US ECONOMIC UPDATE MAY 2022

REVISING DOWN US GROWTH FORECASTS

NAB Group Economics

GDP still looks set for a rebound in Q2 2022, but beyond that the outlook has weakened. We have revised down our GDP forecasts to allow for the fall-out from lockdowns in China and a greater than expected tightening in financial conditions (falling equity prices and dollar appreciation). We have brought forward our expected timing of fed fund rate hikes – we now expect the Fed to hike by 50bp not only in June but also in July. We expect the Fed will move more slowly towards the end of the year; as a result, our forecast of the peak fed funds rate (2.50-2.75% in Q1 2023) is unchanged.

Activity data consistent with Q2 rebound

The most recent economic data have been generally positive and consistent with our expectation for GDP to rebound in Q2, although a fall-off in business survey readings in May points to fading momentum. The economy is facing some strong headwinds and financial conditions have deteriorated.

Retail sales increased by 0.9% m/m April, and there were upward revisions to prior months as well. Even after adjusting for inflation this points to robust spending growth for Q2. While retail sales mainly measure goods consumption, the food services component again grew more strongly (2.0% m/m) than the total, pointing to an ongoing recovery in services consumption from the impact of the COVID-19 wave earlier this year.

This can also be seen in high frequency data for dining numbers and aviation travel, available into May. Both indicators are now close to their pre-pandemic level. The number of new COVID-19 cases has been rising since early April, but it is well below the peak seen earlier in the year and the travel/dining data (as well as Google Mobility) do not point to an impact at this stage.

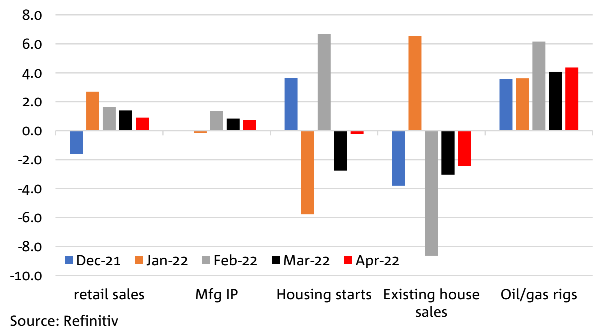
In contrast, the housing sector appears to be weakening, likely reflecting the sharp rise in mortgage rates. This is particularly true for home sales, although housing starts have also fallen in the last couple of months.

On the business fixed investment side, mining sector investment continues to grow, and with energy prices high, this is likely to remain the case for a while. Capital goods orders and shipments were still rising in March although one concern is that capex expectations in the regional Fed surveys so far released in May (the Empire State, Richmond and Philadelphia Fed manufacturing surveys) have seen a notable drop-off (albeit down to a still solid level).

The labour market also remains tight. The unemployment rate is at a low 3.6% and in April the number of non-farm jobs increased by over 400,000.

Q2 data positive so far, outside of housing…

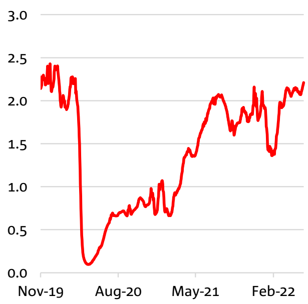
Recent activity data (m/m%)



Source: Refinitiv

…with services sectors continuing to recover

US Aviation traveller numbers (millions)



Source: Refinitiv (TSA)

Seated diners (% change from 2019)

Source: Opentable, Macrobond

Outlook weakening

While the near-term situation appears positive, growing headwinds are creating a lot of uncertainty around the outlook. Moreover, the recovery in the

Date: May 2022 | Author Tony Kelly – Senior Economist

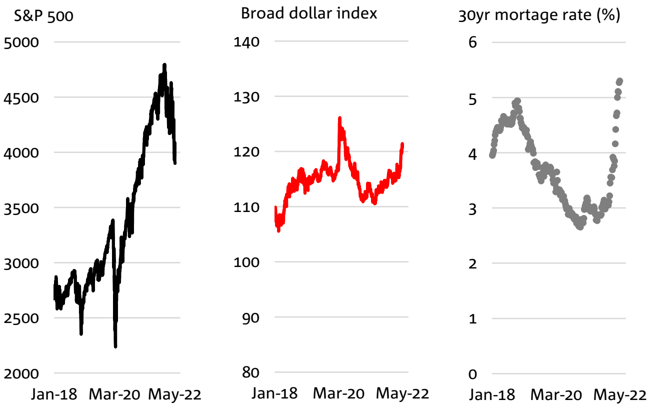
services sector from COVID-19 is supporting growth, but these effects will fade over time. That said, with ongoing supply problems, the need to run production at a high level in order to rebuild inventories may support growth for some time.

A couple of the drags on growth have been evident for a while. The rapid shift in Federal Reserve policy towards a tighter stance (and expectations of future hikes) has quickly flowed through to market rates such as for mortgages. Secondly, the Ukraine/Russia conflict and the steep rise in commodity prices is probably a net negative for the economy, despite being a benefit to the US energy sector.

This month, however, we also made a downwards change to our forecasts for 2022 GDP growth in China, reflecting the large impact of lockdowns to date, and the likelihood that COVID-19 will cause on-going disruptions over the rest of this year. A softer Chinese economy will drag on US activity through weaker exports; even if imports from China were also to weaken due to factory shutdowns (a mechanical offset to the GDP impact), this could worsen supply bottlenecks, possibly curbing US production and reinforcing inflation pressures.

Moreover, there has been a notable tightening in financial conditions. While a deterioration in financial conditions is an expected outcome of tighter Fed policy, the fall in equity markets is still striking. Since the end of March equity prices have fallen by around 13% (and by -18% from their peak early in 2022). While we do not typically change our forecasts for every swing in equity prices, this correction is too large and sustained to ignore.

Financial conditions tightening



Sources: Macrobond, Refinitiv, MSCI, Federal Reserve, Freddie Mac

Back-of-the envelope estimates suggest that, even allowing for further house price growth, household wealth has declined by over $5 trillion so far this year. While estimates of the impact of changes in wealth are not large (typically a few cents for every dollar of wealth gained or lost), the size of the decline in wealth is large enough to represent a material drag on consumption.

At the same time, the US dollar has been appreciating. We recently changed our FX forecasts to incorporate a stronger US dollar over our forecast horizon (by over 5% relative to our previous expectations based on a trade-weighted basis). Dollar appreciation negatively impacts the international competitiveness of US businesses and will likely drag on exports while boosting imports.

Support for the economy will continue to come from strong household balance sheets. Real US household income declined by around 20% over the year to March and yet consumption increased over this period. Over this period, households reduced their savings rate, but only in recent months has it fallen below its pre-COVID-19 level. This suggests that consumers have only just begun drawing down on the savings accumulated in recent years. The run down in real income has not just been an inflation story; in fact, over this period most of the decline has been due to an end of COVID-19 fiscal payments to households. However, this process has largely ended and so, while other headwinds have picked up, the pressure from fiscal policy is fading.

The strength of demand and difficulties finding labour should also help sustain business investment. However, for both households and businesses, a risk is that concerns over the outlook could lead to purchases or investments being delayed or cancelled.

As a result of the change to our China forecast, dollar appreciation and the large fall in equities, we have lowered our forecasts for US GDP. We now expect GDP growth of 2.6% in 2022 (2.8% in last month's update), 1.7% in 2023 (was 2.0%) and 1.3% in 2024 (was 1.4%).

With quarterly growth expected to only be around the 0.2% q/q mark in H2 2023, it suggests it would not take much from here to push the US into recession. Nor is it hard to conceive scenarios which might provide that 'push', such as an additional (or longer) impact on commodity prices from the Ukraine-Russia conflict or a larger than expected lift in rates by the Fed.

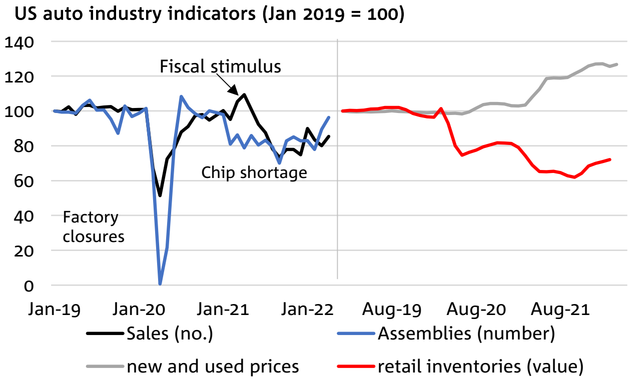
Inflation

Annual CPI inflation eased slightly in April, to 8.3% y/y from 8.5% in March. The last time US CPI inflation was this high was back in the early 1980s. The core (ex food and energy) measure also eased – to 6.1% from 6.4% y/y.

The monthly core inflation rate, after some softening in March, moved higher to 0.6% m/m. That said, the monthly trimmed mean CPI growth rate moderated somewhat (still high at 0.4% m/m but its lowest level since August) while core and trimmed mean monthly PCE inflation declined over February and March. In short, underlying inflation appears to have at least peaked but there is no clear signal that it is easing.

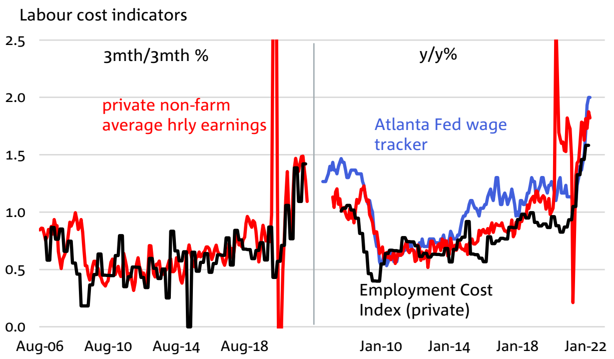
We continue to expect an easing in core inflation starting in the second half of this year. This should be helped by falls in the level of prices for some items as supply shortages are addressed. For example, the large run up in auto prices that has occurred reflected the combination of initial COVID-19 factory lockdowns, the semi-conductor (chip) shortage as well as the boost to demand from the fiscal stimulus early last year. As a result, inventories were run-down to very low levels; however, auto production has now almost recovered, and as inventories are rebuilt prices are likely to fall.

Auto prod. recovery points to lower prices ahead



At the same time, most measures of inflation expectations remain at levels consistent with the Fed's 2% inflation target. That said, the risk is that these expectations measures do not pick up changes in price setting behaviour. In particular, wage growth measures remain elevated. While there has been some softening in growth in the monthly average hourly earnings measure, this was not reflected in the March quarter employment cost index (which adjusts for changes in workforce composition).

Wage growth remains elevated



Sources: BLS, Atlanta Fed, Refinitiv. ECI data are quarterly

Morever, with the Chinese economy likely to face COVID-19 disruptions over the rest of the year, there is an additional risk that supply issues worsen, pushing up prices.

Monetary policy

This month we have altered the timing of the expected increase in the fed funds rate. Following the 50bp increase in May, our expectation had been for a 50bp hike in June, followed by 25bp hikes in the remaining meetings in 2022 and into early 2023, resulting in a peak target range for the federal funds rate of 2.5-2.75%.

However, Fed speakers are basically telling markets to expect a 50bp rate hike not only at the June meeting (as we expect) but also at the July meeting. Basically, the Fed wants to get close to 'neutral' quickly and unless there is a major change in incoming data they appear set on 50bp hikes at these meetings.

Accordingly, we have modified our fed funds rate track and now expect a 50bp hike in July (previously 25bp). This would leave the fed funds rate close to neutral (at least in the Fed's mind).

Beyond July, we would then expect the Fed to start moving more cautiously as we see economic growth and inflation slowing as the year unfolds. As a result, we now only have one (25bp) rate hike in Q4 (previously two) and still expect that the peak will be reached in early 2023 (target range of 2.50-2.75%). The Fed median view of the neutral fed funds rate is currently 2.4% (with a range of 2.0 to 3.0%). While we see inflation easing over the forecast period, it is expected to remain above the Fed 2% target – so a restrictive policy rate appears likely, with the debate more likely to be about how restrictive it needs to be.

How rapidly inflation would need to fall for the Fed to (a) slow down the pace of rate hikes and (b) end the hiking cycle at 2.50-2.75% is unclear. It is also unclear how sensitive the answer to this question is to a decline in economic growth. So not only there is considerable uncertainty around the future path of inflation going forward, how the Fed will react to any given inflation/economic growth outcome is hard to gauge right now.

The Fed is conscious that, historically, hard landings have often resulted from tightening cycles and will aim to avoid such an outcome. This is the basis of our expectation they will become cautious when they close in on the neutral rate. However, if inflation were to remain high and not be clearly moving down towards the 2% target (or inflation expectations move up), their hand will be forced, and a more restrictive policy setting needed. In this scenario, the risk of a recession would be very high.

Contact the author:
Tony Kelly
Senior Economist
Antony.Kelly@nab.com.au

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	3.2	1.8	1.3	0.7	0.9	0.5	0.5	0.5	0.4	0.3	0.3
Private fixed investment	3.2	-2.7	7.8	4.6	4.2	3.1	1.8	1.6	1.4	1.2	1.0	0.8	0.8	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	0.9	-0.2	-0.1	-0.2	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.2	-0.2	-1.9	-1.4	-0.3	-0.2	-1.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Real GDP	**2.3**	**-3.4**	**5.7**	**2.6**	**1.7**	**1.3**	**-0.4**	**0.9**	**0.4**	**0.4**	**0.4**	**0.4**	**0.2**	**0.2**
Note: GDP (annualised rate)							*-1.4*	*3.8*	*1.7*	*1.8*	*1.6*	*1.6*	*1.0*	*1.0*
US Other Key Indicators														
PCE deflator-headline	Dec/Dec % change													
Headline	1.5	1.2	5.5	4.4	1.9	1.8	1.7	1.2	0.8	0.6	0.5	0.5	0.5	0.5
Core	**1.6**	**1.4**	**4.6**	**3.7**	**2.5**	**2.2**	**1.3**	**0.9**	**0.8**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**
	End of period													
Unemployment rate - qtly average (%)	3.6	6.8	4.2	3.5	3.9	4.2	3.8	3.5	3.5	3.5	3.6	3.7	3.7	3.9
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	2.25	2.50	2.75	2.75	2.75	2.75

Source: NAB Group Economics

*Contribution to real GDP growth

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