US ECONOMIC UPDATE AUGUST 2022

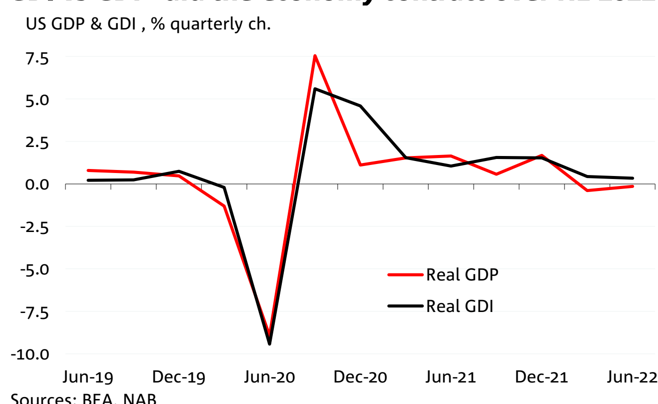
LABOUR MARKET STILL VERY TIGHT DESPITE GDP FALL

NAB Group Economics

While GDP declined in H1 2022 other data point to an economy still growing. The labour market remains very tight, and wage growth elevated. Against this backdrop, the softer than expected July inflation readings will not stop the Fed lifting rates further. Indeed, we have lifted our expectation for where rates will peak in this cycle to 3.50-3.75% (from 3.25-3.50%). We still expect that rate rises, as well as spill overs from recession in Europe, will lead to a recession in 2023.

GDP growth contracted over the first two quarters of 2022, the "technical" definition of a recession. However, other data, including those utilised by the NBER's business cycle dating committee, are not consistent with a recession in H1 2022. Q2 GDP was updated by the BEA this week to show a smaller fall in Q2 (-0.6% q/q annualised compared to the advance estimate of -0.8%). The first estimate of Gross Domestic Income (GDI) growth in Q2 was also released. In theory GDI and GDP growth should be equal although in practice they often differ. Real GDI increased in both in both Q1 and Q2 pointing to slower, but still positive, growth.

GDI vs GDP–did the economy contract over H1 2022?



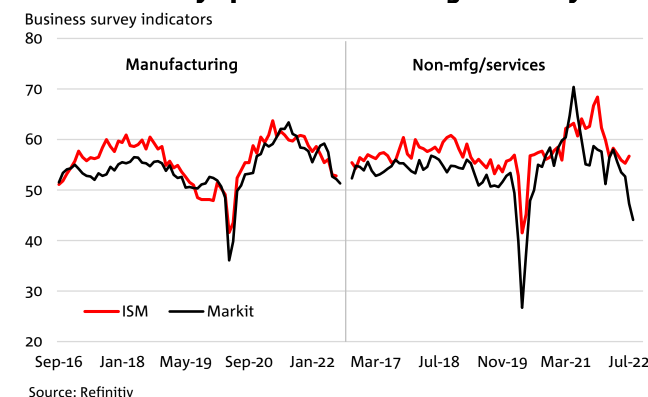
Sources: BEA, NAB

Early Q3 data also, overall, point to an economy still growing. In July, employment growth accelerated while real household consumption grew 0.2% m/m. Also in July, after two soft months, industrial production recorded strong growth (0.6% m/m).

While exports fell modestly in July, the fall in imports was even larger. Taking into account the impact of prices, export volumes appear to have risen (by around 3% m/m) while imports were down around 2%. If sustained, this points to a possible large net trade contribution to GDP growth in Q3; however, at this stage we haven't changed our forecast for a neutral contribution as the data are very volatile month-to-month. Moreover, large swings in imports can be offset by movements in inventories.

On the business investment side, however, there are some signs of weakness. Spending in nominal terms continues to rise with both durable capital goods shipments and orders (ex defence and the volatile transport category) rising (by 0.7% and 0.4% m/m respectively), but based on recent moves in prices, this still may mean (as in Q2) a modest decline in real equipment investment. That said, capex intentions in regional Fed surveys, after falling through the first half of 2022 have stabilised over the last two months. Corporate profits also remain high which should provide some near-term support to business investment plans.

Business surveys point to a slowing economy



Source: Refinitiv

The S&P Global (Markit) PMIs for the US fell again in August (based on the prelim reading). The decline was again particularly pronounced for the services PMI. In contrast, the services ISM indicator (data to July) is at a much stronger level even if it too has been trending downwards. Taken together, the

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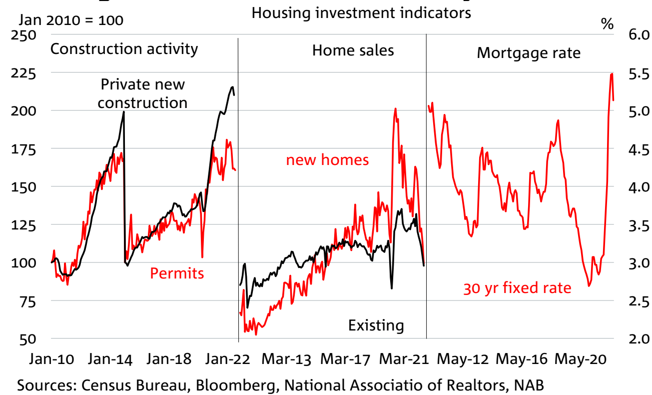
surveys suggest that underlying business momentum is slowing.

The housing market is already experiencing a downturn. This follows the sharp rise in mortgage rates this year. Residential investment declined in Q2 and data for July show no let-up – permits, a leading indicator of construction, remain high but are starting to fall and sales are falling rapidly. A large build-up of new homes available for sale points to growing pressure on future construction activity.

Housing market downturn underway



Sources: Census Bureau, Bloomberg, National Associatio of Realtors, NAB

We have left our GDP forecast largely unchanged, although the upward revision to Q2 lifts 2022 growth from 1.6% to 1.7%. Our forecasts for 2023 (0.2%) and 2024 (1.2%) are unchanged. These forecasts incoporate a reduction in GDP over H1 2023, signalling the US going into a (modest) recession. This in part reflects the expected impact of US monetary tightening with an additional headwind from Europe, which we expect to enter into recession later this year due to energy spillovers from the Ukraine/Russia war. This weak growth outlook will see unemployment start to rise at the back end of this year and rise further over 2023.

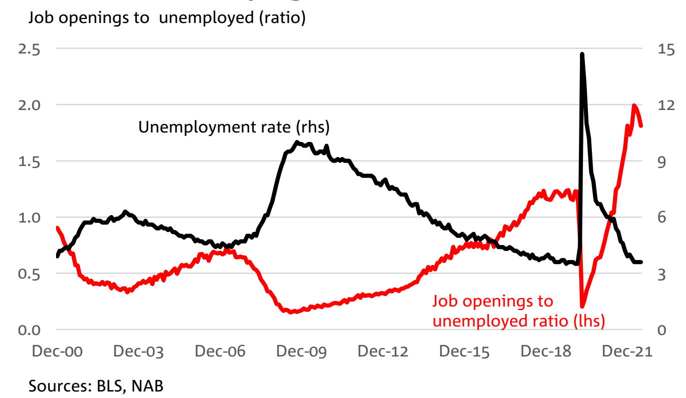
Labour market and inflation

Despite the reported contraction in the economy over the first half of 2022, employment growth remains strong. Non-farm employment increased by 528k in July, its fastest pace since February. The unemployment rate dropped by 0.1ppts to 3.5%.

A disappointment in the July employment report was a small decline in the participation rate, following a fall in May. However, given the volatility in this series, it is too early to say that the recovery evident since mid-2021 is over. Rising labour force participation would help alleviate labour shortages.

The tightness of the labour market is evident in the ratio of job vacancies to unemployment, which are well above their pre-COVID level. Job openings have, however, come off a little in recent months, perhaps the first sign that the weakening in the economy is starting to spill over to the labour market. Historically, movements in unemployment and vacancies are highly (negatively) correlated.

Labour market very tight

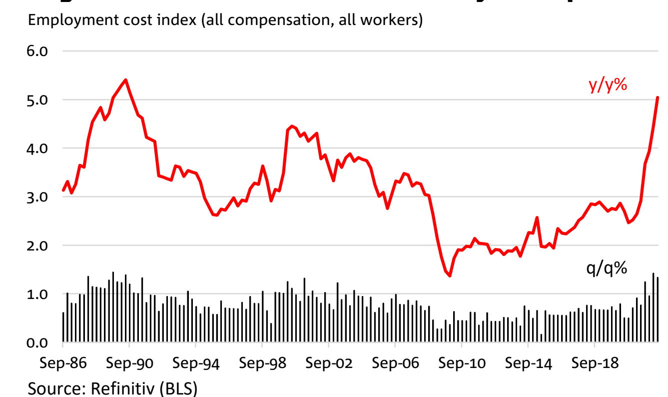


Sources: BLS, NAB

One of the aims of the Fed's rate hikes is to lower demand, in order to achieve a better supply/demand balance, including in the labour market. This is motiviated by a desire to ease wage pressure. While the Fed can take some comfort that survey and market implied measures of inflation still appear to be broadly anchored at a level consistent with the inflation target, the real test is actual price setting behavour, such as for wages.

In this regard, the most recent data are worrying. Growth in monthly average hourly earnings did appear to be moderating but it has moved higher over the last two months. Similarly, the Employment Cost Index (ECI) continued to grow strongly in Q2; the annual growth rate is now at its highest level since the 1990s. The only comfort is that the quarterly growth rate did not accelerate further in Q2, so it is possible that wage growth has peaked.

Wage costs have accelerated but may have peaked



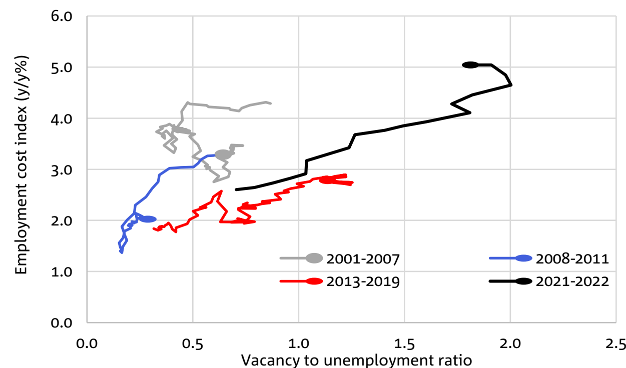
Source: Refinitiv (BLS)

Adding to the concerns, taken at face value, the fall in GDP coupled with strong employment growth, points to a large negatve productivity shock. As a result, non-farm business sector unit labour costs are growing at their fastest pace since the early 1980s. Measured productivty can be very volatile (and subject to revision) but broadly the labour cost story is not a positive one.

History suggests that, after a major shock to the labour market, you do not necessarily return to the same level of wages growth as the shock dissipates.

Th following chart plots a labour market tightness measure (the vacancy to unemployment ratio) against a wage labour cost measure. In the aftermath of the 2001 and 2008/09 recessions – as the labour market recovered, wages growth returned to a lower level than it had been previously. In the case of the post-COVID recovery, however, wage cost growth has been faster, for a given vacancy to unemployment ratio, than it was before. [1]

Labour costs relative to labour mkt tightness have shifted up



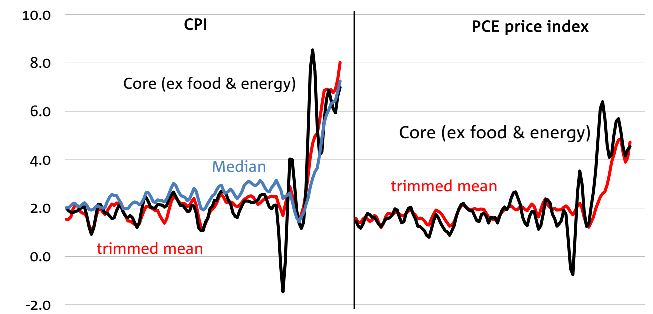
Wage setting is not just a function of labour market tightness or inflation (realised or expected). Other factors such as changing productivity trends are also important. This factor likely helps explain the downshift in wages growth in the 2000s as productivity growth was clearly moving to a lower level in this period. However, as already noted, recent productivity data are weak, contrary to the strength in recent wage growth.

The Fed may take some comfort in the fact that, when the economy slows, at some point wage growth can fall quickly. This was the experience following the 2001 and 2008/09 recessions. In the case of the 2001 recession the unemployment rate rose by around 2ppts – which is only a bit higher than our expectation for how unemployment will lift over the next few years.

On the inflation front, helped by the fall in oil prices, monthly headline CPI inflation was flat in July (0.0% m/m). The annual rate also eased but, at 8.5% y/y, remains very high. Similarly, PCE inflation was -0.1% m/m 6.3% y/y after 1.0%/6.8% y/y in June.

The easing in inflation pressures was also seen in the core (ex energy and food) measures. Core CPI inflation was 0.3% m/m down from 0.7% in June, while the core PCE measure was only 0.1% m/m. However, this follows an acceleration in the previous month or two and on a 3mth/3mth basis they appear to have stabilised at a high level. Moreover, alternative measures of core inflation – such as trimmed mean CPI and PCE inflation, were higher m/m than the core measures (at 0.4% and 0.3% m/m respectively).

Inflation eased in July but needs to be sustained



Sources: Cleveland Federal Reserve (trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. Monthly data to May 2022 (CPI) or April 2022 (PCE).

There are several factors that are contributing to an easing in inflationary pressure. There have been falls in some commodity prices (including for oil, cotton and food), shipping costs are declining, inventories in many industries have been rebuilt, and business surveys point to shorter supplier delivery times and reduced order backlogs (i.e., an easing in supply chain constraints). The appreciation of the USD – by around 6% on a trade-weighted basis since March – will also provide some (modest) deflationary pressure.

This supports our forecast that core inflation will decline over the second half of 2022 and beyond. However, we are still projecting core inflation on a quarterly, annualised basis, to remain above the Fed's 2% inflation target. This reflects the current breadth of inflation, the very tight labour market (not likely to materially ease until next year), the likelihood that housing rents will continue to grow strongly over the next 6-12 months at least and that COVID disruptions have not entirely dissipated (most notably in China). While some commodity prices have come off it is unclear how far this will go (oil prices have recovered some lost ground since mid-August) and natural gas prices are rising (most evidently in Europe but also in the US).

US fiscal policy changes

Two recent fiscal policy developments were the passage by Congress of the Inflation Reduction Act (the IRA) and President Biden's announcement around student debt.

The overall budget impact (and hence impact on aggregate demand) of the IRA is minimal in coming years with most deficit reduction happening at the back end of the 10-year window. The Penn Wharton Budget model found some near-term upward pressure on inflation over 2022 and 2023 but the

[1] This section draws on analysis in a Federal Reserve Bank of Kansas City Economic Bulletin article (10 August 2022).

impact is likely too small to have any meaningful impact.

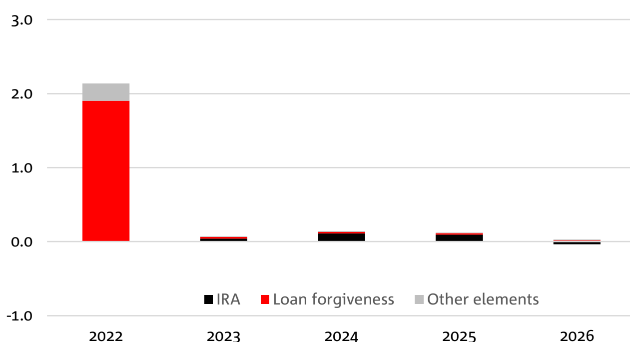
The President's student debt plans have three main elements. Firstly, a partial cancellation of student debts, secondly a new income driven repayment (IDR) plan (which will lower monthly repayments) and lastly an extension of the current moratorium on student loan repayments by 4 months (to end 2022).

The Committee for a Responsible Federal Budget estimates that the cost (over 10 years) will lie between $440 and $600 billion. Their central estimate is $500b, with $360b relating to debt cancellation, $120b for the IDR plan and $20b the repayment moratorium. The Penn Wharton budget model estimates the cost at $600b over 10 years, with debt cancellation, at $520b, the major component.

Penn Wharton estimates the cost in the first year at $526b or around 2% of GDP. While this is large, it overstates the degree of demand stimulus from the plan. One way to view the debt cancellation element is that it is a one-off boost to wealth for the recipients; the increase in spending associated with an increase in wealth is small (less than 10c in the dollar). Alternatively, the lower debt repayments required each year will only be fraction of the total debt cancelled.

Recent fiscal measures and plans

Budget impact (% GDP, + indicates a net cost to the budget) - Penn Wharton estimates



Source: Penn Wharton, NAB

As a rough estimate the plan – if it goes ahead – may add around ¼% (or a bit higher) of GDP to aggregate demand over the next year. This is not a huge amount but nevertheless runs counter to what the Fed is trying to achieve.

Monetary policy

With inflation still well above target, the labour market very tight the Fed is unsurprisingly indicating further rate rises lie ahead.

This was one message from the Fed Chair's Jackson Hole speech last week. Noting that the fed funds rate is now around its expected longer-run level, the Fed Chair added "…with inflation running far above 2% and the labor market extremely tight, estimates of longer-run neutral are not a place to stop or pause."

The Chair also made clear the determination to get inflation under control and noted that while inflation expectations appear to remain well-anchored there is a risk this may change the longer inflation stays high. He also stated that restrictive policy will be required from some time with "The historical record cautions strongly against prematurely loosening policy". He also noted that to get inflation down will likely require a "sustained period of below-trend growth".

We had been expecting a peak federal funds rate of 3.25-3.50%, with this to be reached by the end-2022. However, we have noted that risks around this call were weighted to the upside. The strength of recent labour market (including wages) data as well some additional fiscal stimulus has added to this risk.

As a result, we now expect a higher peak fed funds rate of 3.50 to 3.75%. For the next meeting (in September) it appears to be lineball between a 50bp and 75bp rate hike, but we are incorporating 75bp into our track (with 25bp increases at the subsequent two meetings).

We also had rate cuts starting from Q2 2024. However, with the peak now higher, we see these starting earlier – in Q1 2024 – so that by the end of 2024 the Fed funds rate is 2.50-2.75% (as we had previously). Markets are pricing in rate cuts starting in H2 2023, which is feasible given that we expect unemployment to be rising while inflation will be falling. However, with inflation still expected to 2.5% by end year, and given the Fed's current focus on getting inflation down to target, we see 2024 as the more likely start time for rate cuts if our economic forecasts are realised (a big if that far into the future).

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U.S. ECONOMIC & FINANCIAL FORECASTS

					Quarterly Chng %											
					2022				2023				2024			
	2021	2022	2023	2024	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components																
Household consumption	7.9	2.5	0.6	1.1	0.5	0.4	0.4	0.3	0.0	-0.1	0.2	0.3	0.3	0.3	0.3	0.3
Private fixed investment	7.8	1.6	-0.3	2.6	1.8	-1.1	0.0	0.2	-0.3	-0.3	0.4	0.7	0.8	0.8	0.8	0.8
Government spending	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*	0.1	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*	-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	**5.7**	**1.7**	**0.2**	**1.2**	**-0.4**	**-0.1**	**0.4**	**0.2**	**-0.2**	**-0.2**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*-1.6*	*-0.6*	*1.6*	*0.9*	*-0.8*	*-0.8*	*0.8*	*1.3*	*1.5*	*1.5*	*1.5*	*1.6*
US Other Key Indicators																
PCE deflator-headline																
Headline	5.5	5.2	2.1	1.9	1.7	1.7	0.9	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Core	**4.6**	**4.0**	**2.5**	**2.3**	**1.3**	**1.1**	**0.9**	**0.7**	**0.6**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.7**	**4.7**	**5.2**	**3.8**	**3.6**	**3.6**	**3.7**	**3.9**	**4.1**	**4.4**	**4.7**	**4.8**	**4.9**	**5.1**	**5.2**
US Key Interest Rates																
Fed funds rate (top of target range)	**0.25**	**3.75**	**3.75**	**2.75**	**0.50**	**1.75**	**3.25**	**3.75**	**3.75**	**3.75**	**3.75**	**3.75**	**3.50**	**3.25**	**3.00**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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