US Economic Update 23 Jan. 2022

Q4 GDP looks solid but weakness emerging

NAB Group Economics

- **We have revised up our expectation for Q4 GDP growth, mainly reflecting the November plunge in goods imports. We now expect growth of 2.7% q/q (annualised).**
- **However, there are signs of the economy weakening at the end of 2022, with further falls in retail sales and industrial production in December, while business surveys continue to fall.**
- **The revision to Q4 GDP growth sees our 2023 forecast lift to 0.6% (from 0.2%) but we still expect the US to enter recession in 2023. We also still expect the fed funds target range to peak at 4.75% to 5.00%, with 25 bp increases at each of the February and March meetings.**

Activity and outlook

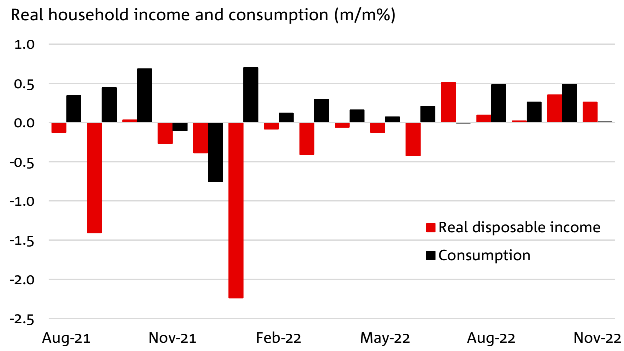
In our December update we noted that early data for Q4 was looking positive but that net trade was looming (again) as a large swing factor, this time in a negative direction. However, a plunge in goods imports in November (-7.4% m/m), even after allowing for another large fall in exports (-2.6%m/m), suggests that the net trade detraction will be much smaller than previously expected. As a result, we have substantially revised up our estimate for Q4 GDP to 2.7% q/q annualised (1.1% q/q previously). The BEA also revised up its estimate of growth in Q3 from 2.9% q/q to 3.2% q/q annualised.

Outside of trade, the Q4 forecast allows for solid consumption and business investment growth, although residential investment, which is still feeling the impact of higher interest rates, is expected to record another large fall. Overall, while Q4 growth is looking positive, there are signs of weakness emerging.

The strength in consumption reflects growth between August and October, with November flat in m/m terms. Another large fall in nominal retail sales (-1.1% m/m) in December suggests a similarly weak outcome to end the quarter is likely.

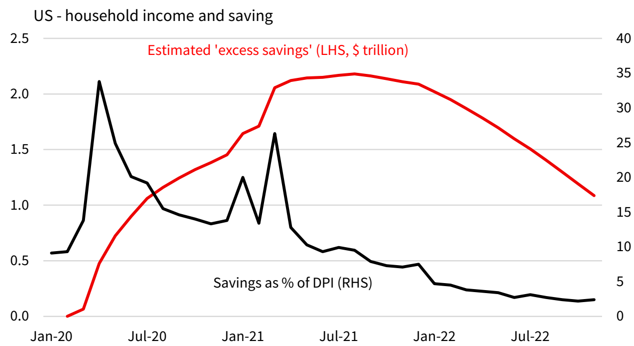
The earlier lift in consumption followed a return to positive real household income growth, helped by falling energy prices. The broader moderation in inflation now underway will continue to provide relief, although this is being accompanied by slowing employment and, tentatively, also wages growth. Household income will also get a boost in January from the large cost of living adjustment (8.7%) that will flow through to social security benefit recipients, which may also provide a temporary boost to consumption growth.

Real income turnaround helped consumption



Sources: Refinitiv, NAB

'Excess savings' falling; savings rate low



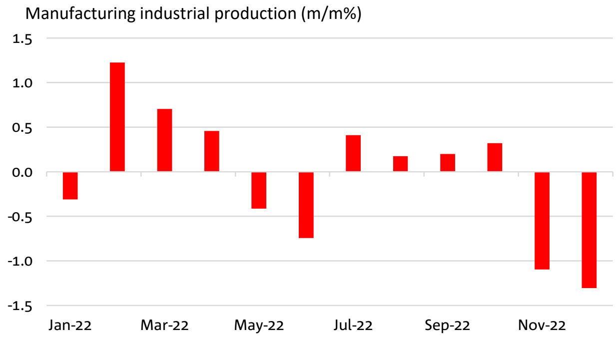
Source: Refinitiv (BEA), NAB

The improvement in income growth in the latter part of 2022 meant that households no longer needed to run down the savings rate to support consumption. The savings rate appears to have stabilised in recent months, but at a very low level. This means that the 'excess savings' built up by households continue to decline – at some point households are likely to normalise the savings rate. Exactly when this happens (and how rapidly it occurs) is, however, highly uncertain.

Similarly, while equipment investment looks likely to show robust growth again in Q4 (based on non-defence capital goods shipments), orders have been weakening. Future (six-month) capex intentions as reported in regional Fed surveys have also declined since around mid-2022. On the positive side, non-residential structures investment appears likely to record its first growth in almost two years although a downturn in architectural billings index (a leading indicator) suggests that this turnaround won't persist through 2023.

Manufacturing industrial production also recorded another large fall in December. The ongoing normalisation of spending back towards services, higher inventory levels and the 14% appreciation of the USD between mid-2021 and October 2022 have been factors weighing on the sector. The dollar has eased more recently, which will provide some relief, but our expectation of a weaker global economy in 2023 is another headwind.

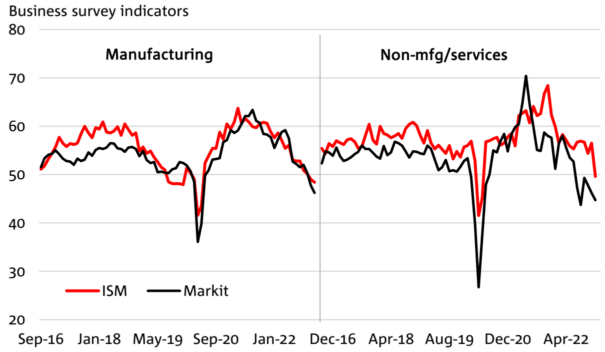
Manufacturing downturn underway



Sources: Refinitiv, NAB

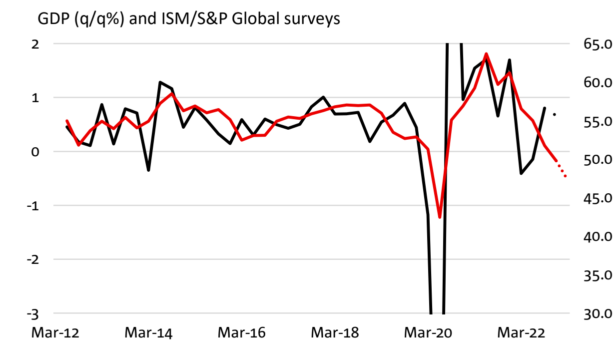
The downturn in manufacturing production is not a major surprise as the timelier business surveys trended down for much of 2022, eventually moving into contractionary territory. The surveys have provided a less clear signal on the services sector, with the ISM indicator, while moderating, remaining at a solid level for most of the year. However, this indicator plunged in December.

Services ISM no longer a significant outlier



Source: Refinitiv

Surveys and GDP growth



Sources: Refinitiv, NAB. Average of S&P Global composite and NAB composite of ISM mfg and non-mfg surveys. Q4 2022 GDP estimated. Q1 2023 survey readings set at Dec. 22 month level.

The business surveys are not very reliable indicators of quarterly GDP growth – something very apparent in 2022, with GDP falling in H1 2022 when the surveys were at still solid levels but then rebounding as the surveys moved towards contractionary territory. However, the surveys (on a quarterly basis) tend to be less volatile than GDP growth and generally provide a guide to the underlying trend in activity.

Given the weakness in some of the 'hard' activity data towards the end of 2022, as well as the signal from the surveys, we maintain our forecast for a small drop in GDP in Q1 2023 (and a larger fall in Q2).

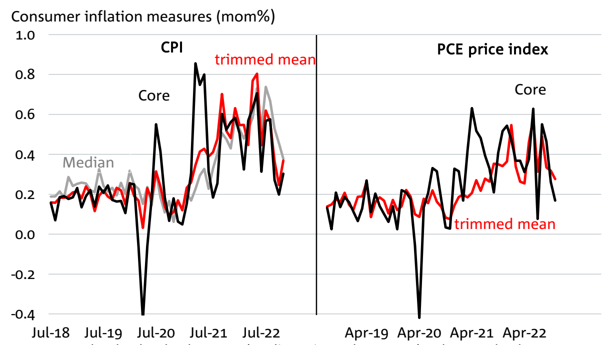
That said, there are some positive factors for Q1 – the recent improvement in real household income (together with the boost from the social security cost-of-living adjustment in January) could see stronger consumption growth then we are projecting. Further, some indicators of financial conditions have eased recently, including declines in the USD, bond yields and mortgage rates. It is also possible that part of the recent data weakness reflects the impact of severe winter storms in December, which will reverse with more benign weather conditions.

Regardless of when it may start, we still see a recession in the US in 2023 as more likely than not (albeit we expect it to be a 'modest' recession by past standards). Mainly due to the upwards revisions to Q3 and to our forecast for Q4 2022, expected 2023 year-average GDP growth has been revised up to 0.6% (from 0.2%). The forecast for 2024 is unchanged at 1.1%.

Inflation, the labour mkt & the Fed

While the CPI excluding energy and food ('core') grew slightly more strongly in December – at 0.3% m/m compared to 0.2% m/m in November, it was the third consecutive month where it was well below the 0.5% m/m average experienced over October 2021 to September 2022. Trimmed mean and median CPI inflation has also declined. There has also been some shift down in measures of underlying PCE inflation. Similarly, core PPI inflation is well down from its peak.

Inflation easing



Sources: Cleveland Federal Reserve (median, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. CPI to Jan. 2022, PCE to Dec. 2021.

Recently the Fed Chair has been breaking core inflation down into three components – goods, housing services (rents), and non-housing services.

CPI core goods prices have fallen in each of the three last months. The rebuilding of inventories, the easing in supply chain problems, together with moderating demand for goods, should keep downward pressure on prices. That said, the recent fall in the USD will work the other way – in December the price of imported non-petroleum goods increased for the first time since April 2022.

Housing services (rental) inflation has stabilised but remain high. However, measures of rental price growth for new leases have slowed dramatically. As they lead the CPI/PCE measures (which cover all leases) this element of inflation is also set to ease over 2023.

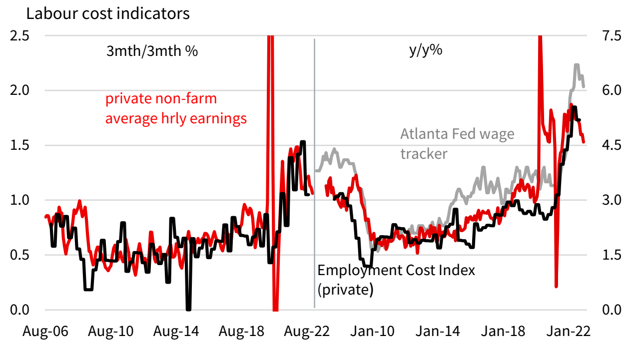
That leaves core services (ex. housing services) – the largest category (for core PCE inflation) – as the main concern for the Fed. Given the importance of labour costs for this category the Fed wants to see a less tight labour market and, in particular, an easing in wage growth.

There has been some easing in labour market indicators. Non-farm jobs growth in December (+223k) was the lowest in two years. Hours worked per employee again fell in December – implying a fall in total hours worked for the second consecutive month. The number of job openings has also come-off. All that said, the number of job openings remains very high, monthly jobs growth is also high relative to underlying population growth and the unemployment rate fell back to 3.5% in December. In short, the labour market remains very tight.

Despite, this there are some signs of an easing in wage growth. The strong average hourly wage growth initially reported for November was revised down and the growth rate in December (0.3% m/m) was one of the lower prints for 2022. On a y/y basis, average hourly earnings growth peaked at 5.6% in March 2022 and fell back to 4.6% by end 2022.

This rate of wage growth is still too high for the Fed, but the downwards trend will provide some comfort. The monthly wages data can be distorted by changes in workforce composition. As a result, the Q4 Employment Cost Index, which adjusts for compositional changes, which will be released at the end of January, will be an important marker for the Fed.

Some moderation in wage growth…but still high



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

We expect that the Fed will downshift to 25 bp increases at its next two meetings (February and March) – a move that has been given support by some recent Fed speakers. This would take the Fed funds rate target range to 4.75-5.00%. The combination of an easing in inflation, a weakening economy and signs that the labour market is becoming less tight should mean that the Fed goes on hold at this point.

There are upside and downside risks around this view. Fed member December meeting projections incorporated an expectation of a slightly higher peak (5.00-5.25%). However, the Fed saw only a slow deceleration in inflation in 2023 and was far more optimistic on the growth outlook. If we are right – and we see recent inflation prints and activity data as supporting our view – then when the Fed adjusts its expectations, it will modify its funds rate track at the same time. If such a reassessment were to happen before its March meeting, it is possible that the last hike could be in the February meeting.

Assuming our expectations of a downturn in the economy (largely centred around mid-year) are correct, and an ongoing easing in inflation, we still expect the Fed to start reducing rates towards the end of the year, and to continue this through 2024 as it moves the funds rate back towards its perceived neutral level.

Contact the author:

Tony Kelly
Senior Economist
Antony.Kelly@nab.com.au

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	2.9	1.1	0.8	0.6	0.8	0.3	-0.1	-0.1	0.2	0.3	0.3	0.3	0.4
Private fixed investment	7.4	0.3	-0.8	2.5	-0.9	0.7	-0.4	-0.4	0.0	0.6	0.8	0.9	0.9	1.0
Government spending	0.6	-0.7	1.2	1.2	0.9	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	-0.4	0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.7	0.1	-0.1	0.8	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**2.1**	**0.6**	**1.1**	**0.8**	**0.7**	**-0.1**	**-0.3**	**-0.1**	**0.2**	**0.4**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)					*3.2*	*2.7*	*-0.2*	*-1.3*	*-0.3*	*0.9*	*1.5*	*1.7*	*1.8*	*1.8*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.7	5.5	2.5	2.0	1.1	0.8	0.7	0.7	0.6	0.6	0.5	0.5	0.5	0.5
Core	**4.7**	**4.7**	**2.6**	**2.2**	**1.1**	**1.0**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.6**	**5.2**	**3.5**	**3.6**	**3.6**	**3.8**	**4.2**	**4.6**	**4.9**	**5.0**	**5.1**	**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

Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

Jacqui Brand
Personal Assistant
+(61 0) 477 716 540

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0) 436 606 175

Brody Viney
Senior Economist
+(61 0) 452 673 400

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

International Economics

Tony Kelly
Senior Economist
+61 (0)477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

Global Markets Research

Ivan Colhoun
Chief Economist
Corporate & Institutional Banking
+(61 2) 9293 7168

Skye Masters
Head of Markets Strategy
Markets, Corporate & Institutional Banking
+(61 2) 9295 1196

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