US ECONOMIC UPDATE 29 JULY 2022

GDP FALLS AGAIN IN Q2

NAB Group Economics

GDP again declined in Q2. While the fall was smaller than in Q1, the poor result cannot be so easily dismissed by reference to trade and inventory distortions. While we (tentatively) expect some growth over the rest of 2022, we see GDP declining again in H1 2023 as the full impact of the Fed's rate hikes come through. With unemployment rising, there will be no debate about whether this constitutes a recession. With inflation still high, we still see the Fed lifting rates further although the pace should slow from here. We expect the fed funds rate to peak at 3.25-3.5% by year-end.

GDP fell by 0.2 q/q (-0.9% annualised) in Q2 marking the second consecutive fall. Over the first half of the year GDP has declined by 0.6%.

Unlike in Q1, this result is harder to put down to one-off factors or some volatile elements. While there was a large negative contribution from inventories this was in large part offset by a positive net exports contribution. Consumption growth was weak, residential investment declined, business investment – strong in Q1 – was flat while public consumption and investment again fell. Reflecting this broad-based weakness, domestic final demand fell in Q2 – unlike in Q1 where it rose (particularly private demand).

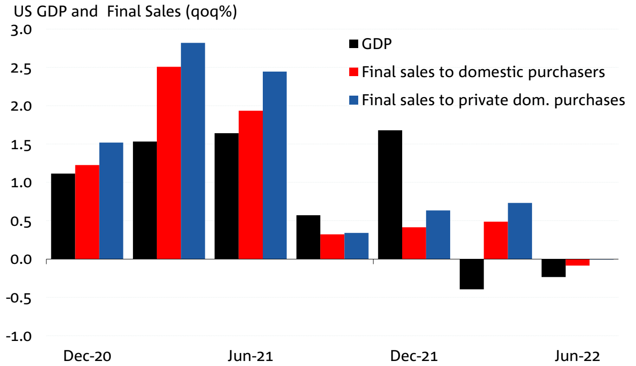
Some interest sensitive areas of the economy saw falls, including durables goods (-0.7% q/q) and residential investment (-3.7% q/q). Non-durable goods consumption also declined; this was in part due to consumers again cutting back on petrol purchases in the face of high prices.

There was also a large drop in at-home food consumption – at the same time, food services and accommodation grew strongly (3.2% q/q) suggesting that there was a switch towards more eating out. Transportation services consumption also strengthened, contributing to robust services consumption growth (1.0% q/q). This points to on-going normalisation of activity as the impact of COVID-19 wanes, with further rebalancing of goods and services consumption likely. Similarly, on the services trade front, there were increases of 25-35% in travel credits and debits as inbound and outbound tourism continued to recover.

Real household disposable income again declined. This measure has been falling since Q2 2021 – in part due to high inflation but also due to the ending of various COVID-19 related payments to households.

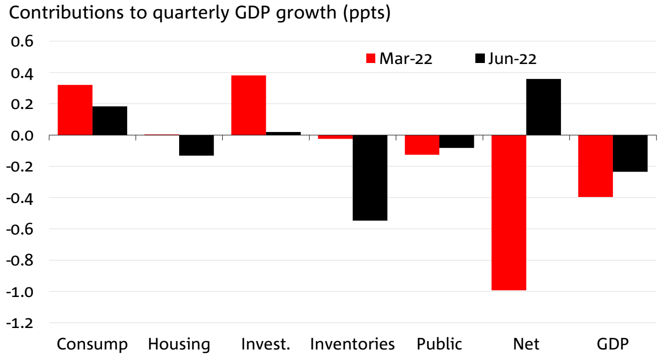
However, the Q2 fall (-0.1% q/q) was the smallest decline over this period. With consumption still rising, the savings rate again fell. While the savings rate has been below its pre-COVID level in 2022, households have only used a small part of the pool of savings accumulated through the pandemic.

Q2 GDP fall, this time joined by domestic demand



Sources: BEA, NAB

Weakness across the board



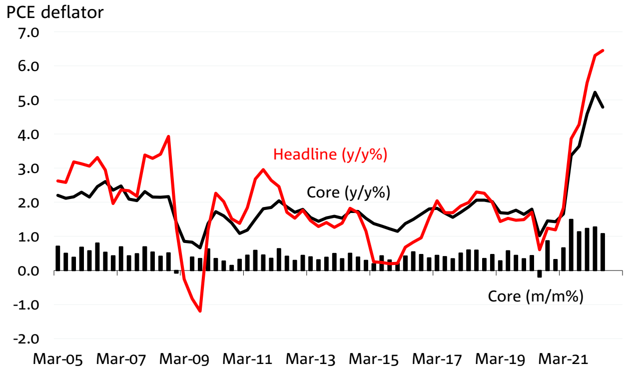
Sources: BEA, NAB. Data not annualised

Consumer inflation remained very high. The personal consumption expenditure (PCE) price index increased 1.7% q/q, to be up 6.5% over the year. Core (ex energy and food) was also strong at 1.1% q/q

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

(4.8% y/y). While this was down on Q1 (1.3% q/q, 5.2% y/y) the quarterly result implies very strong June month core inflation (over 0.5% m/m). Similarly, core CPI, and other underlying price measures such as trimmed mean CPI, were elevated in June so there is still no clear signal of inflation easing.

Inflation remains very high



Sources: BEA, NAB

Has the US been in recession?

A common recession indicator is two or more consecutive quarters of negative GDP growth. However, the fall in GDP is hard to reconcile with the 1.8% increase in non-farm employment over the six months to June even allowing for the normal lags. That said, the across-the-board weakness in Q2 feels more like a recession than the Q1 print.

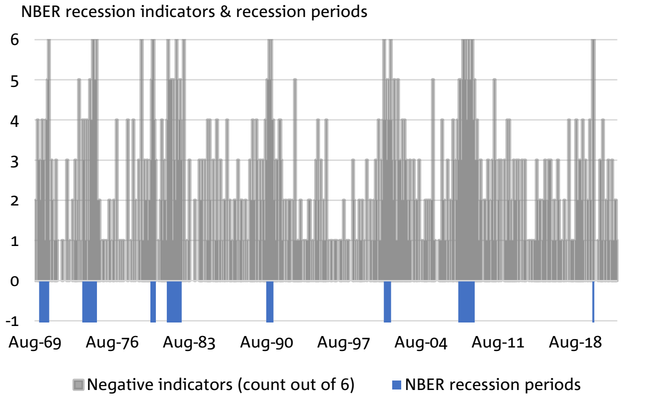
In the US, an alternative measure of recession timing is provided by the NBER Business Cycle Dating Committee. Currently the Committee examines six monthly data series, relating to industrial production, employment, sales, household income and consumption to determine whether a recession has occurred or not. This has meant periods have been declared as being in recession even without consecutive GDP falls.

The NBER also considers quarterly GDP and real GDI. Conceptually, GDP should equal GDI but due to data issues they often differ. This was the case in Q1 where real GDI increased even as GDP fell.

Since the late-1960s there have been falls in at least three of the six indicators in the first month of a designated recession period. When there were only three indicators declining, in subsequent months even more of them fell. Only half of the indicators have been released for June. However, over the January to May period, the number of indicators recording negative growth was between one and two (although this could change with data revisions).

For June, it is possible that more than two of the indicators were negative. This suggests that June is the first month where it is feasible the NBER could declare the start of a recession. However, the Committee typically looks for a fall in activity lasting more than a few months, so even if June indicators were particularly weak, this would likely need to be sustained into Q3 to declare the US is in recession.

At least to mid-Q2, indicators looked at by NBER not flagging a recession



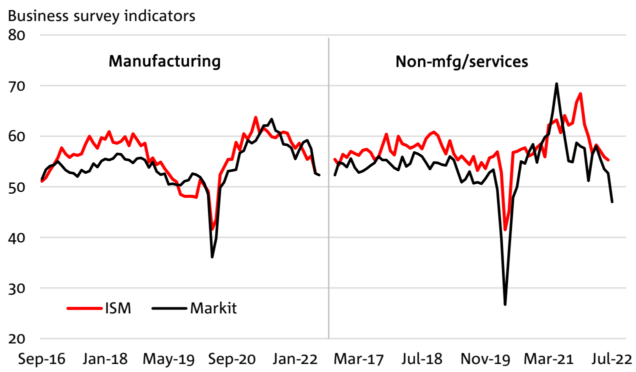
Implications for the outlook

In last month's update we lowered our growth forecasts for the US and incorporated an expectation that it would enter a recession, albeit a relatively modest one. We considered the most likely recession timing to be mid-to-late 2023.

The Q2 GDP release supports this call in terms of direction - it is clear that the economy is weakening and that the downwards pressure will build over time. The broad-based weakness in the Q2 GDP data raises the possibility that the downturn may have already started and may become more pronounced over the rest of this year.

Supporting this possibility were declines in July business survey readings. While survey readings have been falling for a while, they had remained in expansionary territory (above 50 for PMIs). However, the Markit services PMI fell sharply, and into contractionary territory in July. There was also a further (more modest) fall in the manufacturing PMI. Next week we will get the results of the July ISM surveys, but we note available regional Fed surveys are broadly consistent with the Markit measure.

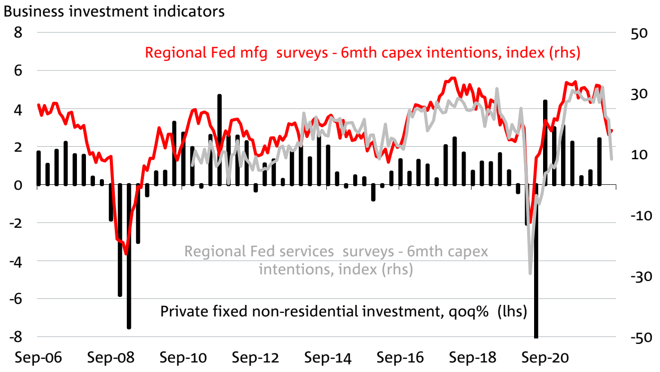
Surveys downwards trend accelerated in July



Source: Refinitiv

Businesses also appear to be marking down their capex plans. A very tight labour market, elevated capacity utilisation and still solid profits (at least through to Q1) would normally be supportive of further solid investment growth. However, in Q2 business investment was flat, and given the very uncertain outlook and increased cost of capex, (and talk of recession) it is possible that business investment will fall more quickly.

Capex plans being wound back



Source: BEA, Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

That said, the recent weakness in headline GDP may in part reflect the withdrawal of COVID-19 fiscal programmes and some lagged impacts of the large disruptions to the Chinese economy from COVID related lockdowns. The former is now largely complete while the latter has eased, although risks remain. With oil prices having declined recently, retail gasoline prices have fallen, which will also provide some relief.

With the Fed still lifting rates we expect the trough in activity to be in 2023. However, we now expect this to be more concentrated in the first half of the year (and note the risk it might be even earlier). Unlike the recent falls in GDP, we expect this will be accompanied by rising unemployment, with the unemployment rate projected to be around 4¾% by end 2023 (3.6% currently).

While we still have only a relatively modest recession in our forecasts, there are risks around this. On the downside, if the Fed were to raise rates higher then we expect then this would add to the downturn. Global developments will also be important. Recently, concerns over gas supply to Europe have led to a spike in prices and raised the risk of energy rationing in the winter. At the extreme, this has the potential to cause a major European downturn which would spill over to other countries, including the US. Similarly, there is a risk that future lockdowns again materially disrupt the Chinese economy, renewing supply chain problems.

Monetary policy

The Fed lifted rates by 75bp at its meeting this week, taking the fed funds rate to 2.25-2.50%.

This is around the Fed's view of its neutral level (2.50%) and reaching this benchmark led to some change in tone by the Fed Chair, although further rate increases remain firmly on the agenda. He noted that, having indicated they would move 'expeditiously' back to neutral, that this has now been achieved. Moreover, he stated that "As the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases while we assess how our cumulative policy adjustments are affecting the economy and inflation". He also noted that there had been "some progress on supply and demand getting back into alignment" – something the Q2 GDP report reinforces.

This suggests that the urgency to raise rates that has been driving the Fed has somewhat receded. Rates were too low and had to be raised but now incoming data and the outlook will matter more. This doesn't mean that there isn't still a clear bias to lift rates further – the Fed Chair wouldn't rule a 75bp increase in the September meeting and talked about achieving at least a 'moderately restrictive' setting and stated that they are still looking for "compelling evidence" that inflation is easing.

The Fed Chair pointed to the June meeting projections as the best guide to the Fed's current thinking – the median Fed member projection was 3.25-3.5% by end 2022. While these projections also allow for another 50bp of rate hikes in 2023 he noted that the further out the projections go the less value they have.

Last week we changed our track for the Federal funds rate by bringing forward the expected timing of rate hikes. We still expect a peak federal funds rate of 3.25-3.50% but for this to be reached by end-2022 rather than in early 2023.

The funds rate peaking at 3.25-3.5% is predicated on inflation easing over the back half of the year. The easing in demand and commodity prices, rebuilding of inventories, dollar appreciation and improvement in supply chain indicators all support this view. However, it is possible that cost and other pressures have not been fully passed through yet or that inflation dynamics/expectations have shifted.

While inflation expectation measures have eased recently, labour cost indicators will be worth watching. Some have shown growth moderating (average hourly earnings) but others have moved higher (Atlanta Fed wage tracker). The Employment Cost Index for Q2 (released tonight) is arguably the best indicator and will provide a clearer signal in this regard. Of some concern, the fall in GDP over the first half of the year, coupled with strong employment growth, implies a large fall in productivity and a rise in unit labour costs.

The expected downturn in the economy naturally raises the question of when the Fed might start to reduce rates. Markets are pricing in rate cuts starting early-to-mid-2023. Evidently this will depend on the level of inflation and the speed at which it is moving back to target. As the unemployment rate starts to rise the 'full employment' mandate will also start to get increasing attention.

Our forecasts have core inflation of over 2½% by end 2023 which is still well above target. However, we now expect the unemployment rate to be around 4¾% by end-2023 (and rising), a level the Fed would not be comfortable with. While we don't have rate cuts pencilled in until 2024, on these forecasts there is a case for these to come earlier. How quickly the Fed moves may depend in part on how boxed in it feels by its goal of "[achieving] inflation that averages 2 percent over time". This implies the Fed should be aiming for below 2% inflation for a period of time, which would argue against rate cuts if inflation was to remain well above target.

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U.S. ECONOMIC & FINANCIAL FORECASTS

						Quarterly Chng %											
						2022				2023				2024			
	2020	2021	2022	2023	2024	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	Year Average Chng %																
Household consumption	-3.8	7.9	2.4	0.6	1.1	0.5	0.3	0.4	0.3	0.0	-0.1	0.2	0.3	0.3	0.3	0.3	0.3
Private fixed investment	-2.7	7.8	1.8	-0.3	2.6	1.8	-1.0	0.1	0.2	-0.3	-0.3	0.4	0.7	0.8	0.8	0.8	0.8
Government spending	2.5	0.5	-1.4	1.0	1.2	-0.7	-0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Inventories*	-0.6	0.1	0.7	-0.3	0.0	0.0	-0.5	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.2	-1.9	-1.0	0.0	-0.1	-1.0	0.4	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**-3.4**	**5.7**	**1.6**	**0.2**	**1.2**	**-0.4**	**-0.2**	**0.4**	**0.3**	**-0.2**	**-0.2**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)						*-1.6*	*-0.9*	*1.7*	*1.0*	*-0.8*	*-0.8*	*0.8*	*1.3*	*1.5*	*1.5*	*1.5*	*1.6*
US Other Key Indicators																	
PCE deflator-headline	Dec/Dec % change																
Headline	1.2	5.5	5.6	2.2	1.7	1.7	1.7	1.2	0.8	0.6	0.6	0.5	0.5	0.4	0.4	0.4	0.4
Core	**1.4**	**4.6**	**4.3**	**2.6**	**2.3**	**1.3**	**1.1**	**1.1**	**0.8**	**0.6**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
	End of period																
Unemployment rate - qtly average (%)	**6.8**	**4.2**	**3.9**	**4.8**	**5.3**	**3.8**	**3.6**	**3.7**	**3.9**	**4.0**	**4.2**	**4.5**	**4.8**	**4.9**	**5.0**	**5.1**	**5.3**
US Key Interest Rates	End of period																
Fed funds rate (top of target range)	**0.25**	**0.25**	**3.50**	**3.50**	**2.75**	**0.50**	**1.75**	**3.00**	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**	**3.50**	**3.25**	**3.00**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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