US Economic Update 31 May 2023

Activity – and inflation – resilience continues

- **We are revising up our Q2 GDP growth estimate though we still expect a downturn in the US economy (most likely H2 2023). We now see GDP growth of 1.3% (was 1.0%) in 2023 and 0.7% (was 0.9%) in 2024.**
- **Agreement to increase debt ceiling has been reached – but still needs to be passed by Congress - so risks have not entirely gone away. Fiscal and economic impact of the deal appears small.**
- **Inflation continues to remain high without clear signs of a downtrend across the underlying measures.**
- **Resilience in both the activity and inflation data increases the risk that the Fed takes rates higher, although we still consider no change at the June meeting the most likely outcome.**

Where is the US economy at?

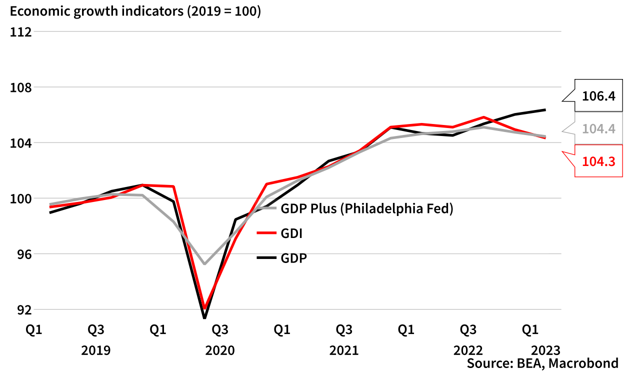
The advance estimate of Q1 GDP was slightly revised up by the BEA to 1.3% q/q (annualised) from 1.1%, with only relatively minor changes at the component level.

The BEA has also released the first estimate of real gross domestic income (GDI) for Q1. The GDI data suggest the economy contracted by 0.6% q/q, following a -0.8% fall in Q4. This is a stark contrast to the stronger outcomes shown in GDP. While there is usually a degree of measurement error between growth in GDI and GDP (which should conceptually be equivalent) the gap over the past two quarters has been unusually large.

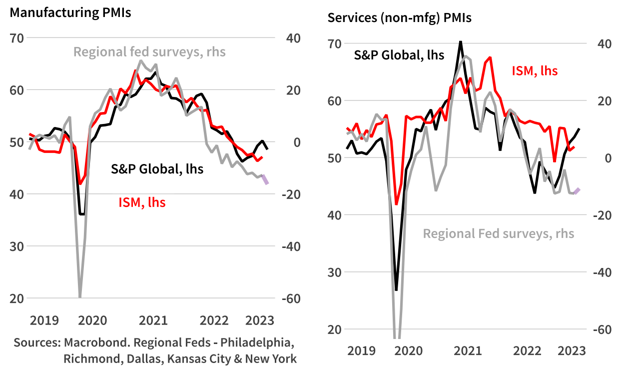
A simple average of the two measures suggests small declines in each of the two quarters. An alternative is 'GDP Plus' compiled by the Philadelphia Fed which uses statistical methods to try and extract the underlying signal from the GDI and GDP data. GDP Plus also suggests the economy contracted over the last two quarters, but to a smaller extent than the GDI data indicates.

Similarly, the various business surveys have sent conflicting messages. Through much of 2022, the surveys suggested conditions were weakening, but not to a level that (in the past) would be consistent with a recession. In particular, the ISM services indicator remained at a solid level. More recently the S&P Global PMIs have shown improvement (particularly in services) while the ISM measures have moved down, albeit the services measure has been volatile. The available regional business surveys, in contrast, have been weak for some time.

Economic growth measures diverging

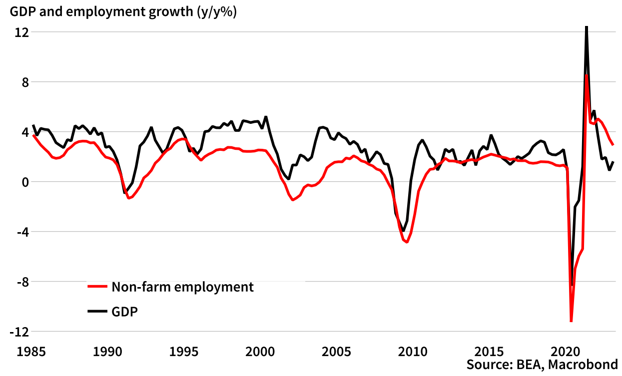


Survey measures also pulling in different directions



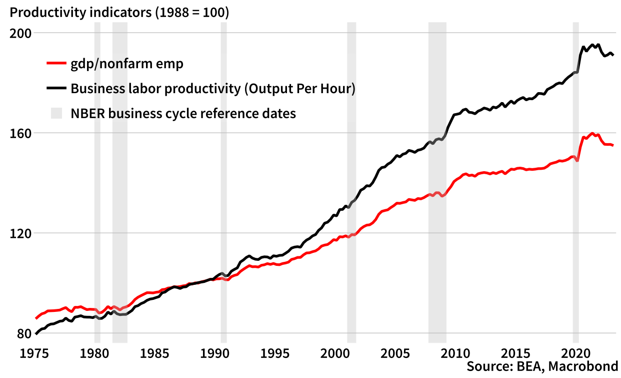
Just as we discounted the contraction in GDP data in H1 2022, we doubt the US has contracted in the last two quarters as indicated by GDI. In part we draw this conclusion because of the strength of employment growth. The NBER business cycle dating committee (the arbiter of when recessions occurred in the US) considers both non-farm payroll employment and the household survey employment measure in considering recession timing. Since the start of 2022 employment has grown far more strongly than GDP. This is unusual as, due to productivity growth, the reverse is typically the case.

Reversal of typical employment/GDP growth pattern



There was a large shift up in productivity as the economy recovered from the early 2020 shutdowns, and this is now being unwound. A lift in productivity early in recoveries (as well as a dip early in the downturn) is not unusual but the speed/magnitude of the COVID recovery has been stark. Because of the large sectoral adjustments (and supply chain issues) that occurred through the pandemic, aggregate productivity measures are less useful than normal. But with the pandemic fading, as well as associated supply and sector level disruptions), the jump in productivity has been partially unwound and now is getting close to where pre-pandemic trends might have suggested it would be at. This suggests that the outperformance of employment (relative to GDP) is unlikely to persist for much longer.

Early COVID productivity lift reversing



In April, non-farm employment growth remained robust (up 253,000) although there still appears to be a trend slowdown underway. Other labour market measures suggest the labour market remains very tight although it has eased at the margin. The unemployment rate edged down a notch, to 3.4% but job vacancies have moved down. Average weekly hours are almost back to their pre-covid level, so the strong employment growth partly reflects a recovery in workforce participation allowing less intensive use of existing employees.

Revising up our Q2 GDP estimate

Monthly consumption data have been quite volatile this year. After a large increase in January, consumption declined over February and March. However, there was another spike in April, with growth of 0.5%m/m, setting up solid Q2 result even if monthly growth is weak over May and June.

Similarly, manufacturing production rose 1.0% m/m in April, reversing the March fall, helped by a surge in motor vehicle production. Core (ex defence & transport) capital goods orders also rose strongly (1.4% m/m) after falling in Feb/March; core shipments (which feed into GDP calculations) growth was a more modest 0.5% and has moved sideways (in nominal terms) since January but the lift in orders limits the downside risk to shipments in coming months.

In contrast, exports declined in April, while there was a spike in imports. This means that net exports is set to detract from growth in Q2 although trade data can be very volatile.

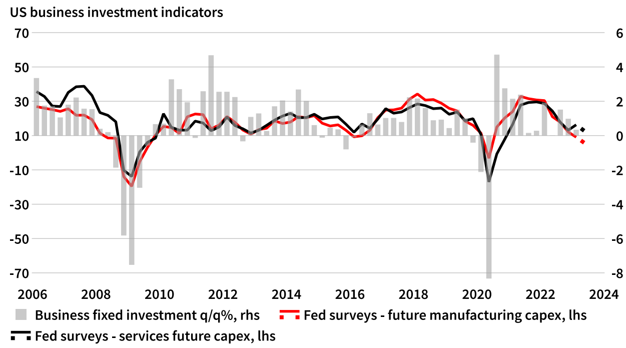
Reflecting the overall strength of the activity data early in the quarter, we have revised up our estimate of Q2 GDP growth from -0.1% q/q to 0.3% q/q. We still expect to see a downturn in the economy which we now pencil in for Q3/Q4 2023.

These changes, as well as the upwards revision to Q1 by the BEA, mean that 2023 GDP growth is now expected to be 1.3% (was 1.0%) and 2024 growth 0.7% (was 0.9%).

The strength in April consumption came despite the weakest monthly growth in real household income since mid-2022. As a result, the savings rate remains low and the pool of 'excess savings' accumulated in the pandemic continues to decline. As employment growth slows and households move to a more normal savings behaviour consumption growth is likely to soften.

On the business investment side, forward looking indicators continue to point to weak outcomes. The Q1 incomes data pointed to falling business profits, including margin compression, which also sends a negative signal around capex (and employment).

Leading capex indicators still weak



Sources: Macrobond, NAB. Dotted lines indicate full sample of regional fed surveys not avaialble

While timing of the downturn is uncertain – reflecting the long and variable lags of monetary policy – our fears that one will occur have not diminished. Indeed, the risk of a more severe downturn than we are forecasting has gone up. This reflects the very slow progress in bringing inflation down and the associated possibility that inflation may have become entrenched at a level above the Fed's 2% target, which will force the Fed to ratchet rates up again.

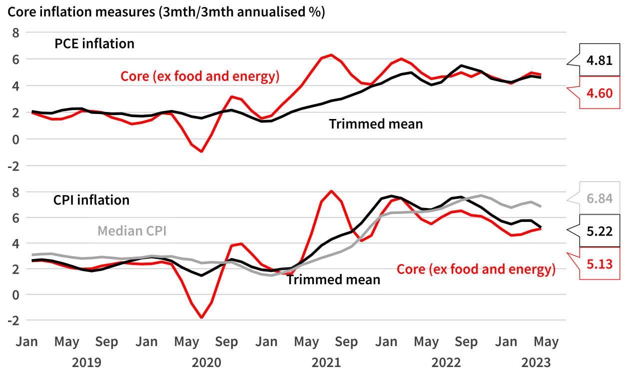
Inflation also resilient

April inflation readings generally disappointed. On both a core (ex energy and food) and headline basis CPI and PCE inflation increased by 0.4% m/m, similar to, or higher, than in March.

On a 3m/3m basis there is little to cheer either. While most underlying inflation measures are off their peak, at best they are now only gradually decelerating and, in some cases, just moving sideways.

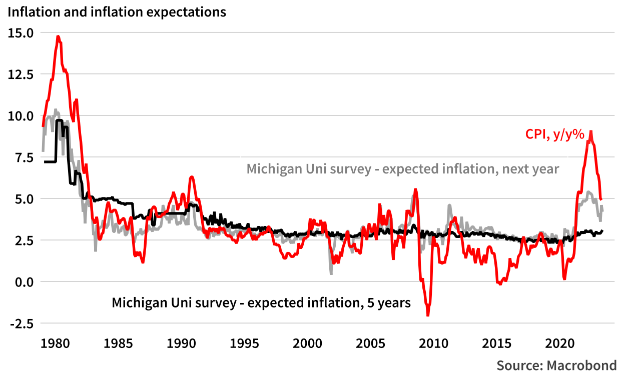
To be clear, we still expect to see a decline in inflation over time. The producer price inflation (on a core basis) is back around pre-COVID levels so upstream price pressure has clearly moderated (consistent with the observed improvement in supply chain indicators) and measures of new housing rental inflation point to a deceleration in the PCE/CPI housing rents growth. Our expectation of a further slowdown in growth (and easing of labour market pressures) if realised should also take pressure off prices.

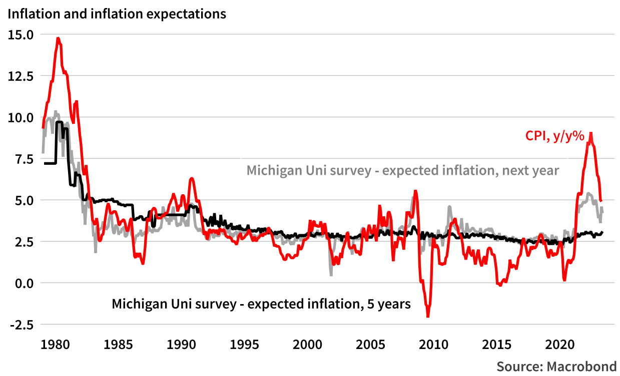
Disappointing progress on inflation



However, exactly where inflation will settle, even with a modest contraction in the economy, is very uncertain. Much comfort has been drawn from medium/long term inflation expectation indicators remaining at levels broadly consistent with the Fed's inflation target. However, short term inflation expectations remain high. The slowdown in inflation that followed the early 1980s and 1990s recessions was arguably best picked up by the short-term inflation expectation indicator.

Inflation expectations – short term measures high





As a result, we still think the risks around our inflation forecasts are weighted to the upside.

Monetary policy

The resilience of the economic data – both for activity and inflation – add to the risk that the Fed will hike rates further, contrary to our baseline that the peak of this cycle has been reached.

At its May meeting the Fed statement dropped the previous reference to "…some additional policy firming may be appropriate…" signalling that a pause was on the cards. That said, the Fed's May meeting minutes indicated a committee divided between raising rates ("some" participants) and pausing ("several") in future meetings. Recent Fed member speeches have reflected this divide.

Recently, the Fed Chair indicated that, given the extent of rate rises to date, the Fed "can afford to look at the data and the evolving outlook to make careful assessments." This reflects a recognition that policy is clearly at a restrictive level, that there are lags between policy changes and the impact on the economy, and the uncertain impact of recent banking sector stress in the US.

The Chair's remarks are consistent with a pause, at least at the June meeting. However, incoming data has the potential to shift Fed views and market pricing now sees a roughly two-thirds chance of a hike in June, with a (25bp) hike fully priced in by July. Our baseline view for the Fed reflects our expectation that the economy (and inflation) will weaken over the rest of the year. However, even if this broadly plays out, data can be volatile month-to-month and this week's employment report and the May CPI (released during the Fed's two-day meeting) have the potential to affect the June decision.

The bigger issue (and risk) is not whether the Fed raises rates by another 25bp, but that inflation data continues to disappoint, leading the Fed to start another series of rate rises causing a more severe downturn.

Fiscal machinations

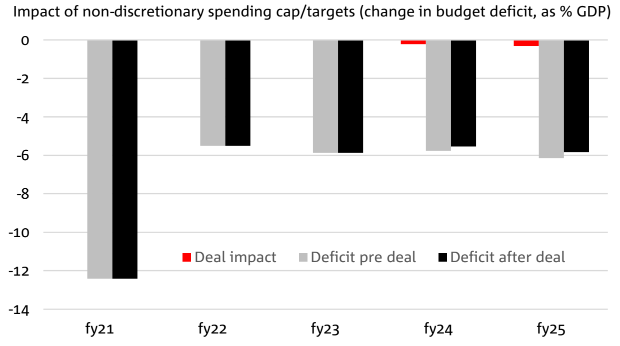
Fiscal policy has dominated the headlines recently, given the possibility of a US Government default on its debt if an increase in the debt ceiling is not passed in time.

President Biden and the leader of the House have reached an agreement (Fiscal Responsibility Act of 2023) to extend the debt limit, but it still needs to be passed by both houses of Congress. Based on advice from the Treasury Secretary on when the 'extraordinary' financing measures being utilised will be fully exhausted) this needs to occur by 5 June. Votes on the Act in both the House and Senate are expected this week.

We expect that it will be passed but clearly there is still some risk (with potentially severe economic impacts) that it won't. At least some representatives from both parties are considering voting against it.

At the time of writing, the Congressional Budget Office had not yet released its cost of the agreement. Our rough estimate of what it might cost – largely based on reporting of what have been variously described as caps or targets for non-defence discretionary spending – suggest a reduction in the deficit of around 0.2% in FY24. The starting point for US fiscal policy settings for coming years was largely neutral (represented by the change in the budget deficit). This agreement only marginally moves in a tighter direction and does not materially change the economic outlook.

Fiscal impulse still around neutral if deal passes



Source: CBO, NAB estimates

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	2025	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	8.3	2.7	1.9	0.9	1.8	0.3	0.9	0.4	-0.1	0.1	0.2	0.3	0.4	0.4
Private fixed investment	7.4	-0.2	-1.9	0.5	3.8	-1.0	-0.1	-0.1	-0.4	-0.5	0.0	0.6	0.7	0.9
Government spending	0.6	-0.6	2.6	0.7	0.8	0.9	1.3	0.2	0.1	0.1	0.2	0.2	0.2	0.2
Inventories*	0.2	0.7	-0.6	0.1	0.1	0.5	-0.6	0.1	-0.1	-0.1	0.1	0.0	0.0	0.0
Net exports*	-1.7	-0.6	0.5	-0.1	-0.1	0.2	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**2.1**	**1.3**	**0.7**	**1.9**	**0.6**	**0.3**	**0.3**	**-0.2**	**-0.1**	**0.2**	**0.3**	**0.4**	**0.5**
Note: GDP (annualised rate)						*2.6*	*1.3*	*1.1*	*-0.8*	*-0.2*	*0.9*	*1.4*	*1.6*	*1.8*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.7	5.7	3.3	2.2	2.1	0.9	1.0	1.0	0.7	0.5	0.6	0.4	0.6	0.6
Core	**4.7**	**4.8**	**3.5**	**2.2**	**2.2**	**1.1**	**1.2**	**1.0**	**0.8**	**0.5**	**0.6**	**0.5**	**0.5**	**0.6**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.0**	**4.7**	**4.7**	**3.6**	**3.5**	**3.5**	**3.6**	**4.0**	**4.2**	**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**	**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

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

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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