US Economic Update, 7 October 2022

Recession risk – Q3 breather likely temporary

NAB Group Economics

- **Incoming data point to GDP growth returning to positive territory in Q3, albeit the main driver is the volatile net exports component.**
- **The Fed delivered a 75bp rate hike in September, as expected. However, member projections were hawkish and we have revised up our rate expectations – we now see a peak target range of 4.25-4.50% (previously 4.00-4.25%).**
- **We still expect the US to enter recession in 2023. Reflecting tighter policy expectations, we have modestly lowered the GDP growth forecast and in 2023 we expect no growth (was 0.2%), including at least two quarters of negative growth.**

Current conditions & outlook

After two quarters of negative growth, GDP is set to bounce back in Q3, and we now expect annualised quarterly growth of around 2.0%.

However, the key support for Q3 GDP at this stage is net exports, which is expected to make an even larger growth contribution than in Q2 (but without the large inventory detraction seen in that quarter). The trade data have been volatile, and so do not provide much signal on the underlying strength in the economy.

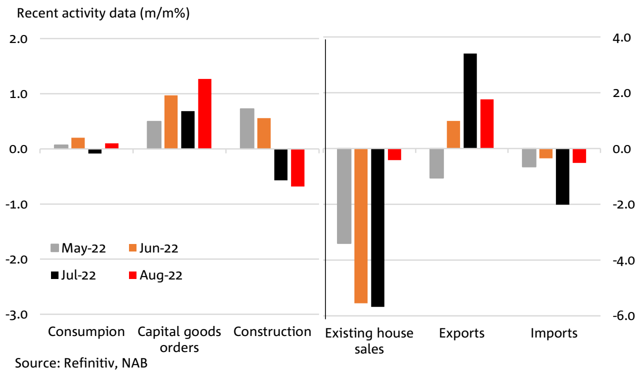
While growth has been sluggish, consumption has held up in the face of falls in real income as households have dipped into the pile of savings accumulated through the pandemic. While it is unclear how far they are prepared to go on this front, the recent falls in oil prices have seen some recovery in real incomes which should support near term consumer activity.

Capital goods orders (ex. defence and aircraft) – an indicator of equipment investment – have also picked up in recent months. That said, survey measures of capital spending intentions have been mixed – they are still easing in the capital-intensive manufacturing sector, but they have stabilised in the services sector. There are still areas of clear weakness – this is particularly the case for residential investment, but it is also true of the broader construction sector.

While GDP growth looks likely to turn up in Q3, business surveys are sending are a less optimistic signal about the trajectory of the economy. While there have been some large divergences in the various business surveys of late, the underlying trend remains downwards, although the services sector may have stabilised in recent months.

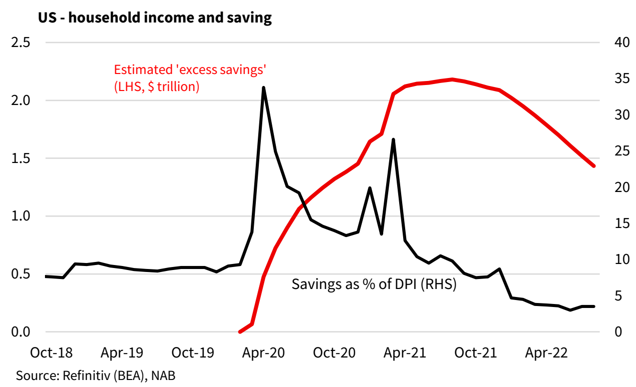
Not unexpectedly, given the Fed's policy moves, financial conditions are also tightening. Yields have risen, as have mortgage rates. House prices, which were still growing strongly as recently as May, started to fall in July. Moreover, equity prices started falling again from around mid-August, moving back to around the lows seen in June. The fall in equity prices and likely further declines in housing prices, will compress household wealth, and represents a headwind to consumption growth.

Partials consistent with positive Q3 GDP growth



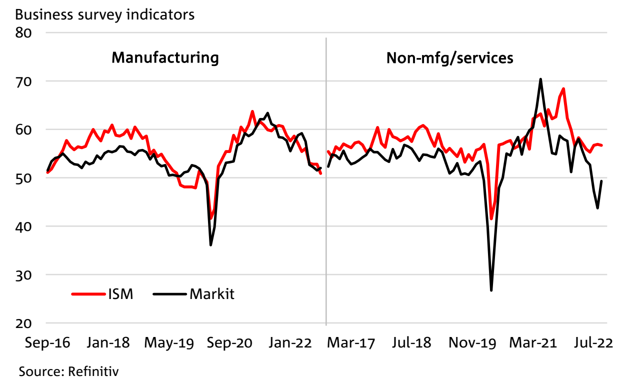
Source: Refinitiv, NAB

Households utilising pandemic savings



Source: Refinitiv (BEA), NAB

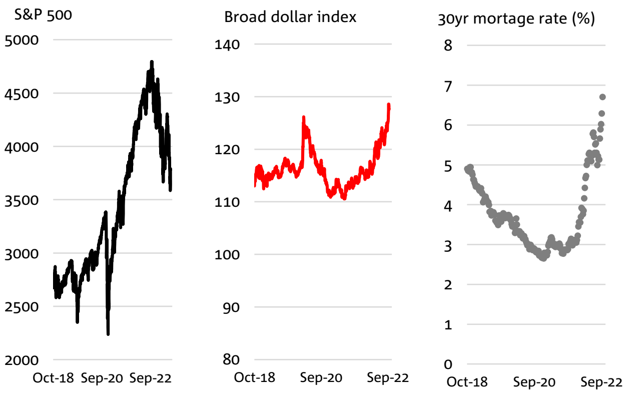
Business surveys mixed but, overall, falling



Source: Refinitiv

The US dollar has also continued to strengthen which will reduce the competitiveness of the US traded goods sector (particularly if the rest of the world slows in the face of energy shocks and tighter policy settings). Financial market volatility and broader measures of financial stress have also either remained relatively high or deteriorated.

Financial conditions tightening



We continue to expect that the US economy will go into recession next year, due to the expected impact of the Fed's monetary policy tightening as well as other headwinds. These include the Ukraine/Russia war as the crunch in European energy markets is likely to trigger recessions in Europe, including in the Euro-zone and UK.

Reflecting upward changes to our expectations for Fed monetary policy tightening, we have marked down our forecasts for US GDP growth further, despite upwards revision to forecast growth in Q3 2022 (to 2.0% q/q annualised from 1.6%) and to historical data. In year average terms, we now expect growth of 1.8% (previously 1.7%) in 2022, 0.0% in 2023 (was 0.2%) and 1.1% in 2024 (was 1.2%). The 2023 forecast allows for two to three quarters of negative growth (with the Q3 growth forecast essentially flat).

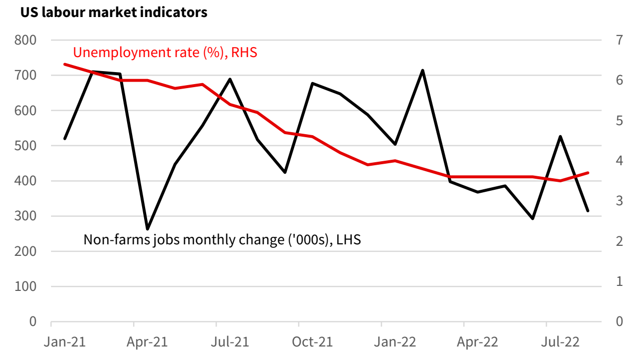
Labour market and inflation

The labour market has remained very tight through 2022 despite the growth slowdown. While jobs growth weakened around the middle of the year, it has remained well above the level that would be expected over time given underlying demographics. The unemployment rate rose in August, although it is still low and a one-month change is not sufficient to signal a turning point.

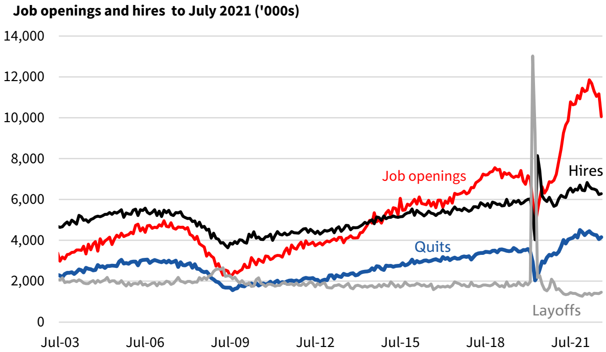
There was also a very large downwards move in job openings in August. Job hires and quits have also been easing, and layoffs edging up, although all these indicators (particularly openings) remain favourable by historical standards.

Whether this incipient softening is having any impact on wages growth is less clear. Monthly average hourly earnings growth has slowed (but is still robust). However, this was not the case in the Employment Cost Index (through to Q2) which adjusts for compositional changes, while the Atlanta Fed's wage tracker has stabilised at a high level.

Labour market starting to soften…but still tight



Sources: Refinitiv, BLS, NAB

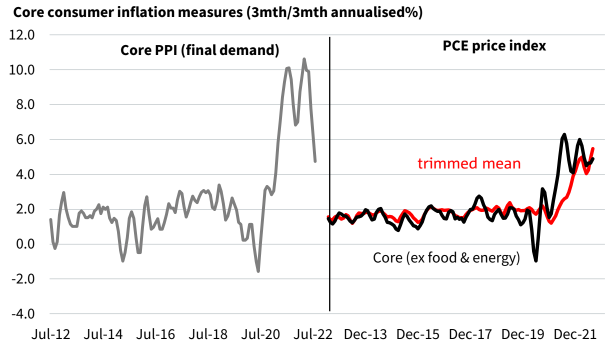


Sources: BLS, NAB

Inflation has moderated over the last couple of months although this largely reflects downward moves in oil prices. Over July and August, the CPI increased by 0.1% (annualised 0.6%) while PCE inflation was only a bit stronger (0.2% over the two months or 1.0% annualised). Lower gasoline costs will also weigh on September inflation.

However, core consumer inflation, after a weak July was again strong in August, and on a 3mth/3mth basis there is no clear sign it is decelerating.

Underlying consumer inflation still high but producer price inflation waning



Sources: Dallas Federal Reserve (Trimmed mean PCE), BEA, NAB.

In contrast, core producer prices (PPI) have started to decelerate. Measures of supply chain disruptions (such as business survey readings on supplier delivery times or order backlogs) and higher inventory levels indicate that pressure on prices from this source are easing. Global freight rates have been falling and used car auction prices are declining. The stronger US dollar will also dampen imported price inflation.

Survey and market implied measures of inflation have also pulled back recently. This will give the Fed some comfort, although inflation expectations are only important so far as they actually underpin decisions around price and wage increases; as noted above there are not yet clears signs of a slowing in the latter.

Monetary policy

Ahead of the Fed's end September meeting we lifted our expectation of how high the Fed funds rate would go (from 3.50 to 3.75% to 4.00-4.25%). This allowed for rates to reach 4.0% (top of target range) by end 2022 with a further 25bp rate increase in early 2023.

As expected, the Fed delivered a 75bp rate hike at its September member. However, Fed member projections for the Fed funds rate were also significantly revised up. The median Fed projection (for the top of the target range) is 4.50% in 2022 and 4.75% in 2023

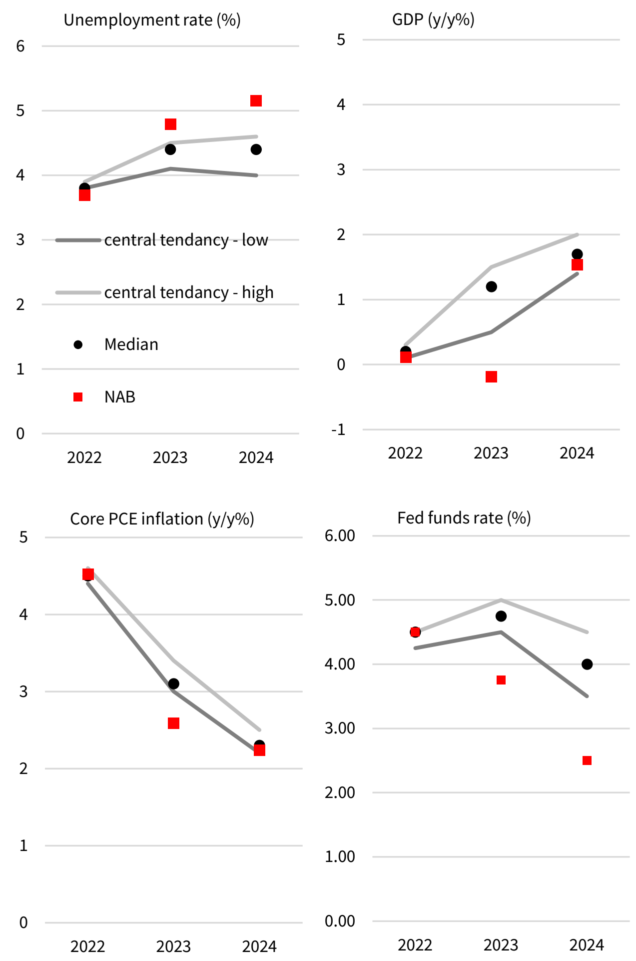
As the Fed sets policy there is no point fighting its clearly signalled intentions, at least over the near term. For 2023, we are far more pessimistic both in terms of GDP growth and unemployment, but our forecasts for the rest of 2022 are not significantly different.

Accordingly, we now expect the fed funds rate target range to reach 4.25-4.50% by the end of this year (75bp in November and 50bp in December) and for the Fed to then pause as the economy turns down. In the median Fed projection for end 2022, there was an almost even split between members expecting 4.25% or 4.50% (top of range) and so there is a possibility that the Fed moves a little bit more slowly over the rest of 2022. Against this, there is the risk they keep hiking into early 2023; the Fed raised rates in the 1st half of 2022 even as GDP declined, so a run of lower inflation prints, further signs of labour market softening, including indications wages growth is slowing, will also be important determinants of when the Fed pauses.

The higher the Fed moves, and the weaker the economy is, then the earlier it is likely to pull the trigger on rate cuts (assuming inflation is tracking back towards its inflation target). With a higher peak fed funds rate now in our projections, and a further mark down in growth, we now expect the Fed to start reducing rates late in 2023 and to continue doing so through 2024, bringing rates back to around their perceived 'neutral' level by the end of the year.

NAB and Sep 22 Meeting FOMC projections*

* End year projections – level for unemployment and fed funds rate; Q4 change on Q4 a year earlier for GDP and core PCE inflation.



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U.S. economic 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	8.3	2.6	0.6	0.9	0.3	0.5	0.2	0.4	0.1	-0.1	0.0	0.2	0.3	0.3	0.3	0.3
Private fixed investment	7.4	0.2	-1.1	2.5	1.2	-1.3	-0.7	0.2	-0.4	-0.5	0.1	0.6	0.8	0.8	0.9	0.9
Government spending	0.6	-1.1	1.0	1.3	-0.6	-0.4	0.3	0.3	0.3	0.3	0.4	0.4	0.3	0.3	0.3	0.3
Inventories*	0.2	0.8	-0.4	0.0	0.1	-0.5	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.9	0.0	-0.2	-1.0	0.3	0.5	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**1.8**	**0.0**	**1.1**	**-0.4**	**-0.1**	**0.5**	**0.2**	**-0.2**	**-0.3**	**0.0**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*-1.6*	*-0.6*	*2.0*	*0.7*	*-0.6*	*-1.2*	*0.0*	*1.1*	*1.4*	*1.5*	*1.6*	*1.7*
US Other Key Indicators																
PCE deflator-headline																
Headline	5.7	5.4	2.3	2.0	1.8	1.8	0.8	0.8	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Core	**4.7**	**4.5**	**2.6**	**2.2**	**1.4**	**1.1**	**1.1**	**0.9**	**0.6**	**0.7**	**0.6**	**0.6**	**0.6**	**0.5**	**0.6**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.7**	**4.8**	**5.2**	**3.8**	**3.6**	**3.6**	**3.7**	**3.8**	**4.1**	**4.5**	**4.8**	**5.0**	**5.1**	**5.1**	**5.2**
US Key Interest Rates																
Fed funds rate (top of target range)	**0.25**	**4.50**	**3.75**	**2.50**	**0.50**	**1.75**	**3.25**	**4.50**	**4.50**	**4.50**	**4.25**	**3.75**	**3.25**	**3.00**	**2.75**	**2.50**

Source: NAB Group Economics

*Contribution to real GDP growth

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