US Economic Update 10 February 2023

January data surprise = higher fed funds rate

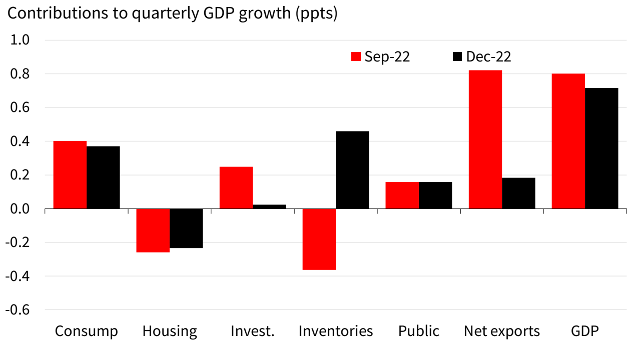
NAB Group Economics

- **Solid GDP growth to end 2022, but domestic final demand growth was weak.**
- **January employment report very strong with a large bounce in non-farm employment. January services ISM also bounced back from its December fall; but other surveys still weak.**
- **We now expect, in addition to a March 25bp hike, that the Fed will also lift rates in May before pausing at a target range of 5.00-5.25%. We have also shifted out the timing of when we expect the Fed to start cutting rates from 2023 Q3 to Q4.**

Activity and outlook

GDP grew by 0.7% q/q (2.9% annualised) in the final quarter of 2022. This was close to our expectations (2.7% q/q annualised) although inventory accumulation was stronger than we had anticipated, increasing the risk of an inventory correction in coming quarters. In contrast, business investment growth was much softer and while consumption growth was only a little down for the quarter, it fell in both November and December.

Q4 GDP Growth solid, but mixed details

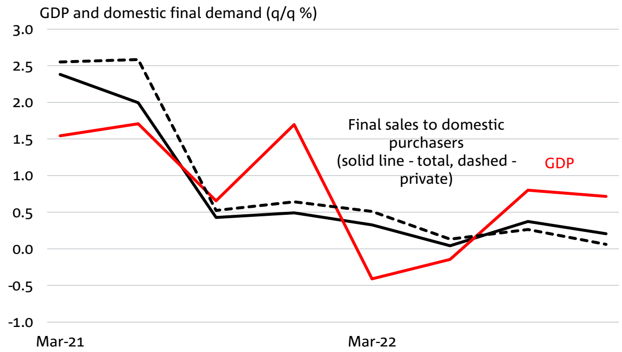


Sources: BEA, NAB. Data not annualised

While GDP growth bounced back in the second half of 2022, domestic final demand (which excludes inventories and export demand) has been softer, particularly in the private sector. The latter only grew by 0.1% q/q to end 2022.

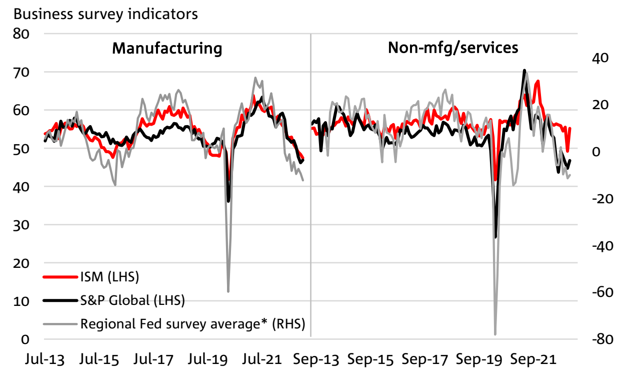
Business surveys also pointed to an easing in activity over 2022. The main outlier was the ISM services indicator which fell more gradually and remained at a solid level until the December 2022 reading. However, the December plunge was almost entirely reversed in January. The S&P Global measures also improved in January and their services indicator has broadly stabilised in recent months, although it remains in contractionary territory.

Domestic demand weak



Sources: BEA, NAB

Services ISM bounces back in January

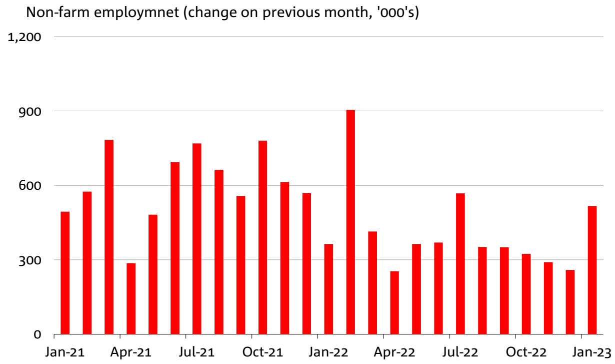


Sources: ISM; Markit; Dallas, New York, RIchmond, Dallas, Philadelphia and Kansas City Federal Reserves.

The other main January data surprise was in the employment report. After having declined in each of the previous five months, non-farm employment growth jumped higher. Moreover, there were upward revisions to previous months and average weekly hours worked – which had also been moving down – bounced back. The December JOLTS data also saw a pick-up in job vacancies.

We noted last month that while labour market indicators were generally easing, they continued to paint a picture of a tight labour market. The January report just serves to highlight how strong the labour market is. Due to productivity growth, GDP growth is normally faster than employment growth. However, non-farm employment grew by 3.3% over the year to January, despite GDP only increasing by 1% over 2022. This can be partly explained by the lagged relationship between the two indicators, but not fully. Clearly, there is degree of pent-up demand for employees, reflected in the high level of job vacancies, and perhaps reflecting continued service sector normalisation post-COVID-19 (with the service sector being relatively labour intensive).

Employment growth spiked higher in January



Sources: Bureau of Labor Statistics, NAB

Accordingly, while we have not made major changes to our GDP forecasts in this publication, we have lowered our expectations for how far the unemployment rate may rise over the next two years (lowering the end 2024 estimate from 5.2% to 4.8%)

More broadly, the large upward moves in the Services ISM and employment in January challenge our forecasts, which envision a downturn in the economy this year, starting in the current quarter. Similarly, a large 18% m/m lift in auto sales in January (after declining by 12% over November/December) may flag a bounce in consumption after two weak months. There are reasons why the recent spikes in these indicators can be discounted – they are lagging rather than leading indicators (employment), they just returned to where they were (ISM) or they are volatile (auto sales). The combination of unseasonably cold weather (and storms) in December, followed by a relatively mild January may provide a partial explanation for the swings in the data. Alternatively, they may be harbingers of an upturn up in the economy.

Our view of a US recession was based on three contributing factors – the rapid and significant tightening in US monetary policy, a global energy shock due to the Ukraine/Russia war (which would slow global growth, particularly in Europe), and ongoing COVID-19 disruptions continuing to hold back the Chinese economy. However, energy prices have been coming off and the Euro-zone is doing better than we had expected. China has abandoned its zero-COVID policies, leading us to revise upwards our 2023 forecast.

However, monetary policy was the most important factor and remains in play. The slowdown in consumption at the end of 2022, the slowing in capital goods orders growth (suggesting weaker business investment), as well most business surveys point to a weak economy as we start 2023.

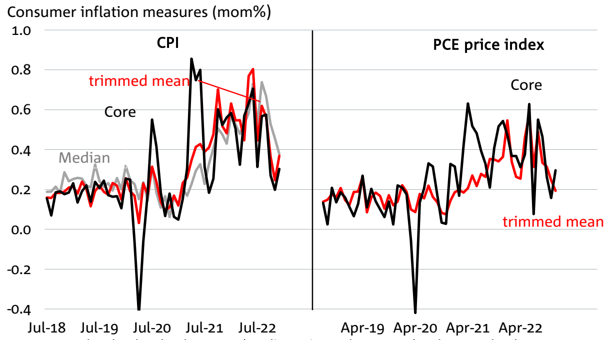
For this reason, we have not made any major changes to our GDP forecast this month. That said, we are slightly less pessimistic on 2023 and while we still have GDP falling this quarter, a significant part of this is due to an expected fall in the pace of inventory accumulation. We now expect GDP growth of 0.7% in 2023 (previously 0.6%), but with an offsetting move in 2024 (now 1.0%, previously 1.1%) as monetary policy stays restrictive for longer.

Inflation

Inflation continued its descent in December. The CPI grew by 6.4% y/y (from 7.1% in November), with monthly inflation of -0.1% m/m. Similarly, PCE inflation was down to 5.0% y/y (from 5.5%), with monthly growth of only 0.1%.

Core (ex food and energy) measures did pick up on a month-on-month basis, but even here remained well below where they had been. Other measures of underlying inflation have also come down – in particular, m/m growth in the Dallas Fed's trimmed PCE measure was at its lowest rate since early 2021, suggesting the disinflation is broad based.

Inflation easing

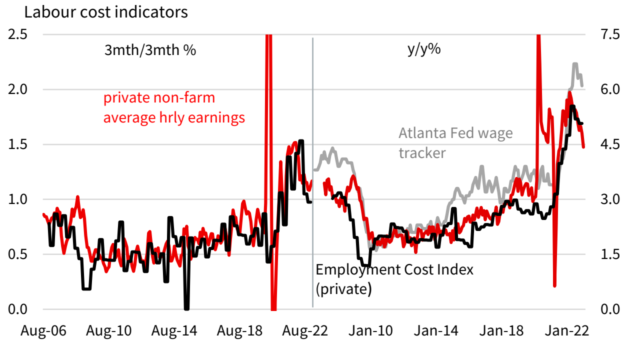


Sources: Cleveland Federal Reserve (median, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. CPI to Jan. 2022, PCE to Dec. 2021.

We continue to expect inflation to ease further over 2023 and 2024. The improvement in supply chains, and the rebuilding in inventories that has occurred, should continue to place pressure on goods prices. It may not be a smooth process, however – import prices (excl. petroleum) rose in December, highlighting that US dollar depreciation will add to inflation (albeit modestly). Similarly, second hand motor vehicle auction prices have ticked up again in recent months. Housing rental inflation also remains high but measures of growth in rents for new leases point to this easing.

The Fed has been emphasising the importance of wage growth in determining where services inflation (ex rentals) goes from here. Even here, despite the still very tight labour market, pressure is easing as wage growth continues to show signs of moderating. Wages growth has come off its peak across a range of indicators. Growth in the Employment Cost Index eased further in Q4 and, while on a 3mth (on previous 3mth) basis, average hourly earnings growth edged back up in January, the reading for January itself of 0.25% m/m was the lowest in two years.

Wages still look to be falling ECI. But still high



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

Monetary policy

The enduring strength of the labour market, and changes to our forecast for the unemployment rate, lead us to make two changes to our fed funds rate projections.

- Firstly, in addition to a hike in March, we now also expect the Fed to raise rates by 25bp in May before pausing. This would result in a peak fed funds rate of 5.00-5.25% (previously 4.75-5.00%) for this cycle.
- Delay the start of Fed rate cuts – with this now expected to occur in Q4 2023 (previously Q3).

The median December meeting Fed member projections had a peak fed funds rate of 5.00-5.25%. Chair Powell has been happy to reference this projection as providing a guide to at what rate policy may be sufficiently restrictive. There is now a greater degree of data dependency in the Fed's comments, compared to much of last year, where they saw a clear need to get rates higher. While we had thought the downshift in inflation and likely signs of a weakening economy would see the Fed pause in March, labour market data has worked in the other direction. The easing in some indicators of financial conditions, such as 10yr bond yields and equity prices, reinforces the case for further hikes.

The bias in the December Fed member projections was for an even higher peak fed funds rate (with seven members 25bp above the median 5.00-5.25% projection and only two below). However, we still have a more negative view of the economic outlook, and expect a faster run down in the inflation rate, than the Fed. Of course, if the economy (or inflation) holds up more than we expect, the risk is that the Fed moves to around 5.25-5.50%.

Similarly, while the Fed is indicating that it expects to hold rates at their peak for an extended time, this is predicated on a relatively soft landing for the economy (and relatively slow progress on inflation). By the end of this year, we still expect to see the unemployment rate clearly moving up – and breaching the Fed's assessment of its long-term sustainable level of 4%. Unemployment rising, inflation closer to target (and trending down) and a fed funds rate well above the Fed's view of its long-term level should be enough of a trigger to start cutting rates.

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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	1.1	0.8	0.6	0.5	0.3	0.0	0.0	0.1	0.3	0.3	0.3	0.3
Private fixed investment	7.4	-0.3	-2.4	2.4	-0.9	-1.7	-0.2	-0.2	-0.1	0.5	0.7	0.9	0.9	0.9
Government spending	0.6	-0.6	1.7	1.2	0.9	0.9	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Inventories*	0.2	0.7	-0.3	-0.1	-0.4	0.5	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.6	0.5	-0.1	0.8	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**2.1**	**0.7**	**1.0**	**0.8**	**0.7**	**-0.1**	**-0.2**	**0.0**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*3.2*	*2.9*	*-0.4*	*-0.8*	*-0.1*	*0.8*	*1.2*	*1.6*	*1.5*	*1.6*
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	0.5	0.5	0.5	0.5	0.5
Core	**4.7**	**4.7**	**2.6**	**2.1**	**1.1**	**1.0**	**0.7**	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.2**	**4.8**	**3.5**	**3.6**	**3.5**	**3.6**	**3.8**	**4.2**	**4.4**	**4.5**	**4.7**	**4.8**
US Key Interest Rates														
Fed funds rate (top of target range)	**0.25**	**4.50**	**4.75**	**3.00**	**3.25**	**4.50**	**5.00**	**5.25**	**5.25**	**4.75**	**4.25**	**3.75**	**3.25**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP growth

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