US Economic Update 17 March 2023

Fed caught between strong data & bank panic

- **Reflecting strong January data we have revised up our Q1 GDP growth forecast. That said, we still expect to see a downturn in the US economy this year.**
- **Authorities moved quickly to stabilise the US banking system following the collapse of Silicon Valley and Signature banks. The potential fall out for bank lending and business/consumer confidence is a negative for the economy.**
- **Recent data and revisions point to inflation easing more slowly than previously expected.**
- **Our forecasts still allow for the Fed to hike rates by 25bp at its March meeting (and by the same amount in May) although a pause in March would not be a surprise, particularly if financial markets remain under stress. We expect the Fed will wind back (if not end) QT, or flag its intentions to do so.**

Revising Q1 GDP forecast higher

Economic activity data for January have been strong, in stark contrast to weak end-2022 outcomes. As a result, we have revised up our expectations for Q1 GDP (to 1.7% q/q annualised from -0.4% previously).

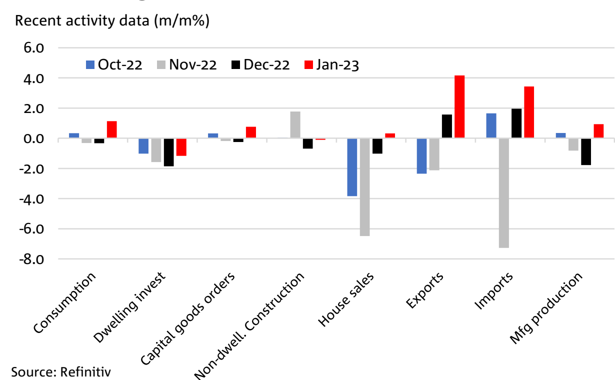
Household consumption increased 1.1% m/m, reversing the -0.6% fall over the final two months of 2022. Similarly, manufacturing industrial production and capital goods and shipments (ex. defence and aircraft) increased in nominal terms after falling in the two previous months. Housing indicators were mixed, but stronger than in previous months with overall sales turning positive, while new residential construction declined at a slower rate. Trade data strengthened in December and growth in January was stronger again.

December was colder than normal and storms caused severe disruptions in parts of the US. In contrast, January was warmer than usual. December had 13% more heating days than the 10-year average while January had 13% less. February was also warmer than normal, but to a lesser degree than January (10% less heating days than normal).

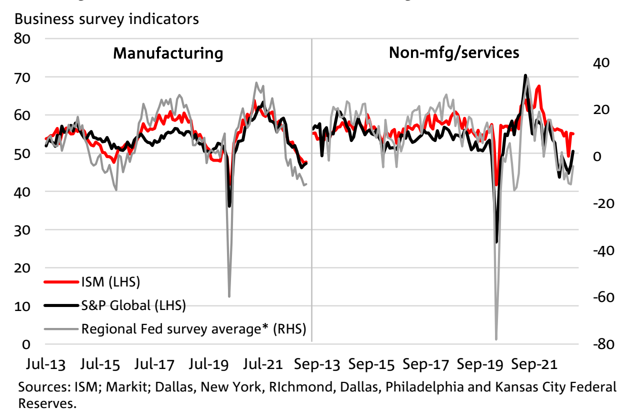
However, the size of the moves in the economic data is larger than would normally be explained by weather events. Other factors that might explain the turnaround include an improvement in real disposable income growth – including the impact of a large increase in social security benefits in January – and some easing in financial conditions over recent months (such as lower mortgage rates). Non-residential building investment – which had been very weak up to Q4 – is also experiencing an uptick.

Business surveys for February point to an ongoing contraction in the manufacturing sector. On the other hand, services showed some improvement overall with the difference between the S&P Global and ISM measures narrowing.

Data stronger across the board in January



Surveys have stabilised recently



We expect some expected reversal of the strong January data over February/March. There are mixed signals in this regard in the Initial data for February - January's 18% surge in auto sales was partially unwound in February (-8% m/m), but control nominal retail sales (which feed into GDP calculations) were up 0.5% m/m (with January revised slightly higher).

Bank panic

A deposit run on Silicon Valley Bank (SVB) last week quickly led to it being closed by regulators. Signature Bank also came under stress and was also closed. Other banks (such as First Republic) have seen very large falls in their share prices but have continued to operate.

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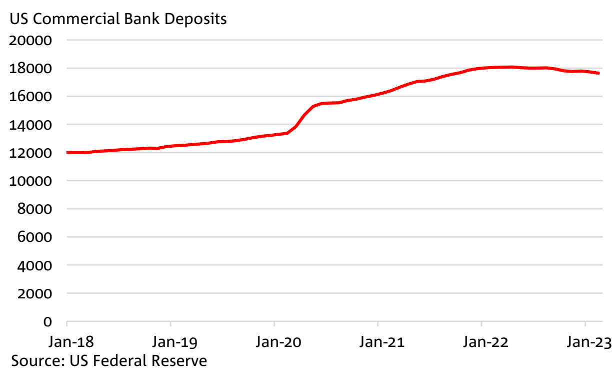
SVB was particularly exposed to the tech sector, which has been struggling, leading to a lower level of deposits. At the same time, there was a fall in the market value of SVBs bond holdings (without appropriate management of this risk; i.e. there was a large duration mismatch in it its balance sheet). SVB also had a high proportion of deposits which were not covered by deposit insurance (as they were above $US 250,000) making it more run prone. Similarly, Signature Bank was seen as heavily linked to the crypto sector. Unlike the GFC, issues with loan quality do not appear to have been a major issue.

While some of these issues/management failures were unique to these banks, there are some broad-based pressures at play. The value of bond holdings fall as yields rise (although appropriate hedges can manage this), and overall US commercial bank deposits have been declining. This reflects the reduction in the size of the Fed's balance sheet ('QT') as security holdings mature.

Bank deposits have been declining



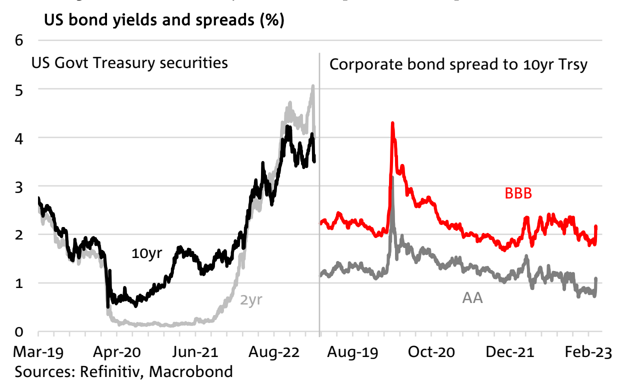
Source: US Federal Reserve

In response the Fed has put in place new liquidity facilities (the Bank Term Funding Program (BTFP)) and authorities moved to enable all depositors with SVB and Signature access to their money in full. These measures should substantially reduce the risk of deposit flight from other institutions.

As a result of the concerns around the banking system, there were large falls in yields on government bonds – as expectations of future Fed action was wound back – corporate bond spreads rose, equity prices fell and measures of market volatility (VIX) rose. However, these moves need to be seen in the context of an easing of some indicators of financial conditions over recent months; resulting spreads, level of yields etc were not markedly outside of the range for these variables over the last year.

Apart from changes in interest rates and equities, another way problems in the banking system can be transmitted to the real economy are through lending standards and banks willingness to lend. At an extreme, a sharp credit crunch can cause a downturn in activity.

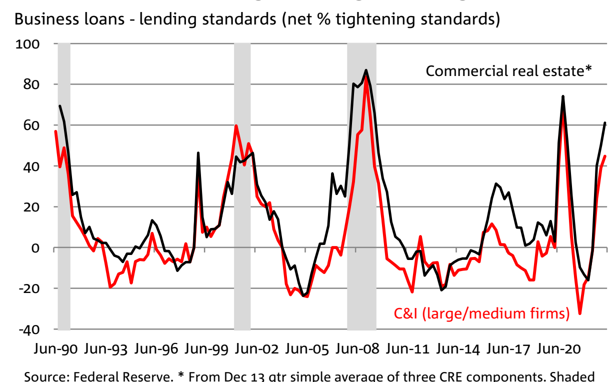
Bond yields down, credit spreads up



Sources: Refinitiv, Macrobond

According to the Fed's Senior Loan Office Opinion Survey, US banks have been tightening their lending standards for US businesses over the last three quarters. Similarly, standards have tightened on consumer loans and, to a lesser extent, residential mortgages.

US banks already tightening lending standards



Source: Federal Reserve. * From Dec 13 qtr simple average of three CRE components. Shaded

Given ongoing recession concerns, a further tightening in lending standards seemed likely and recent developments only reinforce this view. While loan quality was not the trigger for the bank runs, tightening lending standards is one way for banks to reassure investors.

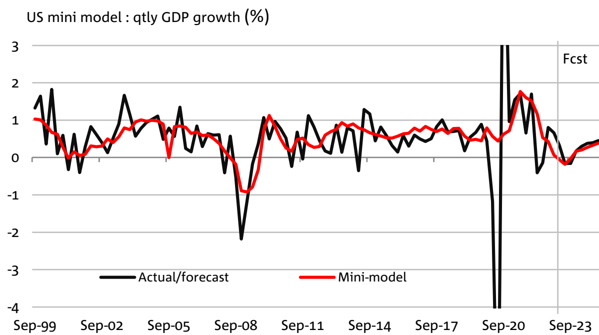
A downturn remains likely

Our expectation for some time was that the US would go into recession this year. Our forecasts had allowed for GDP to start declining as early as Q1.

As already noted, we now expect GDP to grow in Q1, but we are still forecasting small declines in Q2 and Q3 GDP.

While NAB's US mini-model projections of GDP growth have strengthened a little from several months ago, they still suggest a relatively mild recession is likely, with H1 2023 the likely timing. The model has several variants with the average of the different estimates shown in the chart below. Variables (some of which enter with a long lag) include interest rates or a yield curve term, commodity, house and equity prices, the exchange rate and bank lending standards for commercial and industrial loans.

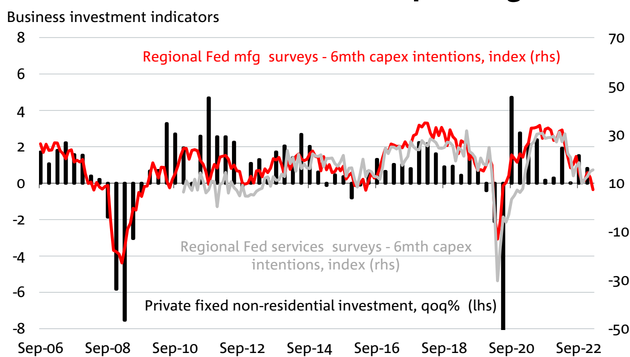
NAB US 'Mini-model' points to a downturn



The problems in the US banking system are likely to be negative for the economy, although it is hard to quantify to what degree. Even if markets settle due to the measures announced by authorities (as we assume), lending standards will likely tighten and risk aversion increase. This may see households and businesses defer or cancel spending (particularly on large ticket items).

Regional Fed surveys of investment intentions were already consistent with declines in business investment. This is likely to be centred on equipment investment, with the AIA architectural billings index suggesting that the recent upturn in non-residential building investment has a while to run, but should fade in the second half of 2023.

Business investment indicators pointing down

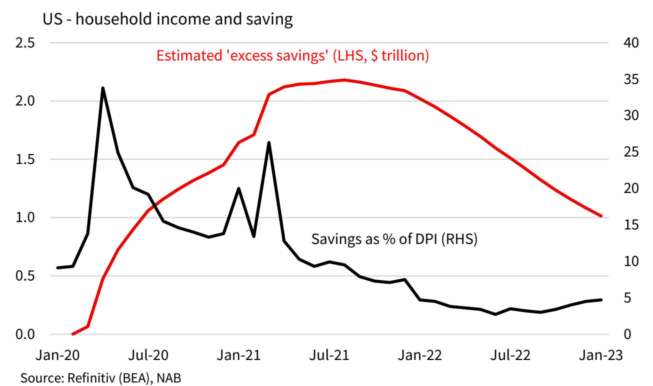


There have been some signs of improvement in dwelling investment. Building permits are still falling, so the fall in construction investment still has further to go, but housing sales have broadly stabilised. This likely reflects the easing in mortgage rates from October to early February. However, mortgage rates subsequently moved higher, so sales may come under renewed pressure.

Consumption has benefited from the strong growth in employment and wages, as well as the fall in oil prices that since mid-2022. Even with broader price growth remaining strong, real household incomes increased 4% over the six months to January. This may partly explain why the household savings rate has moved higher recently, as some households would have had less need to reduce savings to sustain consumption. Alternatively, the rise in the savings rate may indicate a degree of consumer caution as, despite some recent improvement, consumer confidence remains weak.

Even with the recent lift, the savings rate remains below its pre-pandemic level. As a result, the 'excess savings' accumulated during the pandemic (based on accumulated savings relative to their pre-pandemic trend) continue to fall. This suggests that pressure is likely to come on consumption, particularly if the downwards trend in job creation resumes (as we expect it will), slowing income growth.

'Excess savings' continue to run-down



The upwards revision to our Q1 forecast means that the projection for year-average 2023 growth is higher (1.1% against 0.7% previously) but our forecast for 2024 is little changed (0.9% against 1.0% previously).

Evidently, the risk around our forecast is that the downturn occurs further down the track. In particular, the still solid position of household finances and elevated corporate profits (data to Q3) has potentially left the private sector in a position to absorb a rapid rise in rates for longer than we expect.

However, in this scenario, the labour market stays tighter for longer. The Fed's approach has been somewhat reactive – with strength in labour markets and/or inflation – being used to justify rate increases even though the full impact of past increases has not yet been felt. It is possible that the recent banking issues will change the Fed's risk assessment of how to balance the risk of doing too little versus the risk of doing too much but we won't get a clearer idea of this until the March meeting.

Labour markets tends to lag changes in activity, so we have viewed this approach as likely to mean that the Fed would go too far even if there was a path to getting inflation down while avoiding recession. The recent, strength in inflation (discussed below) also casts doubt on the notion that inflation can be brought back to the Fed's target without a downturn. So, while there is uncertainty around the timing, we still think a recession is likely sometime this year.

Inflation

As with the economic data, the most recent prints have been strong. In February the CPI was up 0.4% m/m, while the core (ex food and energy) CPI inflation was 0.5%

m/m. January PCE inflation (headline and core) was 0.6% m/m.

With revisions to previous data (in part due to changed seasonal factors), it now appears that the deceleration in inflation has been slower than previously thought. That said, looking through the month-to-month volatility by using a 3mth on previous 3mth growth rate, all of the different measures of underlying inflation have eased, even if they remain well above the Fed's target and, in the case of the CPI, progress stalled in February.

In terms of core PCE inflation, the Fed's current approach is to decompose it into core goods, housing and core services ex housing inflation. The latter series remains high and is yet to show any clear signs of slowing. In contrast, price growth for the other two components has either substantially eased (core goods) or leading indicators (rents on new leases) point to a slowdown later this year (housing).

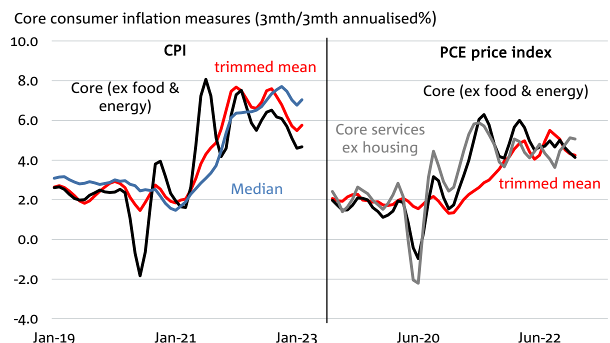
Flat-to-declining goods inflation is in line with historic norms. Similarly, so far, growth in rents for new leases do not point to a particularly low level of housing service inflation. So, for overall inflation to return to the Fed's target, core services ex housing inflation – which is around 50% of total PCE inflation also needs to decelerate. The lack of progress in this regard is a concern.

With wages being a large part of service sector costs, the Fed has been emphasising the importance of a less tight labour market and a downshift in wage cost growth. Various wage growth indicators have moderated. In both January and February, non-farm private sector average hourly earnings grew by less than 0.3% m/m – the softest readings in almost a year. However, the hourly earning series is affected by compositional change and, overall, the various wage measures remain too high (absent improvements in productivity growth and, if anything, that has been heading the wrong way).

Given the likely deceleration in housing (rental) costs, and our expectations for an economic downturn, we still expect inflation to slow over the course of this year. However, the recent inflation surprises highlight the uncertainty around the timing and extent of any disinflation, and we have lifted our forecast for core inflation over this year (mainly in Q1 but also subsequent quarters). While survey and bond market implied inflation expectation measures remain broadly at levels consistent with the Fed's target, the risk remains that inflation has become entrenched at a higher level, with the risk that this means tighter monetary policy (and a bigger downturn in the economy) will be required.

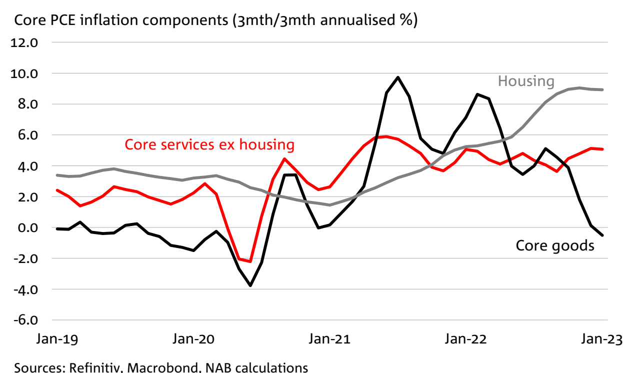
Core inflation easing –slowly & not broad based

Core consumer inflation measures (3mth/3mth annualised%)



Sources: Cleveland Federal Reserve (trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. Monthly data to January 2023

Core PCE inflation components (3mth/3mth annualised %)



Sources: Refinitiv, Macrobond, NAB calculations

Monetary policy

Normally, in the context of the turmoil in the banking sector, the Fed would be considering whether it should be cutting rates, not increasing them. However, current circumstances are not normal.

The recent strength in activity data, a still tight labour market (and only easing slowly), inflation well above target and declining slower than expected, and (until the last week) some easing in financial condition indicators had seen the Fed considering increasing rates by 50bp at next week's meeting.

Undoubtedly, given the US and also European (Credit Suisse) banking problems, the Fed is unlikely to move rates in 50bp increments, at least for now. The turmoil has served to tighten financial conditions and there is likely to be an impact on the economy, reducing the need for Fed hikes.

As already noted, it is possible that it may lead to a reassessment of the risks around different courses of policy action. The Fed's view has been that, if they go too far in raising rates, they have the tools to address the resulting fall in activity (i.e. cut rates). However, the banking problems highlight that the impact of policy tightening is not necessarily incremental. Rapid rate changes mean less time to adjust and so can expose weaknesses in financial institutions. As the GFC showed, major financial market dislocation can lead to long-term scarring, and the resulting recovery can be drawn out.

We have formally left unchanged our forecast that the Fed will hike two more times in this cycle (March and May, each by 25bps). Prior to the banking issues, we had

been reassessing this call (with a possible view to a higher peak) but given the banking issues, we are making no change.

However, it would not surprise if the Fed paused in March – particularly if financial markets and the banking sector (in the US or abroad) remained under stress leading up to the meeting.

On the other hand, the Fed may decide to let economic conditions determine interest rate settings while rely on its regulatory and bank funding options (as already employed with the BTFP) to address financial stability concerns. Beyond the March meeting, if the banking system concerns abate, then the Fed could easily return to a more hawkish mode as the focus returns squarely on inflation and the labour market.

One change we would expect the Fed to make is to either wind back (or end) QT either immediately or to flag its intention to do so. QT reduces bank reserves which, given the banking sector problems, is probably not the optimal way to tighten monetary policy.

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U.S. economic forecasts

						Quarterly Chng %									
						2022		2023				2024			
	2021	2022	2023	2024	2025	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	8.3	2.8	1.4	0.9	1.8	0.6	0.3	0.7	-0.1	0.0	0.1	0.3	0.3	0.4	0.4
Private fixed investment	7.4	-0.2	-1.6	1.5	3.9	-0.9	-1.2	0.2	-0.1	-0.2	0.2	0.4	0.7	0.8	0.9
Government spending	0.6	-0.6	1.9	1.2	1.0	0.9	0.9	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Inventories*	0.2	0.7	-0.4	0.0	0.0	-0.4	0.5	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.6	0.7	-0.1	-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**	**1.1**	**0.9**	**1.9**	**0.8**	**0.7**	**0.4**	**-0.1**	**-0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)						*3.2*	*2.7*	*1.7*	*-0.6*	*-0.6*	*0.7*	*1.2*	*1.5*	*1.6*	*1.8*
US Other Key Indicators															
PCE deflator-headline															
Headline	5.7	5.7	3.1	1.9	1.9	1.1	0.9	1.0	0.8	0.8	0.6	0.4	0.5	0.5	0.5
Core	**4.7**	**4.8**	**3.3**	**2.2**	**2.1**	**1.1**	**1.1**	**1.2**	**0.8**	**0.7**	**0.6**	**0.5**	**0.5**	**0.6**	**0.6**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.0**	**4.7**	**4.6**	**3.5**	**3.6**	**3.5**	**3.5**	**3.7**	**4.0**	**4.3**	**4.4**	**4.6**	**4.7**
US Key Interest Rates															
Fed funds rate (top of target range)	**0.25**	**4.50**	**4.75**	**3.00**	**2.50**	**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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