US Economic Update, 4 November 2022

Q3 GDP – economy growing again (for now)

NAB Group Economics

- **The economy resumed growth in Q3, although this was in large part due to an unsustainably large net export contribution.**
- **Growth in domestic final demand was weak in Q3 and October business surveys point to a weakening economy.**
- **We have made small upwards revisions to our GDP growth forecasts. We now expect growth of 1.9% (was 1.8%) in 2022, 0.1% in 2023 (was 0.0%) and 1.1% in 2024 (unchanged). We still expect the US to go into a mild recession in 2023.**
- **Following the Fed's meeting this week, we now expect a higher peak fed funds rate (5.00%, up from 4.50% previously) to be reached in Q1 2023.**

Q3 GDP – a return to growth

After falling in the first half of the year, GDP grew again in Q3, up 0.6% q/q (2.6% annualised). However, over the last three quarters growth is only just positive (0.1%).

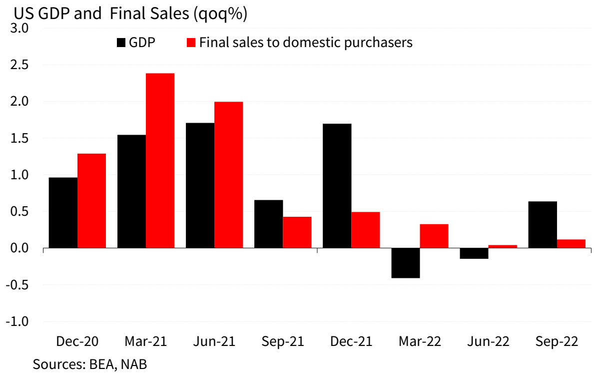
Growth in domestic final demand remained very soft, rising only 0.1% (and only marginally better than in Q2). Private final demand was essentially flat.

By component, consumption growth was moderate (0.4% q/q), business investment bounced back strongly (+0.9%, after 0.0% in Q2) but residential investment experienced a large fall (-7.4%). Residential investment has fallen in each of the last six quarters (and is now close to its pre-COVID level) with the biggest falls occurring in the last two quarters following a steep increase in mortgage rates.

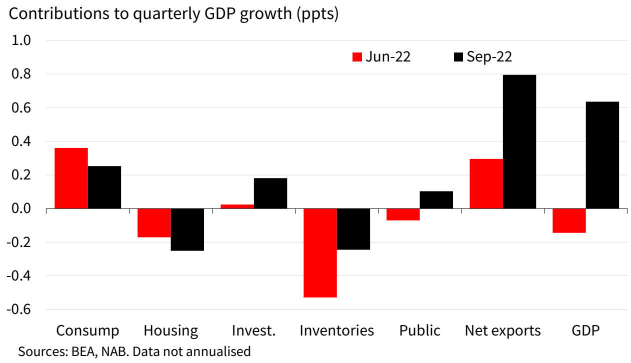
Within consumption, growth was driven by solid services growth (0.7%), while goods consumption declined (-0.3% q/q). Goods consumption was elevated during the pandemic, while services have taken longer to recover, but the gap has narrowed this year, pointing to an ongoing normalisation in spending patterns.

The large contribution from trade reflects another quarter of strong export growth (3.4% q/q) while imports declined – entirely due to a fall in goods imports. Services imports continue to be supported by a recovery in overseas travel. The shift down in imports – from a high level – reflects the overall softening in the economy, a normalisation of consumption patterns (from heavily traded goods to services) and a recovery in inventory levels. However, these influences will fade, and with headwinds coming from dollar appreciation and a weakening global economy, the strength in net trade is not sustainable.

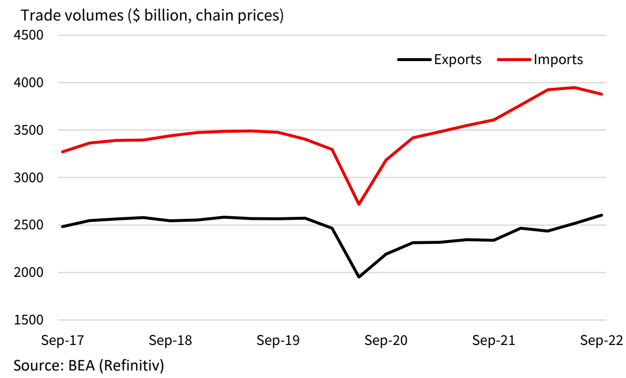
GDP ends run of falls but domestic demand soft



Net trade contribution a key support



Imports unwinding as goods demand normalises and inventories recover



There was a negative contribution to growth from inventories. This reflected a slower pace of inventory accumulation in Q3. Inventories relative to sales were flat, and still look a little low relative to their pre-pandemic level. However, there is considerable variation by sector, with retail motor vehicle inventories still low (even if edging up) while for general merchandise stores and other retailers, they look high (consistent with press reports that some businesses are considering discounting prices to reduce stocks).

Outlook

The Q3 GDP report does not materially change our view of the outlook for the US economy.

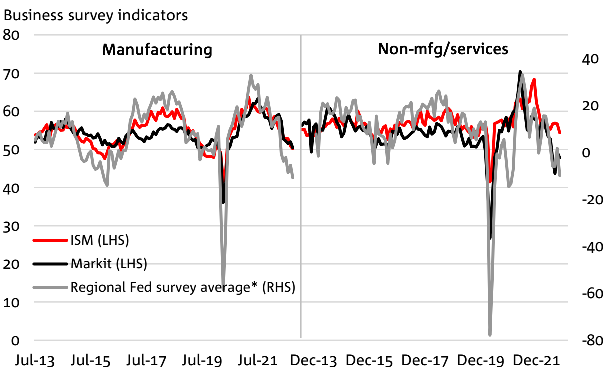
Business surveys are pointing to an ongoing weakening in the business sector, although the ISM services survey is somewhat of an exception as it remains at a solid level. Similarly, future business investment indicators, after stabilising for a couple of months, took another turn down in October.

While some of the business surveys are below their break-even levels, they are not yet at levels historically consistent with a recession. Recent falls in gasoline prices have also provided some relief to households, supporting consumption growth in Q4, as will the continued normalisation of services consumption post the pandemic (although this factor will fade over time).

While we expect to see some modest GDP growth in Q4, we still expect to see the US to go into recession next year (albeit a relatively mild one by historical standards) because of the tightening in monetary policy. An expected downturn in Europe due to the energy shock associated with Russia's invasion of Ukraine, as well as sub-par growth in China, due to on-going COVID-19 restrictions and stress in the property sector, represent additional headwinds.

While the precise timing is uncertain, for now, we have Q1 pencilled as the quarter where activity will first decline, but with the weakness in the economy likely to be concentrated around the middle of the year.

Most business surveys trending down

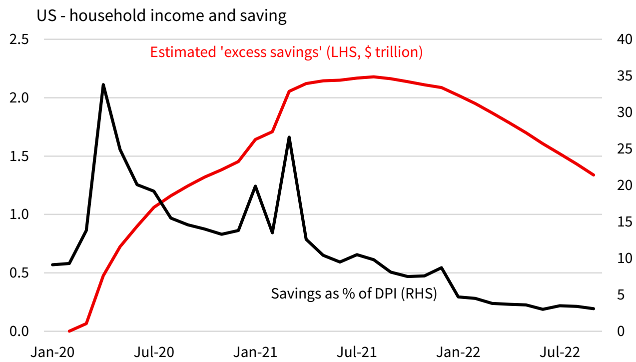


Sources: ISM; Markit; Dallas, New York, RIchmond, Dallas, Philadelphia and Kansas City Federal Reserves.

The outcome for Q3 was a bit higher than we had expected (we had forecast 2.0% annualised q/q). Base effects also suggest that Q4 consumption will be stronger than we previously thought, but upwards revisions to our expected fed funds rate peak points to weaker growth through 2023. Balancing these factors, our year average 2022 and 2023 forecasts have moved a bit higher. We now expect growth of 1.9% in 2022 (was 1.8%), 0.1% in 2023 (was 0.0%), but our 2024 forecast is unchanged at 1.1%

One source of upside risk is that the stock of savings accumulated by households – over and above what might have been expected given pre-COVID trends – may mean that consumption is substantially more resilient than past relationships would suggest. Households have already been utilising these excess savings to support consumption over the last year, given the squeeze on real incomes from very high inflation, but there is still a long way to go before they are exhausted. However, there is no guarantee that households will want to fully run down the excess savings given consumer sentiment is weak and wealth is under pressure from share market and, more recently, house price declines.

'Excess' savings still high but falling



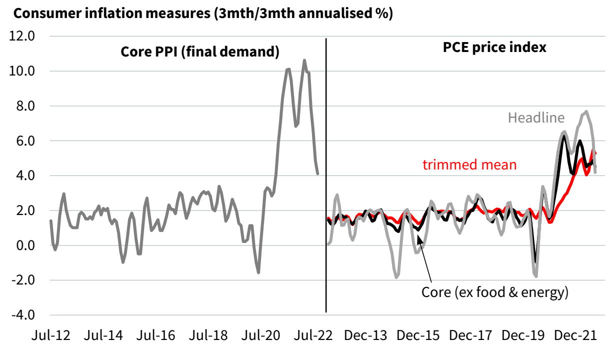
Source: Refinitiv (BEA), NAB

Downside risks include the potential for a steeper global decline, or from inflation remaining more persistent than expected, leading the Fed to take rates above the level we have built into our forecasts.

Inflation

Inflation remains high, even with some relief coming from the recent fall in oil prices. PCE inflation was 6.2% y/y in September and the core measure (which excludes food and energy) was 5.1% y/y. On a 3mth/3mth basis (annualised), headline inflation has come down to 4.2% but the core, and the trimmed mean PCE indicators, have stabilised at a high level.

PCE inflation yet to show signs of slowing, but producer price inflation decelerating…

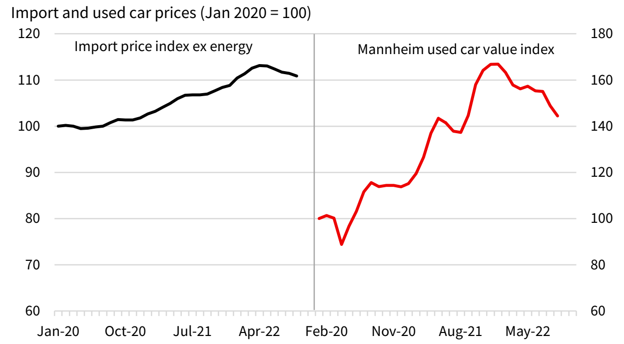


Sources: Dallas Federal Reserve (Trimmed mean PCE), BEA, NAB.

There are some factors currently putting downward presssure on inflation. Commodity prices have been falling, supply chain problems, a factor behind the initial surge in inflation, are easing and there have been large falls in shipping freight rates. The easing in supply constraints has allowed inventories to be rebuilt (although they are still low in some sectors). As a result, producer price growth is slowing, while import prices, helped by dollar appreciation, are falling, as are used car prices.

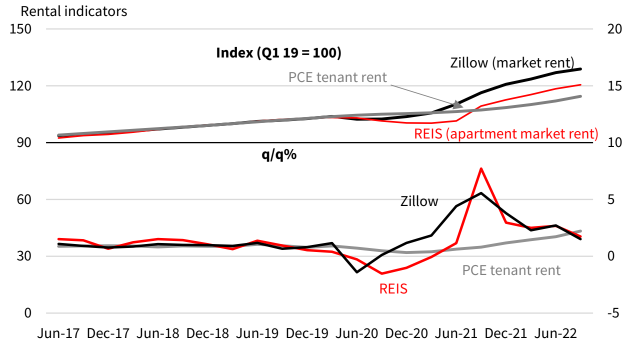
That said, service sector inflation is likely to stay elevated for now. Wages growth may be inching down (discussed below) but remains high. Moreover, rental inflation, particularly important for the CPI (32% weight) but also for PCE inflation (around 15%), is likely to run strongly for a while yet. Vacancy rates are low and rents have been rising strongly – growth in asking rent measures such as Zillow is slowing but still remans high. The rise in asking rents takes a while to feed through into the CPI/PCE measures which are based on all rentals (rather than just new ones or resets) ensuring they will grow strongly for a while yet.

While imported inflation & used car prices falling



Sources: Refinitiv, NAB

…rental inflation to remain strong for a while



Sources: Refinitiv, Macrobond, Zillow. Zillow seasonally adjusted by NAB.

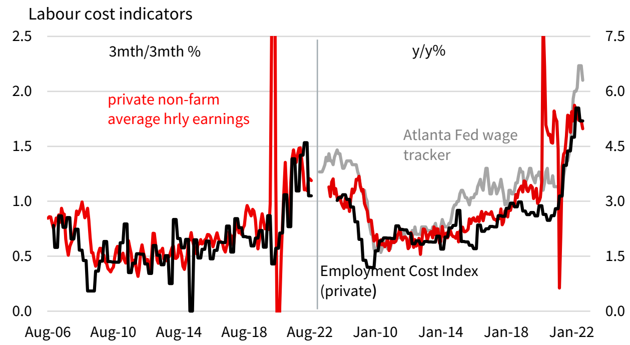
How these competing forces balance out is highly uncertain. We still expect inflation to ease – particularly as the economy slows, but how persistent wages growth, given a still very tight labour market, and elements of service sector inflation, prove to be will be crucial to the actual outcome.

Labour market

The labour market pressures have shown some signs of easing, although the unemployment rate remains low and wages growth high. Employment growth was again robust in September but the 263,000 gain in non-farm employment was the smallest monthly increase since April 2021, and a lower number again is expected for October. While the large downwards move in job openings in August was partially reversed in September, the trend has been downwards since March, although they remain very high.

Wages growth remains high but there are signs that it is starting to ease. The private sector Employment Cost Index (ECI) was up 1.1% q/q (5.2% y/y) in Q3, down on the previous two quarters. Similarly, average hourly earnings growth has eased in the last two months (to around 0.3% m/m) although the data can be volatile and are affected by compositional change. The Atlanta Fed's wage growth tracker – only available on an annual change basis – also appears to have peaked and has started to inch down.

Wage growth may have peaked



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

Monetary policy

As expected, the Fed raised rates by 75bp at its FOMC meeting this week.

The Fed's meeting statement laid the platform for a slower pace of rate hikes at the next meeting. Specifically, it indicated that in considering the size of future hikes, it would consider the cumulative tightening in policy, the lags with which rates increases impact the economy, as well as incoming data. The Fed Chair also indicated in his press conference that a slowing in inflation over several months wasn't necessary to see a slowdown in rate hikes.

However, the meeting statement also referred to expected "ongoing increases" in the funds rate (i.e., into 2023). The Fed Chair indicated that there was still a long way to go before the fed funds rate reaches a level consistent with getting inflation down to 2%. He stated that this level is higher than indicated in the September meeting projections, noting that inflation has not come down as was expected and that consumption has not been impacted by rate increases as much as they thought it would.

At the September meeting, projections for the end 2023 fed funds rate essentially ranged between 4.50% and 5.00% for the top of the target range (there was one outlier at 4.0%), with a median of 4.75%.

We had expected a further 50bp hike in December (to 4.50%) but for the Fed to then pause given our view that inflation will be showing signs of easing and for the economy to start declining in Q1.

However, the Chair's comments suggest that it will take more of a turnaround in the economy in coming months – particularly the labour market – as well as in inflation than we are expecting to prevent further rate hikes in 2023. Accordingly, we now expect to see 25bp hikes in both the February 2023 and March 2023 meetings. This would take the fed funds rate to 5.0%.

Risks around this are two-sided. In part this reflects the inherent uncertainty around any baseline forecast (and the volatility in monthly data). However, it is possible that the Fed pauses after the February meeting as we think at some point it will become evident that the economy is less resilient than the Fed expects it will be. Equally, however, they could increase rates by more than we are allowing for in upcoming meetings, particularly December or February, or inflation may prove to be more entrenched than we think it is, leading the Fed to conclude the terminal rate needs to be even higher.

With a downturn in the economy still expected, we still think the Fed will reverse course late in 2023. We had the first rate cut pencilled in for September and see no reason to change this. Once the Fed starts cutting, a steady series of rate reductions is the most likely path (50bp a quarter), before slowing up as the 'neutral' level comes in sight.

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U.S. economic forecasts

					Quarterly Chng %									
					2022		2023				2024			
	2021	2022	2023	2024	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	8.3	2.7	0.7	0.8	0.4	0.5	0.1	-0.1	-0.1	0.1	0.3	0.3	0.3	0.4
Private fixed investment	7.4	-0.1	-1.7	2.4	-1.3	0.0	-0.4	-0.5	-0.1	0.6	0.8	0.9	1.0	1.0
Government spending	0.6	-0.9	1.1	1.2	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Inventories*	0.2	0.7	-0.4	0.0	-0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.7	0.2	-0.1	0.8	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**1.9**	**0.1**	**1.1**	**0.6**	**0.3**	**-0.1**	**-0.4**	**-0.1**	**0.2**	**0.4**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)					*2.6*	*1.1*	*-0.4*	*-1.4*	*-0.4*	*0.9*	*1.5*	*1.7*	*1.8*	*1.8*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.7	5.8	2.5	2.0	1.0	1.0	0.9	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Core	**4.7**	**4.8**	**2.8**	**2.2**	**1.1**	**1.1**	**0.9**	**0.7**	**0.6**	**0.5**	**0.5**	**0.6**	**0.6**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.7**	**5.2**	**3.5**	**3.6**	**3.7**	**4.0**	**4.3**	**4.7**	**5.0**	**5.1**	**5.2**	**5.2**
US Key Interest Rates														
Fed funds rate (top of target range)	**0.25**	**4.50**	**4.25**	**2.75**	**3.25**	**4.50**	**5.00**	**5.00**	**4.75**	**4.25**	**3.75**	**3.25**	**3.00**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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