US Economic Update 02 May 2023

Q1 GDP slowdown driven by inventories

- **GDP growth slowed in Q1 to a sub-trend 0.3% q/q, but this was largely due to inventories, with domestic final demand growth strengthening.**
- **There were some positive signs in the March PCE inflation data – with underlying measures printing on the low side (by recent standards) but further low prints are required to confirm inflation is decelerating, particularly given still elevated wage growth.**
- **We expect the Fed to hike rates by 25bp at its meeting this week and then to pause (at a target range of 5.00% to 5.25%). However, until clearer signs of a deceleration in inflation emerge, the risk remains that the Fed will take rates higher.**

Q1 GDP

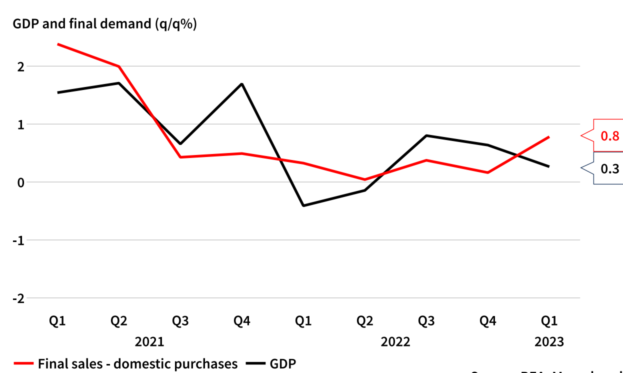
GDP growth slowed in Q1 to 0.3% q/q (1.1% annualised), marginally below our expectation of 0.4%.

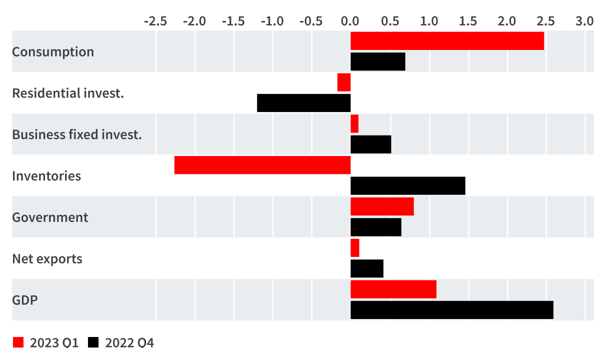
The details were somewhat better than the headline, as a key driver of the lower growth rate was a large detraction to growth from inventories while domestic final demand growth strengthened. The inventory detraction reflects the large run up in stocks in Q4 coming to an end, with the level of inventories little changed in the quarter. While it is possible there will be a rebound in Q2, inventory to sales ratios do not make a strong case for this (and recession fears are an additional reason why business may be cautious around inventory levels).

The acceleration in domestic final demand growth was mainly driven by household consumption – up 0.9% q/q from 0.3% in Q4. Government demand was again strong and while residential investment fell, it did so by a much smaller amount than in the last three quarters.

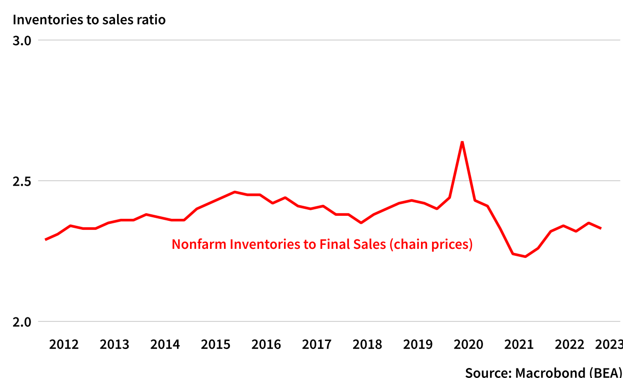
The strength in household consumption was helped by strong growth in disposable income (1.9% q/q after adjustment for inflation), in part due to a large cost of living adjustment to social security recipients (which will not be repeated in Q2). The savings rate remains below its pre-COVID level but rose for the second consecutive quarter, suggesting household willingness to support consumption by lowering savings is diminishing.

GDP slowdown driven by inventories, as consumption lifts domestic final demand





Inventory ratios to sales have not shifted significantly in recent quarters



Government consumption and investment was up 1.2% q/q (from 0.9% q/q in the prior two quarters). However, the Federal government component of this – up 1.9% q/q – is not sustainable based on CBO projections of fiscal year spending ex transfers.

Business investment trends were less positive, consistent with indications from surveys of business

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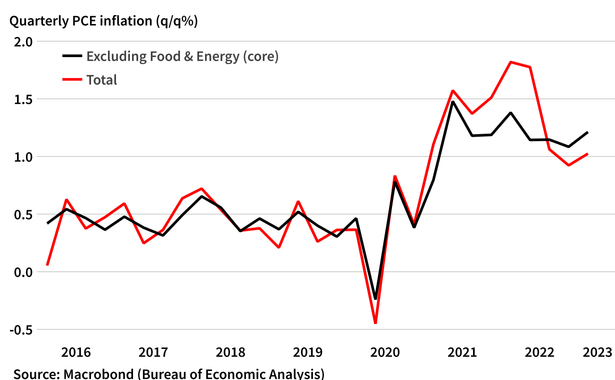
capex indications and a weakening in capital goods orders. Equipment investment declined for the second quarter in a row (-1.9% q/q), while intellectual property investment (software, research and development) grew by its slowest rate (0.9% q/q) since the initial COVID lockdown. Total business fixed investment still recorded a small rise due to strong growth in structures (2.7% q/q). The strength in structures investment was in part due to surprisingly strong growth in mining investment (7.2% q/q) which is unlikely to be repeated in Q2 as the oil rig count has declined since mid-February.

Inflation and labour costs

Quarterly inflation picked up slightly in Q1. The personal consumption expenditure (PCE) price index grew by 1.0% q/q (4.9% y/y). On a core basis (ex food and energy), inflation was slightly stronger, up 1.2% q/q (4.6% y/y).

Already high inflation ticked up in Q1



Source: Macrobond (Bureau of Economic Analysis)

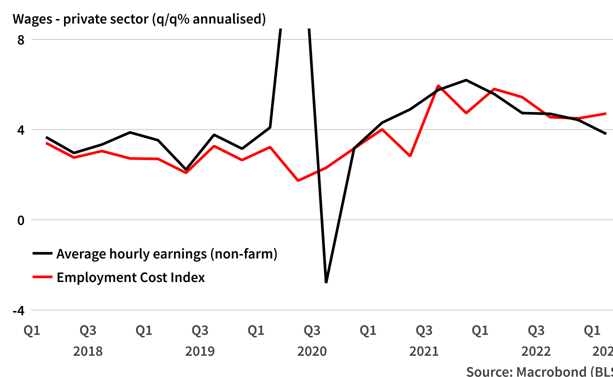
The quarterly core outcome was slightly stronger than expected, reflecting upwards revisions to January and February, while the March result (0.28% m/m) was at the lower end of the range seen over the last two years. Similarly, trimmed mean monthly inflation was the lowest it has been since early 2021, and core services ex housing inflation – which is being closely watched by the Fed – softened to 0.2% m/m.

However, the Fed is looking for more than a single relatively low month of inflation data. Looking at 3mth/3mth growth rates to smooth out the monthly volatility, the various measures of underlying inflation all remain elevated and do not confirm that inflation is decelerating.

Adding to the uncertainty over the outlook for inflation was the Employment Cost Index (ECI) for Q1. Growth in the monthly hourly earnings measure has been slowing, but it can be affected by compositional change which the ECI adjusts for. In Q1, the ECI grew by 1.2% q/q, up slightly from the previous quarter, and remains above the level the Fed would be comfortable with.

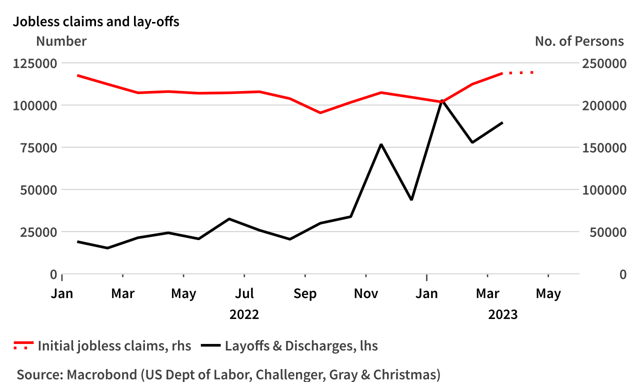
While employment growth slowed in March, it remained robust and above the level (given underlying population trends) needed to keep the unemployment rate at its current very low level. However, some labour market indicators do point to labour market easing – jobless claims and layoffs have risen this year.

Employment cost index growth still elevated…



Source: Macrobond (BLS)

…with labour mkt still tight; but some indicators turning



Source: Macrobond (US Dept of Labor, Challenger, Gray & Christmas)

Outlook

The Q1 GDP numbers have not changed our view on the outlook for the US economy. We still expect to see the economy contract at some point this year due to the impact of the monetary policy tightening since early 2022 and, more recently, banking sector stress which will likely affect credit availability.

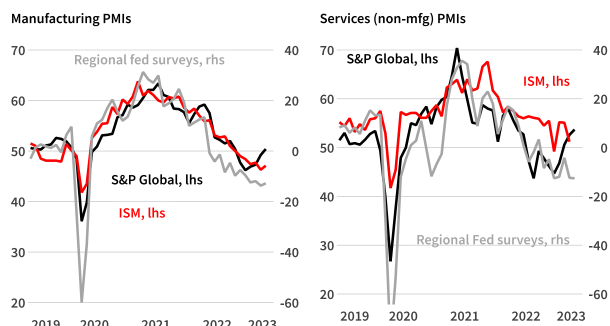
We continue to pencil in a small decline in GDP over Q2 and Q3. While consumption was strong in Q1, the monthly data declined over the subsequent two months setting up the possibility of a weak Q2. Business investment indicators are also weak suggesting further subdued, if not negative, outcomes ahead. Because of the weaker than expected Q1 GDP, we now expect 2023 growth of 1.0% (previously 1.1%), while our forecasts for 2024 (0.9%) and 2025 (1.9%) are unchanged.

That said, the economy has proved resilient to-date, and it is possible that the downturn will start later in the year. Internationally, there has been a rebound in China and the easing in energy prices is providing a lift to Europe (and potentially also Japan), which may lift export demand. Further, there is a chance that the detraction from Q1 growth from inventories may reverse, and the boost to household income in early in Q1 may support consumption for longer than we are factoring in. Households are also benefiting from the strong labour market. While some labour market indicators are

softening (jobless claims/layoffs), how quickly this is accompanied by a move away from recent robust total employment growth is uncertain.

Adding to the near-term uncertainty is the divergence between the different business surveys. The S&P Global PMI has picked up in recent months while the ISM services indicator – which had been a beacon of strength – may be faltering. An average of various monthly regional Federal Reserve business surveys is weaker still.

Diverging trends across the business surveys



Sources: Macrobond. Regional Feds - Philadelphia, Richmond, Dallas, Kansas City & New York

At a more fundamental level, the bigger risk is that a deeper downturn is needed to get inflation back towards the Fed's target.

We expect the Fed to raise rates this week by 25bp, consistent with the guidance from its March meeting and from Fed speakers. While we expect the Fed to then pause, much will depend on future inflation readings as well as how quickly the labour market comes off the boil. If, as we expect, the economy contracts, unemployment starts to rise and inflation clearly slows, then this would set up rate cuts at the end of this year. However, if inflation and wage growth remains entrenched at a high level, then the Fed would likely take rates even higher.

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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	1.5	0.9	1.8	0.3	0.9	0.0	-0.1	0.1	0.3	0.3	0.4	0.4
Private fixed investment	7.4	-0.2	-2.3	1.0	3.8	-1.0	-0.1	-0.6	-0.4	-0.1	0.3	0.7	0.8	0.9
Government spending	0.6	-0.6	2.4	1.0	1.0	0.9	1.2	0.0	0.2	0.3	0.3	0.3	0.3	0.3
Inventories*	0.2	0.7	-0.6	0.1	0.1	0.5	-0.7	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Net exports*	-1.7	-0.6	0.6	-0.1	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**5.9**	**2.1**	**1.0**	**0.9**	**1.9**	**0.6**	**0.3**	**-0.1**	**-0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)						*2.6*	*1.1*	*-0.4*	*-0.5*	*0.7*	*1.1*	*1.5*	*1.7*	*2.0*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.7	5.7	3.3	2.1	2.1	0.9	1.0	1.0	0.7	0.5	0.5	0.4	0.6	0.6
Core	**4.7**	**4.8**	**3.4**	**2.2**	**2.2**	**1.1**	**1.2**	**0.9**	**0.7**	**0.5**	**0.5**	**0.5**	**0.6**	**0.6**
Unemployment rate - qtly average (%)	**4.2**	**3.6**	**4.1**	**4.8**	**4.7**	**3.6**	**3.5**	**3.6**	**3.8**	**4.1**	**4.4**	**4.6**	**4.7**	**4.8**
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

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