 2022 (previously Q3 2022). As we still expect inflation to moderate over 2022 this will allow the pace of subsequent Fed moves to be relatively moderate – one a quarter – as it attempts to bring back rates closer to their neutral level. What neutral is – and whether the Fed will need to go above neutral in order to eventually pull inflation down to target – is an open question. Fed member's median projection of the long run level of the fed funds rate was 2.5% in September. Market rate expectations imply something lower, although anything below 2% implies a real rate less than zero and is below estimates of the neutral rate before the pandemic.

A key risk around this revised rate call remains – as always – incoming data. If inflation remains elevated, and there are big employment gains in coming months, then the Fed could move even earlier. If inflation expectations increase to levels the Fed is not comfortable with or inflation does not moderate as much as expected over 2022, the Fed may increase rates more quickly. If the Build Back Better bill was also to pass the Senate – adding extra stimulus to the economy, then the Fed may feel it needs to increase rates at a faster pace.

Alternatively, if labour force participation were to lift, constraining the fall in the unemployment rate, and inflation and supply chain pressures moderate more quickly than expected, the Fed could delay or pause rate hikes. In particular, if some of the good and services for which there have been large run ups in prices – such as autos – were to unwind to a large degree there is a chance inflation could fall below a 2% pace for a time. If it emerges that the Omicron variant has a combination of transmissibility, virulency and vaccine escape that materially raises public health risks, triggering a more stringent policy response, then this may cause the Fed to pause as it awaits to see the fall-out.

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	8.0	3.4	1.9	2.7	2.9	0.4	**1.4**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.4**	**0.4**	**0.4**
Private fixed investment	3.2	-2.7	7.8	4.4	4.2	3.1	0.8	-0.3	**1.0**	**1.5**	**1.4**	**1.3**	**1.1**	**1.0**	**0.9**	**0.9**	**0.9**
Government spending	2.2	2.5	0.7	1.2	1.8	1.0	-0.5	0.2	**0.1**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	-0.6	-0.1	0.9	-0.1	-0.9	-0.4	0.5	**0.7**	**0.2**	**0.1**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.2	-1.8	-0.4	-0.1	-0.5	-0.1	-0.3	**0.0**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.3**	**-3.4**	**5.7**	**3.8**	**2.1**	**1.5**	**1.6**	**0.5**	**1.7**	**0.8**	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.4**
Note: GDP (annualised rate)						*6.3*	*6.7*	*2.1*	*7.1*	*3.1*	*2.9*	*2.5*	*2.0*	*2.0*	*1.8*	*1.9*	*1.8*
US Other Key Indicators																	
PCE deflator-headline	Dec/Dec % change																
Headline	1.5	1.2	5.0	2.3	2.0	0.9	1.6	1.3	**1.1**	**0.8**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.6	1.4	4.4	2.5	2.2	0.7	1.5	1.1	**1.1**	**0.8**	**0.6**	**0.6**	**0.5**	**0.6**	**0.5**	**0.6**	**0.6**
	End of period																
Unemployment rate - qtly average (%)	**3.6**	**6.7**	**4.3**	**3.4**	**3.3**	**6.2**	**5.9**	**5.1**	**4.3**	**3.9**	**3.6**	**3.5**	**3.4**	**3.4**	**3.3**	**3.3**	**3.3**
US Key Interest Rates	End of period																
Fed funds rate (top of target range)	**1.75**	**0.25**	**0.25**	**1.00**	**2.00**	**0.25**	**0.25**	**0.25**	**0.25**	0.25	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**1.75**	**2.00**

Source: NAB Group Economics

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

Brody Viney
Senior Economist
+(61 0) 452 673 400

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

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