US ECONOMIC UPDATE MARCH 2022

FED LIFTS RATES – MORE TO COME

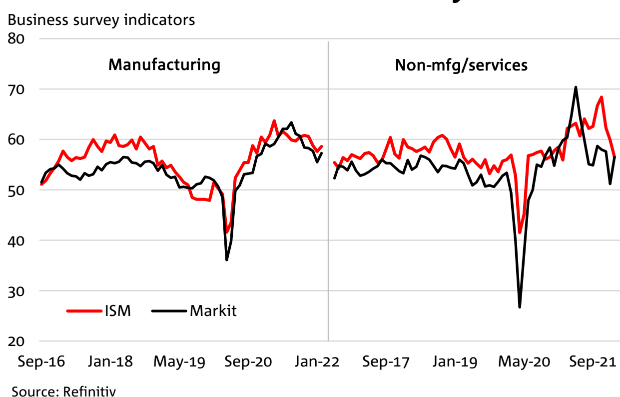
NAB Group Economics

The US economy continues to grow – employment is expanding rapidly, capex expectations are high and households are in a strong position to weather (temporary) storms. However, the economy will be tested by the Russian/Ukraine conflict and a more rapid than previously expected tightening of Fed monetary policy. We expect a further 150bps of Fed rates hikes over 2022 as well as the start of QT in Q2 2022.

The US economy is benefiting from the easing of the COVID-19 wave since it peaked in mid-January. While retail sales were down in February, after a very strong January, the food services category was up 2.5% m/m after falls in two previous months. This suggests that services consumption is likely to move higher, after a sluggish December/January.

Despite this, signals from the major business surveys in February for the services sector were conflicting, although they are both at levels consistent with ongoing expansion. The manufacturing PMIs also remain at a solid level. Manufacturing production picked up strongly in February after a couple of weak months. This was despite a large fall in in auto production which has now retraced around half of the late last year's rebound, suggesting supply disruptions remain a constraint.

Services indicators mixed in February

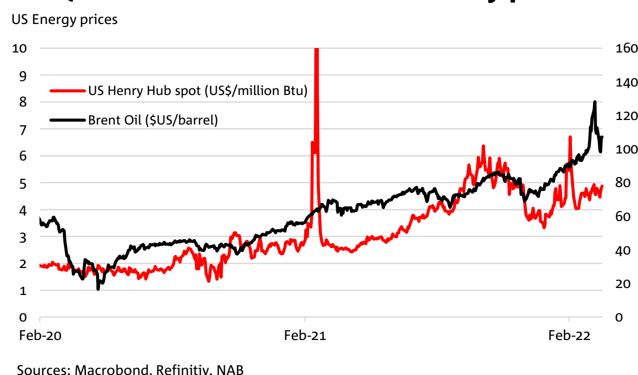


Source: Refinitiv

The conflict between Russia and Ukraine is a clear risk for the US economy. While direct financial linkages and trade are small – goods exports in 2021 to Russia were 0.03% of GDP in 2021 – the conflict is still likely to weigh on the economy.

This reflects the importance of the two countries in commodity markets, including energy (Oil & gas), agriculture (e.g. wheat) as well as metals (e.g. nickel, aluminium, palladium), fertilisers, and gases (e.g. neon). Reflecting this, there have been steep rises in a range of commodity prices, although the increase in US natural gas prices has been far less than seen in Europe and elsewhere.

Russia/Ukr. conflict has seen commodity prices rises



Sources: Macrobond, Refinitiv, NAB

Historically, oil price spikes have weighed on US growth (and preceded US recessions). However, there has been a big structural change over the last decade and the US is no longer a net energy importer. While there will clearly be losers from higher commodity prices, the net effect on the economy will be somewhat offset by gains to energy and other commodity producers. The fact that US natural gas prices have not increased as much as in other markets may also limit the fall out to some energy intensive sectors as their relative competitiveness with some overseas producers may have improved.

Nevertheless, the benefits will be highly concentrated in a few regions and sectors, and any new capex may take time to put in place. Moreover, the considerable uncertainty about the extent and duration of the conflict means the outlook for prices is unclear which may discourage investment.

Date: 24 March 2022 | Author Tony Kelly – Senior Economist
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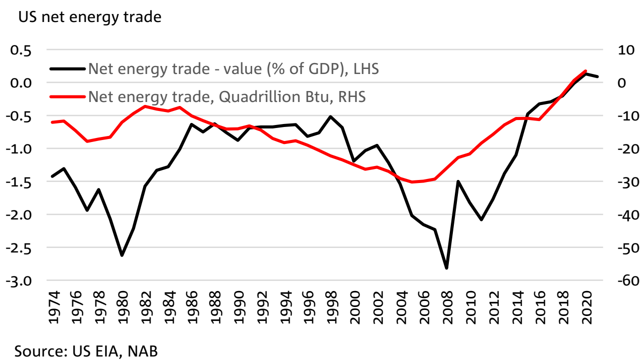
US no longer a net energy importer

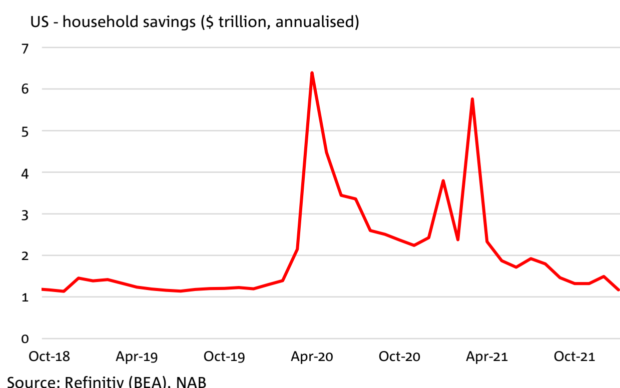


Source: US EIA, NAB

In contrast, the impact on the 'losers', most notably households, will be felt quickly. We have lifted our forecast for headline PCE inflation in 2022 by around 1ppt and lowered our expectation for real consumption growth but to a smaller degree.

We expect that households will absorb part of the higher prices through reduced savings. During the pandemic period, households accumulated savings well above any previous level (helped by substantial government payments). Faced with high inflation as well as a withdrawal of fiscal support from Q2 2021 consumption has still risen at a solid pace, as households have reduced their savings rate which is now a little below its pre-COVID-19 level. As a result, with household balance sheets in a strong position (even with recent equity market falls), the household sector is in a position where it can absorb the higher costs rather than cutting back on planned spending. The risk is that they take a more cautious approach; a risk highlighted by falls consumer confidence.

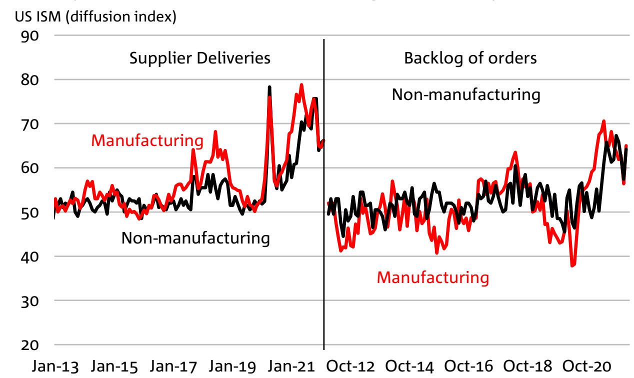
Households have built up savings



Source: Refinitiv (BEA), NAB

The change in our inflation forecasts also reflects an allowance for supply chain bottlenecks persisting for longer. For example, Russia/Ukraine are major exporters of neon which is used in semi-conductor production, itself an important part of many products (autos, household consumer goods). At the same time, rising COVID numbers in China have seen some cities go into lockdown. Business surveys suggest that, prior to these events, that supply pressures had eased – but only somewhat, with recent events suggesting some recent progress may be lost.

Supply bottlenecks have not gone away



The Russia/Ukraine conflict can also affect activity through its effect on business/consumer confidence, as well as financial channels. The ultimate impact will depend on the duration and extent of the war and associated sanctions on Russia – all of which is highly uncertain. This can be seen in the wild swings in commodity prices (but centred around high levels).

COVID-19 also remains a risk; case number are again increasing in Europe and there is a risk that the US will follow suit.

Monetary policy is also becoming less supportive. We now expect a faster pace of policy tightening than before (discussed further below). This change is already evident in mortgage rates which are up almost 1ppt since the start of the year which will act to constrain dwelling investment (although still rapidly growing house prices, low vacancy rates and a strong labour market will limit the fallout).

That said, there are a number of factors that will help sustain the US expansion. Capacity constraints should act as a spur to business investment and indeed surveys of capex intentions remain robust. Businesses also need to rebuild low inventory levels.

The continued recovery in the labour market will provide support to household incomes. Despite the volatility in the activity measures, monthly non-farm employment growth has been in the 400-700k range each month since May last year. This represents an annualised growth rate of 4.9%. Job openings remain exceptionally high, suggesting labour demand will also remain strong as long as labour force participation continues to recover.

Reflecting these factors, we have lowered our GDP forecasts to 3.2% in 2022 (3.5% in our February update) and 2.1% in 2023 (was 2.2%).

These growth rates are still above trend (although quarterly GDP growth in H2 2023 is around its trend rate). As a result, the unemployment rate is expected to stay at a low level out to end 2023 even allowing for a gradual recovery in workforce participation.

As already noted, we have revised up our inflation forecasts, particularly over 2022. Over 2023 we still expect core inflation (which excludes energy and

food prices) will be above the Fed's target, ending the year at 2.3% y/y.

As we noted last month, there are various risks around this inflation view. Given the persistence of elevated inflation, expectations may move higher. Moreover, it is also possible that measures of inflation expectations are failing to pick up significant changes in wage and price setting behaviour in the economy. Downside risks come from the likelihood that there will be downward corrections to the prices of certain goods as supply is restored and inventories re-built; if this was to happen over a short period of time and across a range of goods, then some weak inflation readings would be possible.

Monetary policy

The Fed started the process of tightening policy at its March meeting, lifting the federal funds rate target range from 0.0%-0.25% to 0.25%-0.5%. The post meeting statement also noted that ongoing increases in the fed funds rate would be appropriate and that it expects to start reducing its holding of Treasury and mortgage-backed securities ('QT') at an "upcoming meeting". The Chair indicated that the start of QT could be as soon as May (the next meeting).

There was also a material (and larger than expected) change in Fed member projections of the fed funds rate. The median December projection was for an increase in the funds rate of 75bp over 2022, while the March meeting (including the March hike) saw 175bp.

The Fed's aim is to return the funds rate to its neutral level, or above if required, as "expeditiously as possible" to quote the Fed Chair.

While the Ukraine/Russia conflict increases downside risks to the growth outlook, the Fed is clearly worried about the risk of higher inflation becoming entrenched. As a result, the conflict will not cause the Fed to pause policy normalisation (unless the impact is greater than expected). As the Fed Chair indicated in a speech this week (emphasis added):

> "The added near-term upward pressure from the invasion of Ukraine on inflation … comes at a time of already too high inflation. In normal times… monetary policy would look through a brief burst of inflation associated with commodity price shocks. However, the risk is rising that an **extended period of high inflation could push longer-term expectations uncomfortably higher, which underscores the need for the Committee to move expeditiously**…"

As a result, we now expect a further 150bp of policy tightening over 2022 (totalling 175bp for the whole year compared to our previous expectation of 125bp). We continue to expect QT to be announced in Q2.

Not surprisingly, given the Fed's evident desire to tighten policy quickly, Fed members are open to the possibility of a 50bp rate hike at future meetings. We expect a 50bp rate hike in Q2, most likely in June. It is possible that the Fed also moves by 50 bp at its May meeting rather than just 25bps, but we think this meeting will be used to announce QT which the Fed Chair considers is equivalent to a rate increase (making a 50bp hike more of a stretch).

As already noted, we see core inflation remaining above (at 2.3% y/y) the Fed's inflation target right through to the end of 2023. This suggests that the Fed will need to move the policy rate above neutral unless some of the downside risks to the activity outlook or inflation eventuate.

The median Fed view of neutral is that it is 2.4%, which we consider reasonable. As the Fed gets closer to the neutral rate, given the uncertainty around neutral rate estimates and with the economy expected to slow over the next two years, we see the pace of rate hikes slowing to 25bp a quarter from Q4 2022 to Q3 2023 and ultimately pausing at a target range of 2.50-2.75%. The Fed member projections suggest that a modest overshoot in inflation is tolerable and therefore we don't see an aggressive tightening in policy (i.e. rates well above neutral).

There is of course a high degree of uncertainty about any estimate of the neutral rate. How the Ukraine/Russia conflicts evolves (worsens or abates), changes to fiscal policy post this year's mid-term elections (we expect gridlock so no major tightening or easing) as well as how COVID-19 evolves from here (we expect a diminishing economic impact) will also be important determinants of how the economy performs. The other risk around our rates call will be the evolution of inflation – if it has become entrenched at a higher level than we expect further rate increases will be needed (even at the risk of a downturn). Conversely, if an easing in supply chain bottlenecks leads to a large (and rapid) fall in prices of goods/services which have experienced a large run-up, then inflation may ease more quickly than expected, allowing the Fed to slow the pace of tightening.

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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	1.9	0.5	0.8	0.7	0.6	0.5	0.5	0.5	0.5	0.4	0.4
Private fixed investment	3.2	-2.7	7.8	4.3	4.5	-0.2	0.6	1.4	1.6	1.3	1.2	1.0	0.9	0.9	0.9
Government spending	2.2	2.5	0.5	0.5	1.6	0.2	-0.6	0.3	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Inventories*	0.1	-0.6	0.0	0.9	-0.1	0.5	1.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.2	-0.2	-1.8	-0.7	-0.1	-0.4	-0.1	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.3**	**-3.4**	**5.7**	**3.2**	**2.1**	**0.6**	**1.7**	**0.3**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*2.3*	*7.0*	*1.2*	*2.6*	*2.4*	*2.3*	*2.1*	*1.9*	*1.7*	*1.7*
US Other Key Indicators															
PCE deflator-headline	Dec/Dec % change														
Headline	1.5	1.2	5.5	4.3	1.9	1.3	1.5	1.7	1.3	0.7	0.5	0.4	0.5	0.5	0.5
Core	1.6	1.4	4.6	3.9	2.3	1.1	1.2	1.5	1.1	0.8	0.5	0.6	0.6	0.6	0.6
	End of period														
Unemployment rate - qtly average (%)	3.6	6.8	4.2	3.4	3.5	5.1	4.2	3.8	3.6	3.5	3.4	3.4	3.4	3.4	3.5
US Key Interest Rates	End of period														
Fed funds rate (top of target range)	1.75	0.25	0.25	2.00	2.75	0.25	0.25	0.50	1.25	1.75	2.00	2.25	2.50	2.75	2.75

Source: NAB Group Economics

*Contribution to real GDP growth

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