US Economic Update, 8 Dec. 2022

Domestic demand solid early in Q4

NAB Group Economics

- **Early data for Q4 point to solid domestic demand growth but net exports again loom as a large swing factor for GDP.**
- **Most business surveys have trended down this year and we still expect the US to go into recession next year.**
- **Labour market data continue to be strong, with robust wages data in the November employment report likely to concern the Fed and suggests some upside risk to our expected fed funds target range of 4.75% to 5.00%. That said, we still expect the Fed to step down the pace of hikes – to 50bp – at the December meeting.**

Activity and outlook

Early data for Q4 are painting a reasonably positive picture for domestic demand growth. In particular, household consumption grew by 0.5% m/m in October. This follows solid growth in August and September. Even if consumption was flat for the rest of the quarter, annualised Q4 growth would be over 3% q/q. Around one-third of the October increase was due to a jump in motor vehicle sales, although separate data on auto sales point to this being partially reversed in November.

Business investment also looks set to continue growing in the quarter (at around a similar pace to Q3). Capital goods shipments data to October point to solid Q4 growth in machinery and equipment investment. That said, capital goods orders growth has been slowing, although this may be partly explained by a slowdown in capital equipment price growth.

On a less positive note, nominal private non-residential construction expenditure fell in October foreshadowing another decline in real non-residential structures investment. Housing indicators also remain weak, with sales and construction expenditure all trending down.

Net exports have been a big swing factor this year in GDP calculations. After a large contribution to growth in Q3, declines in exports and a rebound in imports in September and October point to a large net export detraction from growth in Q4.

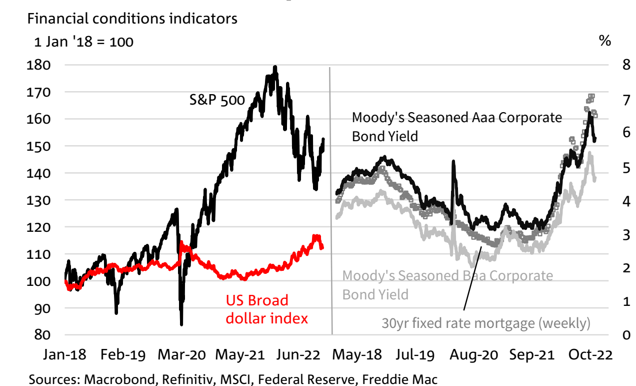
As a result, despite the positive consumption data, we have left our Q4 GDP forecast unchanged at 1.1% q/q annualised.

The BEA revised up the advance estimate for Q3 GDP growth from 2.6% annualised to 2.9% q/q, leading to a small upwards revision to our forecast for year average GDP growth in 2023 to 0.2% (from 0.1%). We still expect that the US economy will experience a recession in 2023. The small year average growth expected for 2023 hides a fall in GDP over the course of the year.

The expectation of a downturn reflects the significant tightening in monetary policy by the Fed this year as well as global headwinds, including the energy shock resulting from Russia's invasion of Ukraine and continued COVID-19 disruptions in China.

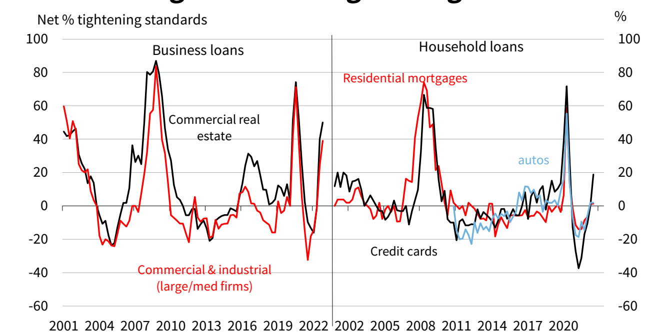
There has been a broad-based tightening in financial conditions over 2022, with large falls in equity prices, an appreciation in the US dollar, as well as large increases in interest rates faced by households and businesses. That said, there has been some relaxation in conditions over the last month or so.

Financial conditions tightened over 2022 even with some recent respite



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

Bank lending standards tightening



Source: Federal Reserve. CRE from Dec. '13 Qtr is a simple average of the 3 categories. Res. Mortgages 2007Q2: 2014 Q4 are prime & from 2015 Q1 average of GSE eligbile, Govt, QM non-jumbo, non-GSE eligible, QM jumbo

The Fed's senior loan officer opinion survey released in November also indicates that there is a tightening in bank lending standards underway. At this stage, this is mainly for business loans – where standards have tightened noticeably – although credit cards have also seen stricter standards put in place. Historically, a

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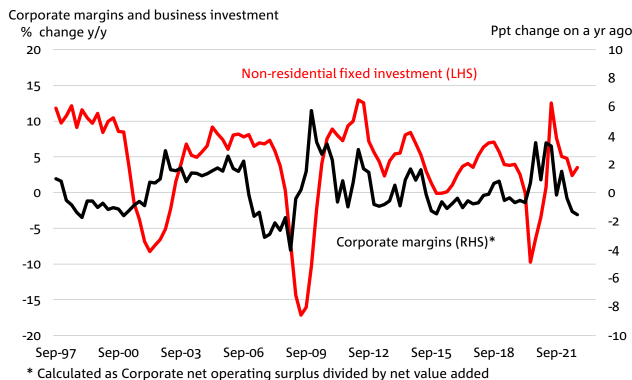
tightening in bank lending standards have been associated with slower GDP growth.

Feeding into this dynamic, there are signs that corporate margins are starting to ease (albeit they remain at a high level), which has typically foreshadowed a pullback in capital expenditure. Regional Federal Reserve surveys of future investment expectations have also fallen, although they would need to decline further to clearly signal falls in the level of investment.

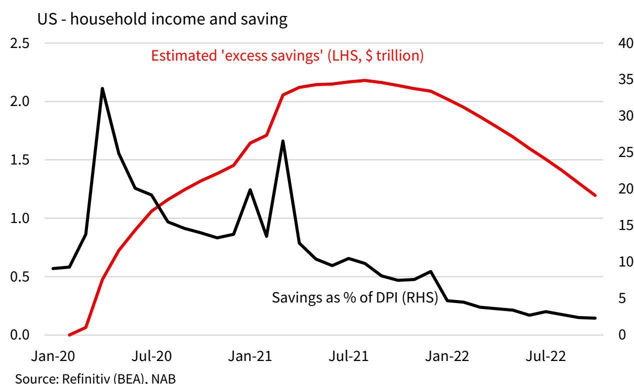
Business investment coming under pressure



* Calculated as Corporate net operating surplus divided by net value added

The recent strength in consumption has been helped by the fall in oil prices, continued strong employment growth (even if slowing) and households lowering their saving rate. Given the large level of 'excess' savings accumulated during the pandemic, it is possible that this latter trend could continue but we think this is unlikely. Consumer confidence is low, wealth is under pressure (with house prices now also moving down on top of the falls in share markets) and over the last sixty years in only one other month has the savings rate been lower than it was in October.

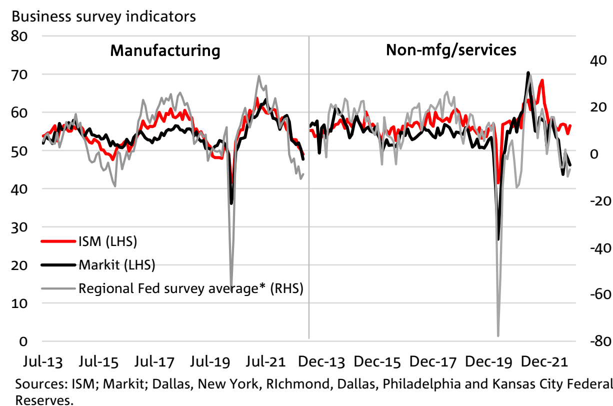
Excess savings falling; saving rate is very low



Source: Refinitiv (BEA), NAB

In contrast to the recovery in GDP growth in the second half of the year, there has been a downwards trend in business surveys since early in the year. The ISM services survey is somewhat of an exception – while it too has moved lower this year, there has been little change since mid-year and it is at a solid level. However, other services sector surveys are much weaker. Taken together they suggest that service sector conditions may have stabilised (at a low level) in recent months.

Business surveys mostly weak



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

We see the downwards trend across most of the business surveys as consistent with our expectation that the US economy will turn down next year, although they are not yet at recessionary levels. For a while, we have been expecting that the economy would start to contract in Q1, but with the middle of the year being the period of greatest weakness. However, monetary policy famously has long and variable lags and the resilience in the labour market, as well as a possible short-term boost from recent falls in commodity prices and some recent easing in financial conditions, may delay the timing of the downturn.

Even if the timing is difficult to pin down, the extent of the deviation in inflation from target and the Fed's focus on actual outcomes for lagging indicators, such as employment, means a recession is more likely than not. The rate increase in November was only the second time, since the start of the 1990s, that the Fed has hiked when the ISM manufacturing survey is under 50. The other time was in in December 2015, when the Fed made the first move upwards post the GFC. But in that instance there was not another hike for twelve months, due to concerns over the economy.

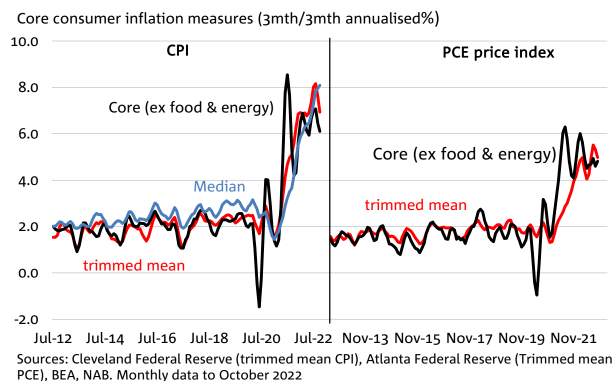
Inflation, the labour mkt & the Fed

Core measures of inflation softened in October. Core (ex energy and food) CPI was 0.3% m/m and core PCE inflation was a touch lower at 0.2% m/m (down from 0.5-0.6% in the prior two months). Trimmed mean and median measures also slowed.

However, on three-month basis, there has been little clear improvement in measures of underlying consumer inflation.

In a speech last week, Fed Chair Powell indicated that it would "…take substantially more evidence to give comfort that inflation is actually declining"'. He also discussed core inflation by breaking it down to three components – housing services and core goods and services inflation.

October inflation relief needs to be sustained



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

There are grounds to expect that goods inflation will ease further as well as housing services inflation sometime next year.

Excluding energy, import prices have declined in recent months while producer prices have slowed (and were flat in October for the core final demand category), as a weaker global economy and unwinding of supply constraints reduces pressure on goods prices. The Zillow rental indicator, based on our seasonal adjustment, is running at around 0.3% m/m – still robust but well down on where it has been the last two years (average of around 1% m/m) and below the 0.6-0.7% m/m growth in the CPI/PCE rent inflation measures. The latter are based on all rentals, so the slowdown in growth of rents on new leases will flow through with a lag.

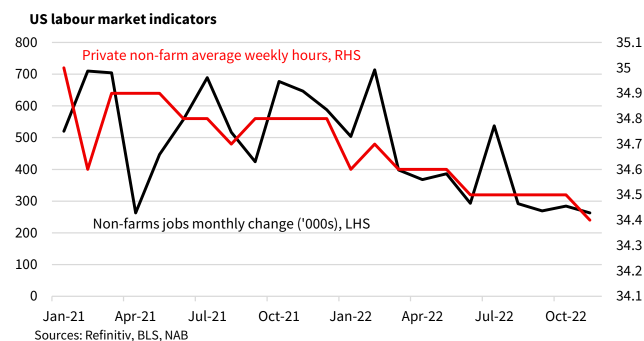
For core services inflation, Powell noted the importance of labour costs, with wages growth seen as being above levels consistent with the Fed's inflation target. As a result, he indicated that "…another condition we are looking for is the restoration of balance between supply and demand in the labor market". He also considered that there was only tentative evidence of labour demand moderating.

In this regard, the November employment report was a disappointment. Growth in non-farm employment does still appear to be trending down, but the November increase of 263,000 was more than what is needed to match new entrants to the labour force over time. That said, average hours worked are also falling and total hours worked fell in November. Data from Challenger also show a lift in layoffs by businesses, so labour demand does appear to be moderately, albeit not that quickly.

The element of the employment report that would have most concerned the Fed was in respect to wages growth.

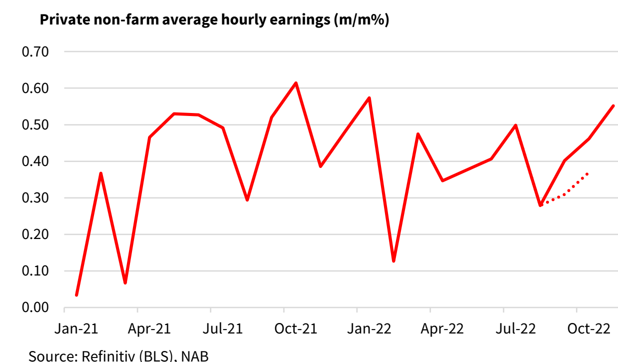
We noted last month that there were signs that wages growth may be starting to ease. Powell also noted that wage growth may have 'ticked down'. However, this is now less evident as average hourly earnings growth was revised up for September and October, and growth in November was the strongest since January.

Employment and hrs worked easing



Sources: Refinitiv, BLS, NAB

But wage growth surprised upwards



Source: Refinitiv (BLS), NAB

Our current projection for the Fed funds rate is for a 50bp rise in December followed by 25bp increases in each of the first two meetings of 2023. This would take the target range to 4.75 – 5.00%.

In his speech last week, Powell also noted the lags in monetary policy and that it '…makes sense to moderate the pace of our rate increases as we approach the level of restraint that will be sufficient to bring inflation down. The time for moderating the pace of rate increases may come as soon as the December meeting." Accordingly, we see no need to change our call for the December meeting, which would represent a step down from the 75bp hikes seen in each of the last four meetings.

Beyond that, the November wages data is a reminder that Fed policy will remain highly data dependent. A continuation of strong wages growth (or a resumption of very high core inflation readings) could see rates go above 5%. On the other hand, if the October inflation readings are repeated, together with clear signs that the economy is slowing and that the labour market is easing, then the Fed could come under pressure to pause a bit earlier. Given the Fed's determination to bring inflation under control (even at the risk of a recession), and how tight the labour market is (with only gradual signs of easing), the risk is tilted to a higher peak fed funds rate than we expect, rather than a lower one.

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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	2.8	1.0	0.8	0.4	0.9	0.1	-0.2	-0.1	0.1	0.3	0.3	0.3	0.4
Private fixed investment	7.4	0.1	-1.2	2.5	-1.0	0.3	-0.5	-0.4	0.0	0.6	0.8	0.9	1.0	1.0
Government spending	0.6	-0.8	1.1	1.2	0.8	0.2	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	-0.3	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.8	-0.1	-0.1	0.8	-0.5	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**1.9**	**0.2**	**1.1**	**0.7**	**0.3**	**-0.1**	**-0.4**	**-0.1**	**0.2**	**0.4**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)					*2.9*	*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	5.7	2.6	2.0	1.0	0.9	0.8	0.7	0.5	0.5	0.5	0.5	0.5	0.5
Core	**4.7**	**4.8**	**2.8**	**2.2**	**1.1**	**1.0**	**0.8**	**0.7**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.7**	**4.8**	**5.3**	**3.5**	**3.7**	**3.8**	**4.0**	**4.4**	**4.8**	**5.1**	**5.2**	**5.2**	**5.3**
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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