US ECONOMIC UPDATE JANUARY 2022

FED POLICY TIGHTENING BROUGHT FORWARD

NAB Group Economics

Q4 GDP growth expectations have lowered but still look robust. The current COVID-19 wave is likely to lead to a soft start to 2022 but demand for labour remains high and the unemployment rate continues to fall rapidly. As a result, we now expect the Fed to start lifting the fed funds rate at its March meeting. We also expect the Fed to announce the end of its asset purchases at the January meeting with an unwinding of its balance sheet ("QT") likely to start towards the end of 2022.

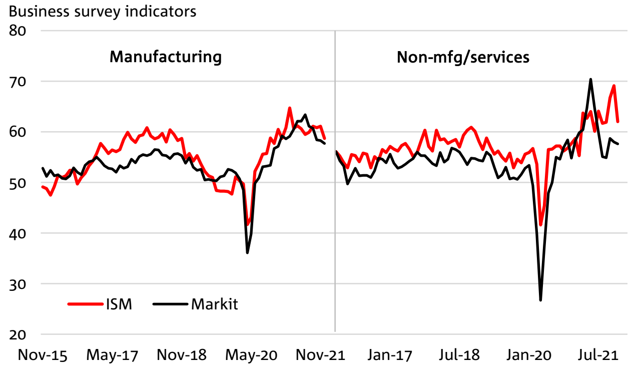
Q4 strong/Omicron temporary drag in Q1

Expectations for very strong GDP growth in Q4 have been wound back following some recent weak partial data. In particular, there was a large fall in December retail sales (-1.9% m/m) as well as a downward revision to the prior month. Industrial production also fell slightly in December, while November trade data pointed to a weaker net export contribution.

Even so, we still expect robust growth in Q4 (5.8% q/q, annualised). Despite the December fall, retail sales growth strengthened in quarterly terms, indicators of business investment generally remain positive and residential investment indicators improved in the quarter. Inventory accumulation is expected to make a large contribution to growth in the quarter.

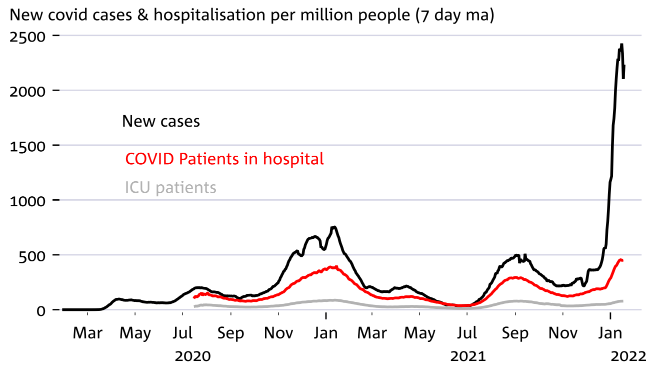
Similarly, business survey readings were solid in December, even if they have come-off their peaks. Moreover, there were welcome signs that supply chain disruptions were starting to ameliorate.

Business surveys still consistent with solid growth



Source: Refinitiv

US in midst of another COVID wave



Source: National Australia Bank, Our World in Data

However, the survey readings are yet to reflect the full impact of the latest wave of COVID-19 spreading in the US and in other countries. It began in early December as a Delta wave and accelerated in January, as Omicron became more prevalent. Consistent with overseas experience, it looks like being a relatively short and sharp wave and cases already appear to have peaked.

Nevertheless, while there has been no significant reintroduction of restrictions, high frequency data point to some impact on consumer activity. Further, the sheer number of cases – and associated isolation requirements – is disrupting businesses. This is occurring in an environment where new staff were already difficult to find. With Omicron also making its way through other countries, there is a risk externally sourced supply issues may also re-intensify.

As a result, we have also pared back our expectations for Q1 GDP but lifted Q2 and Q3 expectations to include some rebound.

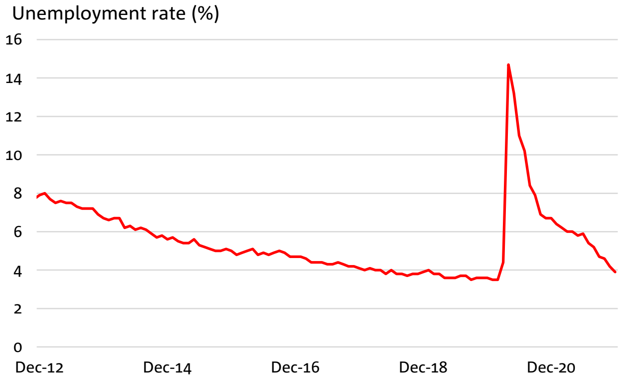
We now expect GDP growth of 5.6% in 2021 (previously 5.7%), 3.4% in 2022 (was 3.8%) and 2.2% in 2023 (was 2.1%).

Date: January 2022 | Author Tony Kelly – Senior Economist

As with activity indicators, the gain in non-farm employment in December of just under 200,000 also disappointed. It was the weakest result over 2021 and followed a soft November.

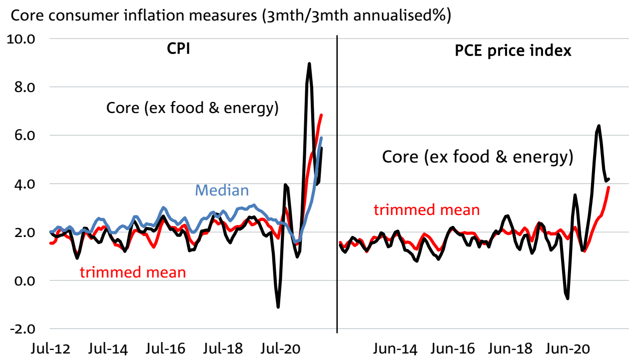
The weakness in employment growth appears to more reflect labour supply issues than any weakness in demand. While the workforce participation rate is edging up, it is recovering only slowly. Job vacancies remain elevated, as does average hourly wage growth, and the unemployment rate again fell significantly in December – down a further 0.3ppts. Over the last six months it has fallen by one percentage point. It points to a very tight labour market even with employment well below its pre-COVID level.

Unemployment rate continues to fall rapidly…



Sources: BLS, NBER, NAB. Shaded areas represent recession periods.

…while inflation remains high



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

At the same time annual CPI inflation, at 7.0% y/y in December, moved to its highest level since the early 1980s. While the monthly growth rate eased, due to a fall in energy costs, the core (ex food and energy measure) was on par with recent months at 0.6% m/m, and a range of different measures of underlying inflation also remain high.

We continue to expect inflation will moderate from its current levels as some of the COVID-19 related supply disruptions (including to labour markets) unwind, although the recent Omicron wave highlights the difficulty in forecasting exactly when this will occur. There is a risk that the uplift in underlying inflation measures, as well as wages growth, foreshadows a higher, sustained level of inflation in the future than we expect, so risks to inflation remain tilted to the upside.

Monetary policy implications

With the inflation criteria for the Fed to start rate hikes already met, the remaining question has been when the Fed's 'maximum employment' criteria would be met.

While employment growth has disappointed in the last few months, other indicators are pointing to an increasingly tight labour market. The unemployment rate in December was below that implied by Fed members median Q4 2021 forecast from the December meeting (as it was for our December 2021 Update forecast). Moreover, continued strong inflation (and wage) prints – and growing attention to upside inflation risks – suggest that the Fed will not take an ambitious approach to defining what constitutes 'maximum employment'.

We have previously noted that an unemployment rate a bit below 4% appears to be a rough guide as to what Fed members consider to be an appropriate point at which to start raising rates. With the unemployment rate already at 3.9% and likely to fall over coming months, this implies the start of the rate hiking cycle is imminent. Indeed, recent comments from a range of Fed members indicate that they are at least open to considering, if not already advocating for, a rate hike in March.

Accordingly, we now expect the Fed to increase the target range of the funds rate by 25 bps at its March meeting. Once tightening starts, we expect the Fed will lift rates by 25 bps a quarter through to the end of the forecast period (end 2023). This reflects our expectation that the unemployment rate will remain clearly below 4% and inflation above the 2% target (even if moderating) over this period and so the Fed will want to return the fed funds rate to what it considers neutral (around 2.5%), if not be forced ultimately to move to an even tighter policy stance.

There is considerable uncertainty around any estimate of the neutral level of the fed funds rate. This is one reason for adjusting rates at a relatively slow pace although if done in conjunction with a run-off of the balance sheet changes in rates alone will understate the degree of tightening taking place.

The December meeting minutes also indicated that the Fed has started to discuss when and how it might reduce the size of its balance sheet (quantitative tightening or "QT"). QT is a form of policy tightening which can tighten financial conditions through reducing liquidity or by raising longer-dated yields through an increase in the term premium. Given liquidity is ample right now, any initial impact should occur through yields.

The meeting minutes indicate that most Fed members consider that QT should occur sometime after the first rate rise but that, compared to the last episode, it should happen sooner after lift-off.

The latter is not saying much, as after the Fed funds rate was lifted in December 2015 there was a one year delay before the next rate hike. Nevertheless, comments from Fed speakers also suggest they are open to starting QT at a lower fed funds rate than they did back in 2017 (when QT started with a target range of 1 to 1.25%).

As with the 2017 QT, the favoured approach appears to be to allow the balance sheet to run-down by only reinvesting principal payments if they exceed specified monthly caps.

Back in October 2017, QT started with monthly caps on the amount of balance sheet run-off of $10b ($6b Treasuries/$4b MBS) which increased over a twelve-month period to $50b ($30b Treasuries, $20b MBS). However, the Fed's balance sheet is much larger now both in absolute terms (see charts below) but also as a proportion of GDP. Moreover, as the December minutes note, the economic backdrop is very different with unemployment much lower and inflation significantly higher.

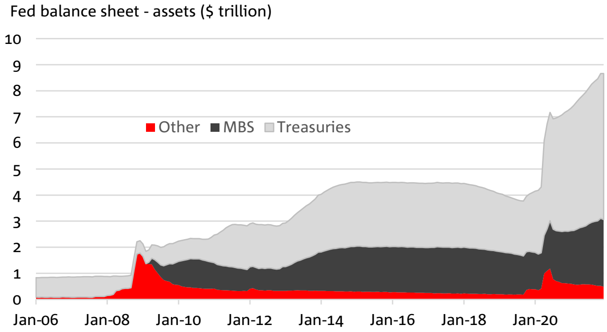
Therefore, it is likely that the pace of QT will be faster than in 2017, something acknowledged in the minutes. As before, the monthly cap may start at a lower level initially and be increased over time but we expect it will ultimately be $100b with a split of $60-$70b for Treasuries and $30-$40b for MBS. A $70/$30b split would be similar to the previous QT episode adjusting for the change in the size of Treasuries/MBS relative to 2017, but some Fed officials would prefer that the Fed's asset holdings were primarily Treasury securities (which would argue for a faster MBS run-off).

While there is considerable uncertainty, some past research suggests that QT at this pace for a full year would be roughly equivalent to around 40-50bps of rate hikes.

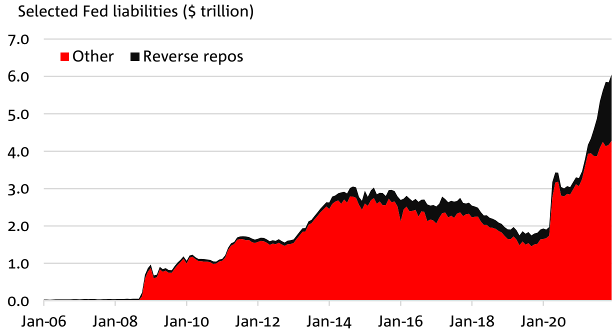
With the Fed yet to decide on the details of how the balance sheet run-off will work – which could take several more meetings – and given that it is likely to wait until the rates has been increased at least a couple of times, we suspect that the most likely timing is for QT to be announced in Q3 and commence in Q4.

To what extent the balance sheet will have been wound back by the time QT is completed is unclear. Last time there were problems in financial markets when reserves fell below $1.5 trillion, which would suggest (particularly given the expansion in the economy since then) that reserves this time around would end up well above this level. However, the Fed's relatively new standing repo facility may also affect the level of reserves needed with some Fed members considering it may lower the required level. Given these uncertainties the Fed is unlikely to specify an end date for QT (or a target level of reserves), although given the current level of reserves, and a (maximum) $100b per month run-off pace, QT will likely continue into 2024.

Fed balance sheet larger than prior to previous QT



Sources: Refinitiv, NAB



Sources: Refinitiv, NAB

While the Fed started contemplating QT in December, it was still engaged in QE. On current settings, asset purchases will continue into February (and end in March). However, easing policy as it is considering bringing forward policy tightening to March makes little sense. As a result, we expect at its January meeting that QE will end effective immediately.

Back in 2017, in the quarter the Fed announced QT it did not hike rates (in contrast to quarterly increases prior to, and after, that quarter). We do not expect a pause this time around given the different economic backdrop, but it is a possibility. A weakening in the economy or a faster easing in inflation pressures than we forecast could also see a slower pace of policy tightening.

Conversely, if inflation does not ease as expected over 2022 – or inflation (and wage) expectations move higher, raising inflation risks further – then the Fed may well accelerate the pace of policy tightening given how far inflation is from target and that policy settings (fed funds rate and balance sheet) are well below their neutral level.

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U.S. ECONOMIC & FINANCIAL FORECASTS

						Quarterly Chng %									
						2021		2022				2023			
	2019	2020	2021	2022	2023	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	Year Average Chng %														
Household consumption	2.2	-3.8	7.9	3.1	2.1	0.5	**0.8**	**0.4**	**0.8**	**0.7**	**0.5**	**0.5**	**0.4**	**0.4**	**0.4**
Private fixed investment	3.2	-2.7	7.8	4.2	4.2	-0.2	**0.7**	**1.5**	**1.5**	**1.3**	**1.1**	**1.0**	**0.9**	**0.9**	**0.8**
Government spending	2.2	2.5	0.7	1.2	1.9	0.2	**0.1**	**0.3**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	-0.6	-0.1	0.8	-0.1	0.5	**0.9**	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.2	-1.8	-0.5	-0.1	-0.4	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.3**	**-3.4**	**5.6**	**3.4**	**2.2**	**0.6**	**1.4**	**0.4**	**0.9**	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.4**
Note: GDP (annualised rate)						*2.3*	*5.8*	*1.5*	*3.8*	*3.0*	*2.3*	*2.0*	*1.9*	*1.8*	*1.8*
US Other Key Indicators															
PCE deflator-headline	Dec/Dec % change														
Headline	1.5	1.2	5.5	2.7	2.2	1.3	**1.6**	**1.0**	**0.6**	**0.6**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**
Core	1.6	1.4	4.5	3.0	2.3	1.1	**1.2**	**1.0**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**0.6**	**0.6**
	End of period														
Unemployment rate - qtly average (%)	3.6	6.8	4.2	3.3	3.2	5.1	4.2	3.7	3.5	3.4	3.3	3.3	3.3	3.3	3.2
US Key Interest Rates	End of period														
Fed funds rate (top of target range)	**1.75**	**0.25**	**0.25**	**1.25**	**2.25**	**0.25**	**0.25**	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**1.75**	**2.00**	**2.25**

Source: NAB Group Economics

*Contribution to real GDP growth

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