US ECONOMIC UPDATE APRIL 2022

EVEN WITH GDP FALLING IN Q1, THE FED IS SET TO MOVE FASTER

NAB Group Economics

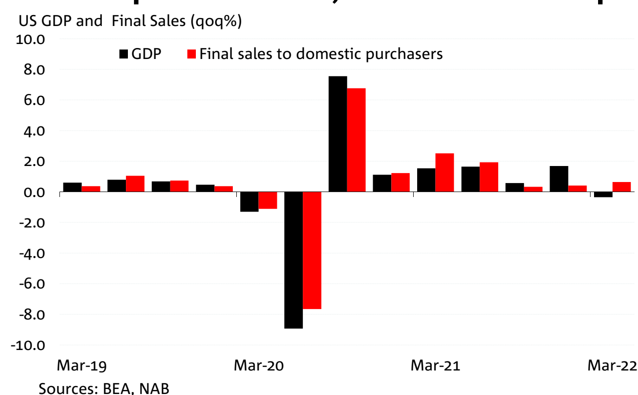
GDP fell in Q1 but the composition of growth was more positive, with consumption solid and business investment strong. Growth is likely to rebound in Q2 but then slow as tighter policy settings, and other headwinds, constrain activity. We expect the Fed to raise rates by 50bps at its May meeting and to announce the start of QT. By the end of 2022, we expect the target range of the fed funds rate to be 2.25 to 2.50%, with it set to peak at 2.50-2.75% in early 2023.

Q1 GDP

US GDP declined by 0.4% q/q in Q1 (-1.4% annualised). This followed rapid growth in Q4 2021 (1.7% q/q). Compared to a year ago, GDP was up 3.6%.

While domestic production fell, domestic final demand grew by a solid 0.6% q/q, the strongest result in three quarters. The gap between the two measures is mainly due to a large negative contribution to GDP growth from net exports, which implies that the growth in demand was met through overseas, rather than domestic, production.

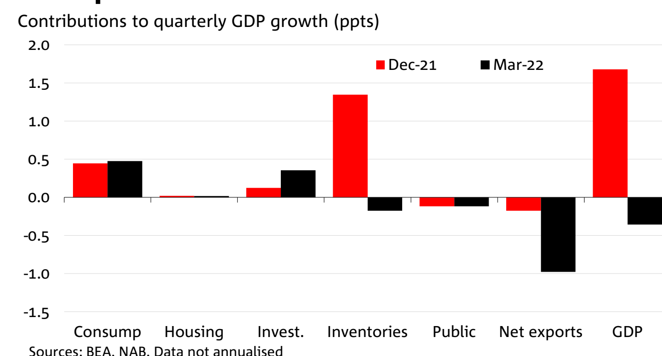
Domestic production falls, domestic demand up



Sources: BEA, NAB

Inventories and public demand also weighed on growth. While inventories grew strongly, the pace was lower than in Q4. (Mechanically, a slower pace of inventory accumulation results in a negative contribution to GDP growth). The need to rebuild inventories is fuelling strong import growth, which again rose strongly (4.2% q/q). The weak net trade outcome also reflected a fall in export volumes in Q1 (-1.5% q/q), although this followed very strong growth in Q4.

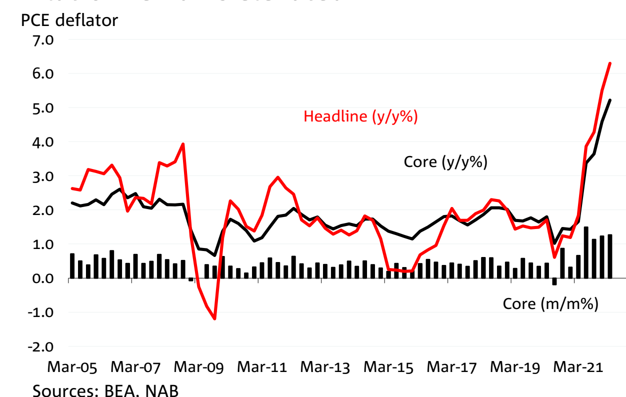
Net exports drove the fall in GDP



Sources: BEA, NAB. Data not annualised

Despite the early 2022 COVID-19 wave, consumption growth strengthened slightly to 0.7% q/q, driven by stronger services consumption. Goods consumption was flat – while durables consumption rose, this was offset by a fall in non-durables (particularly for gasoline and other energy goods, possibly due to consumers reacting to rising prices). Business fixed investment strengthened in the quarter and grew by a robust 2.2% q/q. As with Q4, there was also a moderate rise in residential investment (0.5% q/q).

Inflation remains elevated



Sources: BEA, NAB

Date: 29 April 2022 | Author Tony Kelly – Senior Economist

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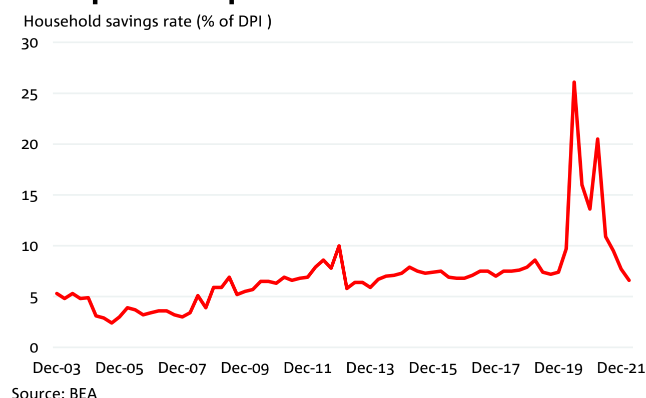
Inflation remained high. The personal consumption expenditure price (PCE) index increased 1.7% q/q (6.3% y/y). This was slightly higher than the previous quarter and represents price growth not seen since the early 1980s. Core (ex-energy and food) PCE inflation was also elevated, up 1.3% q/q (5.2% y/y). That said, core inflation was lower than expected; March data out tonight will tell us whether this was due to a soft March outcome or revisions to prior months.

The level of inflation exceeded household income growth in the quarter. Real household disposable income has declined in each of the last four quarters (down 10.9% y/y) but the fall in Q1, at -0.5% q/q was the smallest over this period. The decline in real income has in part been driven by the roll-off of temporary measures in the early 2021 fiscal stimulus packages and this process is now largely complete.

Through this period of declining real income, consumption has continued to grow. The growth in Q1 consumption supports our view that households will use the high level of savings accumulated through the pandemic to absorb price increases rather than significantly cut back on planned spending. Indeed, the household savings rate in Q1 fell below its pre-pandemic level for the first time.

Households only just starting to drawing on savings built up over the pandemic



Source: BEA

Implications for the outlook

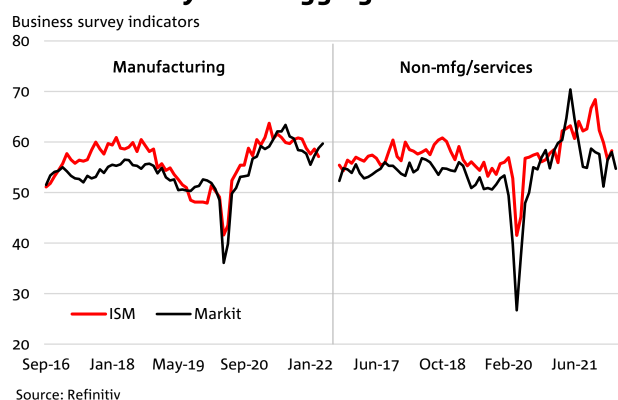
We are taking a glass half-full approach to the Q1 outcome. While it points to ongoing domestic supply constraints, the COVID-19 wave early in the quarter caused widespread business disruption (and workforce absences). The GDP fall, combined with strong employment growth, implies a fall in productivity; however, the latter is very volatile and we would not expect to see this repeated in Q2.

Moreover, private domestic final demand remained strong and activity will continue to be supported by the strong labour market. Even with the unemployment rate at a low level, there is the prospect of continuing solid job gains as the recovery in workforce participation has some way to go. This will support household incomes, with consumption also to be supported by strong balance sheets (including the high level of accumulated savings to draw on).

Capacity constraints should act as a spur to business investment. Consistent with this, regional surveys of business capital expenditure plans remain at high levels. Businesses are also likely to continue to build up inventories – which still, in aggregate, are at a low level relative to sales, although there has been some improvement.

Importantly, business survey readings remain at levels consistent with ongoing growth.

Business surveys not flagging a downturn



Source: Refinitiv

The recent pace of import growth is unlikely to be sustained and, if it were, it would be matched by a strong positive inventory contribution to growth. Goods consumption has largely levelled off (at a high level) and consumption growth will be driven by less trade dependent services activity.

The strength in imports, and strong inventory accumulation, also suggests that supply bottlenecks are easing which should take the pressure of prices.

However, business surveys still point to ongoing supply chain issues and addressing these is unlikely to be a smooth process. Continuing risks around supply are highlight by recent lockdowns in parts of China (as well as disruptions from the Russia/Ukraine war).

While we expect to see a rebound in Q2, growth is likely to moderate over time. The impetus from the removal of COVID-19 restrictions and related disruptions will fade. The expected significant tightening in monetary policy this year – which is already being reflected in market rates for mortgages – will weigh on activity.

At the same time, while the unwinding of COVID-19 fiscal supports is largely complete, Federal fiscal policy will, if anything, likely be a modest headwind. Policy settings will potentially be influenced by elections later this year. But with polls indicating Republicans are likely to regain control of at least one house in Congress, policy gridlock is the most likely outcome.

The rise in commodity prices due to the Ukraine/Russia conflict, while having mixed implications for the US economy (given its large energy sector), is also a net negative overall.

While we assume there will be some bounce back in Q2, we have lowered our GDP forecasts to 2.8% in 2022 (previously 3.2%) and 2.0% in 2023 (was 2.1%). These forecasts embody an expectation that growth will move below its trend level (which is around 1¾% on an annual basis) starting around mid-2023 and into 2024. As a result, growth in 2024 is expected to be only a modest 1.4% and the unemployment rate is likely to be rising.

While we are not forecasting a recession over this period, we acknowledge tail risks are elevated. Moreover, below trend growth rates mean that it would not take much of an additional future shock to the economy to see a downturn realised.

COVID-19 also remains a risk. The increase in cases over April has been relatively modest (compared to previous waves and to what was seen in Europe over March) and a re-introduction of material restrictions in response to future waves looks unlikely. However, the risk of further waves remains, both in the US and abroad, which could again disrupt the labour market (e.g. through isolation requirements) or global supply chains.

Our forecasts also continue to embody an expectation that oil prices will gradually ease starting in the second half of 2022. However, how the Ukraine/Russia conflict will unfold – and its impact on commodity markets – is highly uncertain.

Monetary policy

At its March meeting, the Fed Chair indicated that the aim was to return the funds rate to its neutral level, or above if required, as "expeditiously as possible".

As a result, we had expected a 50bp rate hike in Q2, most likely in June. We had expected only a 25bp hike at the May meeting as we thought that the Fed would also announce its plans to unwind its balance sheet ('quantitative tightening' or QT) which also acts to make policy more restrictive.

In the event, recent comments from Fed members – including from the 'doves' and the Fed Chair – point to a 50bp rate hike in May as well as a QT announcement.

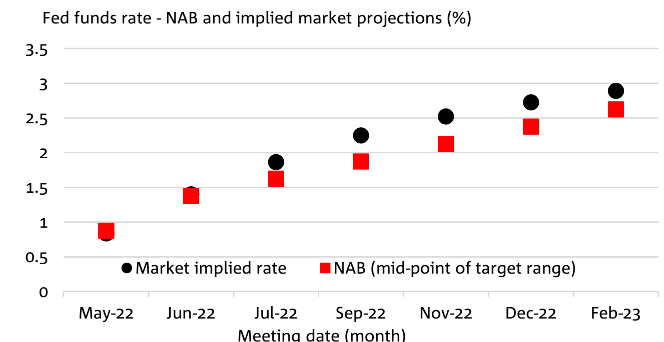
Accordingly, we now expect 50bp rate hikes in both May and June. Beyond this, we see 25bp rate hikes in each of the four meetings in the second half of 2022. This would leave a target range of 2.25 to 2.50% by end 2022, consistent with returning the fed funds rate to its neutral level. The current median Fed member estimate of the neutral rate is 2.40%.

While we see inflation easing over the forecast horizon, core inflation is expected to remain above the Fed's 2% inflation target. This suggests that the Fed will aim to move the policy rate above neutral. As a result, we expect another (25bp) rate hike in early 2023. With fiscal policy also likely somewhat restrictive – and with inflation easing – we see this as the peak for the cycle.

Current market pricing points to the risk that the Fed will move even faster, and to a higher level than we expect (including a 50bp hike in July). However, as the Fed gets closer to the neutral rate, we expect it to slow down the pace of tightening. There are already concerns that Fed policy may trigger a recession and these worries will become more front of mind as they move closer to neutral and as it becomes clear that growth is set to move below its trend level.

How resilient the global economy is to current headwinds – particularly Europe which is most exposed to the fall-out from the Ukraine/Russia war – will also be important. Signs European economies are faltering may stay the Fed's hand. This risk highlights that, as ever, much will depend on the actual data flow. In particular, if inflation eases more slowly than we expect, or inflation expectations move higher, then the Fed will likely be more aggressive (and conversely if inflation eases more quickly than expected the Fed can be less aggressive).

Projected fed funds rate



Source: Refinitiv, NAB

As noted above, and as heavily flagged in Fed communications, we expect QT to be announced in May (and commence in June). The Fed will reduce its balance sheet by only reinvesting maturing securities when they exceed a specified monthly cap. The Fed's March meeting minutes indicated that the monthly caps will eventually be $60 billion for Treasury securities and $35 billion for agency MBS (close to our expectation of a total cap of $100b), but that these caps will be phased in, most likely over three months.

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U.S. ECONOMIC & FINANCIAL FORECASTS

							Quarterly Chng %							
							2022				2023			
	2019	2020	2021	2022	2023	2024	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	Year Average Chng %													
Household consumption	2.2	-3.8	7.9	3.0	1.9	1.4	0.7	0.6	0.5	0.5	0.5	0.4	0.4	0.3
Private fixed investment	3.2	-2.7	7.8	4.8	4.6	3.1	1.8	1.7	1.5	1.3	1.1	0.8	0.9	0.8
Government spending	2.2	2.5	0.5	-0.3	1.6	1.2	-0.7	0.7	0.5	0.4	0.4	0.4	0.3	0.3
Inventories*	0.1	-0.6	0.1	1.0	-0.2	-0.2	-0.2	0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Net exports*	-0.2	-0.2	-1.9	-1.2	-0.1	-0.1	-1.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.3**	**-3.4**	**5.7**	**2.8**	**2.0**	**1.4**	**-0.4**	**1.0**	**0.6**	**0.5**	**0.5**	**0.4**	**0.4**	**0.3**
Note: GDP (annualised rate)							*-1.4*	*4.2*	*2.3*	*2.1*	*1.9*	*1.6*	*1.5*	*1.4*
US Other Key Indicators														
PCE deflator-headline	Dec/Dec % change													
Headline	1.5	1.2	5.5	4.3	1.9	1.8	1.7	1.2	0.8	0.5	0.4	0.5	0.4	0.5
Core	**1.6**	**1.4**	**4.6**	**3.6**	**2.4**	**2.2**	**1.3**	**0.9**	**0.8**	**0.6**	**0.6**	**0.7**	**0.6**	**0.6**
	End of period													
Unemployment rate - qtly average (%)	**3.6**	**6.8**	**4.2**	**3.4**	**3.5**	**3.9**	**3.8**	**3.6**	**3.5**	**3.4**	**3.4**	**3.4**	**3.5**	**3.5**
US Key Interest Rates	End of period													
Fed funds rate (top of target range)	**1.75**	**0.25**	**0.25**	**2.50**	**2.75**	**2.75**	**0.50**	**1.50**	**2.00**	**2.50**	**2.75**	**2.75**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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