US Economic Update 5 Sept. 2023

Q3 off to a strong start even as inflation eases

- **The near- term outlook is stronger. July data – particularly for consumption – are consistent with robust growth in Q3 and we have also revised Q4 higher given current momentum.**
- **For the full year, we see GDP growth in 2023 of 2.1% (from 1.9%) but growth in 2024 is expected to be lower at 0.8% (was 0.6%) as we still see a material slowdown taking hold.**
- **While growth remains above trend – something the Fed Chair has flagged could justify further rate hikes – the easing in labour market pressures and inflation should mean the Fed stays on hold this month.**

Early Q3 take

Early indications of Q3 GDP growth are positive. In particular, household consumption grew by 0.6% m/m in July. This was on top of 0.4% m/m growth in June and, as a result, consumption is already 0.9% above its Q2 level. While there appear to be some transitory factors at play (Amazon Prime day, utilities consumption), the strength was reasonably broad based. As a result, Q3 consumption growth is likely to be strong.

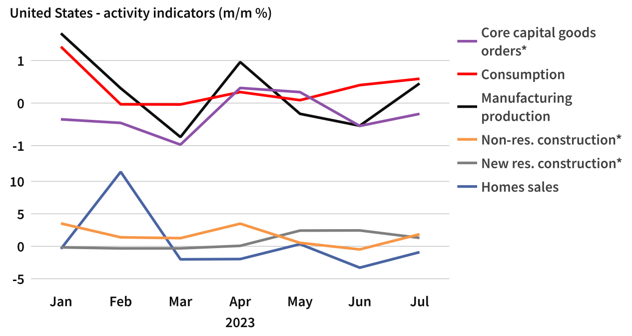
New residential construction grew by 2.2% m/m (in value terms) in July, continuing its recent positive turn. Even allowing for declining house sales, this means that overall residential investment is likely to be positive in Q2, after contracting in the previous nine quarters.

More mixed were business investment indicators. Non-defence shipments fell in July and while core (ex. defence and aircraft) orders were up 0.1% m/m, we estimate they declined in real terms. The strong growth in machinery & equipment investment seen in Q2 may be short-lived.

At the same time, the recent strength of private non-residential construction is showing signs of abating. Business investment in non-residential construction has been boosted by the impact of various government initiatives (such as the CHIPS Act) which provide incentives to invest in tech. This led to a surge in manufacturing non-residential construction earlier in the year; while it is uncertain where it will peak, growth has clearly slowed over recent months.

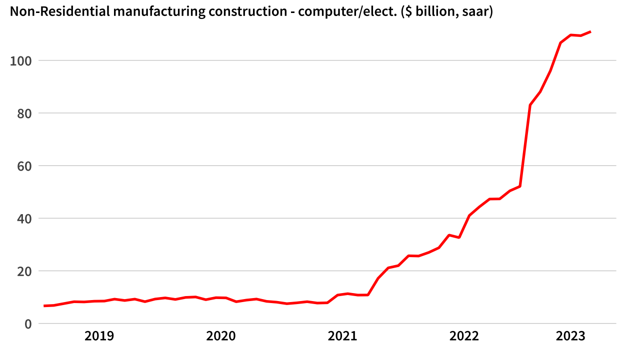
Advance trade data (by value) and trade price indices point to both real goods exports and imports growing in July by 0.8% and 1.5% m/m respectively. That said, the July trade balance was below its Q2 average, pointing to a possible positive contribution to GDP growth in Q3. Trade data can be very volatile and for now we are factoring in a largely neutral net export contribution.

Overall, activity indicators positive in July



Source: Macrobond. * Private, deflated using PPIs for machinery & equip and non-res. construction, and house const. price indices

Tech boost to mfg construction slowing



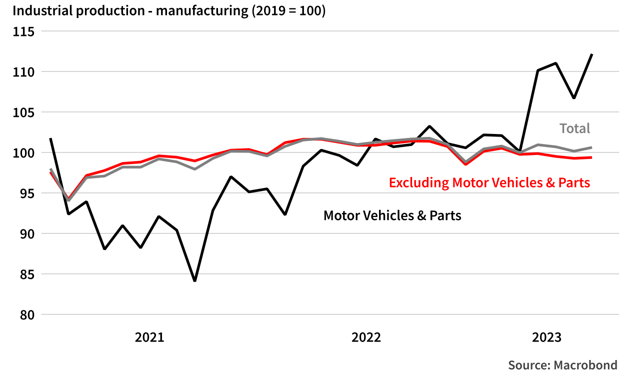
Source: Macrobond

While not an input into GDP calculations, industrial production (IP) was up strongly in July, rising 1.0% m/m, more than unwinding the large fall in June. This in part reflects swings in utilities (movements in which tend to be weather related). Looking at the manufacturing IP component, it was a similar story with a rebound in July (+0.5% m/m) after June weakness (-0.5%).

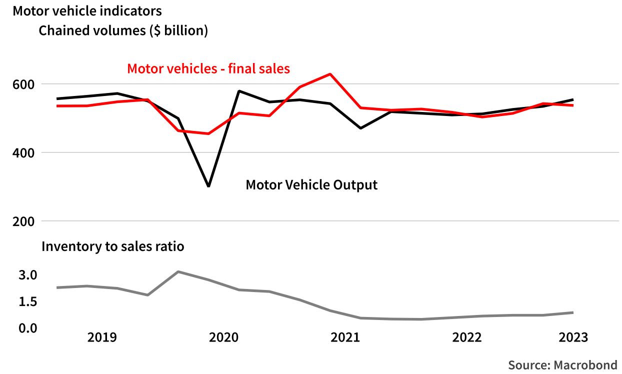
The broader story is that manufacturing IP has fallen slightly over the last year (-0.8% y/y), but the strength in motor vehicle production (and also high tech) has provided important support (with it being 10% higher in July than a year ago).

Supply chain problems lingered longer in the motor vehicle sector, leading to inventories falling to very low levels and large price increases (particularly in the second-hand market). Inventories, relative to sales, remain low but have been slowly recovering, which is also resulting in a fall in some motor vehicle prices (particularly in the second-hand market).

Support for manufacturing from auto sector



MV sales holding up; inventories low but rising

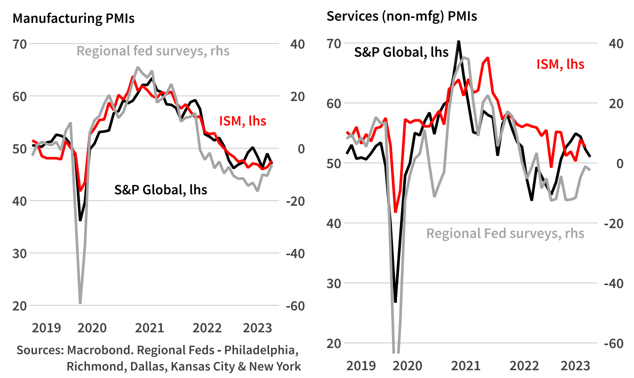


Growth likely to weaken

We expect that GDP growth is likely to slow considerably from here.

Business surveys have sent conflicting messages at times over the few years, but overall are pointing to only weak growth. Manufacturing has been uniformly weak for a while (with the survey differences being about the degree). In contrast, services sector indicators have been more polarised. In recent months, the S&P Global measure has fallen while the regional Fed surveys have moved higher; taken together they appear to suggest growth in the services sector is soft.

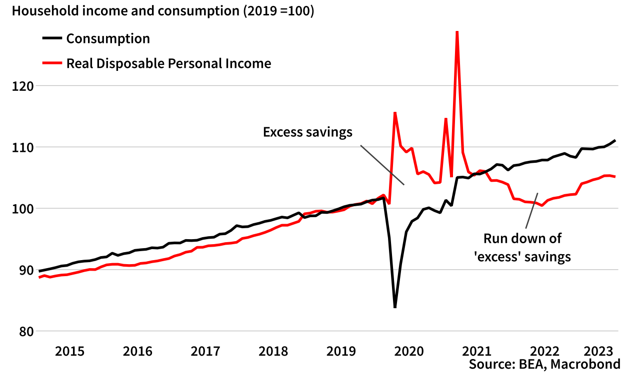
Surveys converging to weak levels



While surveys are not a particularly reliable guide to quarterly GDP growth, they do tend to track the underlying trend over time.

More fundamentally, we expect to see a correction in household consumption, acknowledging that the timing and speed of this is highly uncertain. The pandemic, and associated policy response, saw large swings in both consumption and income. Real consumption is currently running at around, if not higher, than its pre-COVID path while real income is clearly lower. Another way this can be seen, is in the household savings rate which is close to its historical low. The restart of student loan payments will also be a headwind in Q4.

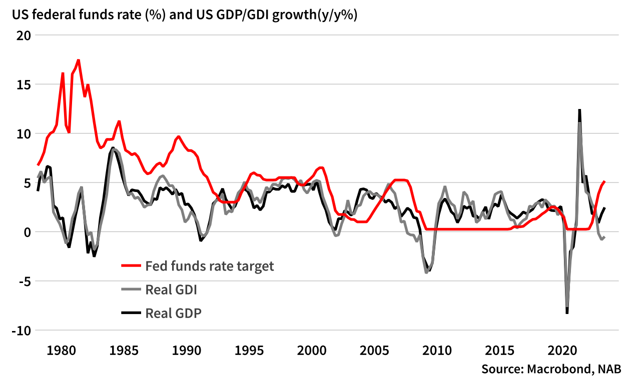
H'holds continue to run down pandemic savings



While developments in tech and the motor vehicle sectors have recently provided support for the economy, for how long this remains the case is unclear. In any event, their contribution to growth will likely ease even if activity remains at a high level. As noted earlier, this is already evident in tech related manufacturing structures data in recent months where growth has slowed.

Fed regional surveys of business capital investment intentions remain soft, even with some recent improvement. A weakening in consumer activity and a subdued global growth environment (particularly in China and Western Europe) is likely to place continued pressure on business investment.

Bucking history? Fed funds rate and growth



From a more top-down view, historically rises in interest rates have been associated with a downturn in activity. At this stage, US GDP growth has proved resilient although, as we have highlighted in previous notes, real GDI (which should equal GDP if there were not measurement issues) has clearly turned down. In Q2, real GDP increased 0.1% q/q (0.5% annualised), an improvement from the negative growth seen in the two prior quarters, but still much weaker than GDP.

The stark difference between GDP and GDI may be (at least partially) resolved when the 3rd estimate of Q2 GDP is released later this month, as it will include the BEA's annual benchmark revisions. However, for our forecasts we continue to take the GDP estimates at face value.

The early strength in activity (GDP) indicators for Q3 means that we have revised up our forecast for the quarter to 2.9% q/q (annualised) from (1.0%). With two months of data still to come (and revisions to past data) there is still a wide range of possible outcomes, but the change better balances the upside and downside risk.

Given the strong momentum in activity data, we have also lifted our forecast for Q4, partially offset by lower expected growth over 2024, which is expected to be well below its longer-term trend rate. This will probably include a small contraction in GDP growth at some point in H1 2024, although only a mild one (and an alternative outcome of continuing, but weak growth would not be a major forecast surprise).

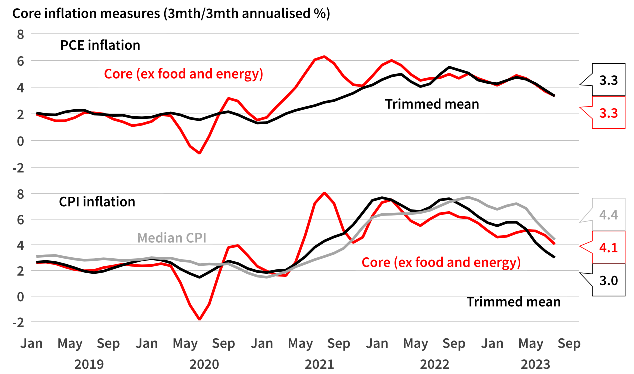
In year average terms, we now expect GDP growth of 2.1% in 2023 (was 1.9%) and 0.8% in 2024 (was 0.6%).

Inflation and the labour market

Inflation data were generally positive for July. Headline annual CPI growth picked up slightly to 3.2% y/y while the headline PCE rose to 3.3% (both from 3.0% in June). However, this was because July 2022 inflation was very soft and fell out of the annual calculations. The m/m readings were moderate – 0.2 % for the CPI and for PCE, both on a core and headline basis. Other measures of underlying inflation – such as median CPI, trimmed mean CPI and PCE also grew at a similar pace and have a clear downwards trend.

The only wrinkle was in the composition of core PCE, with a high print for core services inflation ex. housing, an indicator which has been a focus of the Fed. It increased 0.5% m/m in July, stalling progress on a 3mth/3mth basis, although it remains clearly lower than earlier in the year.

Downwards trend in underlying inflation in place



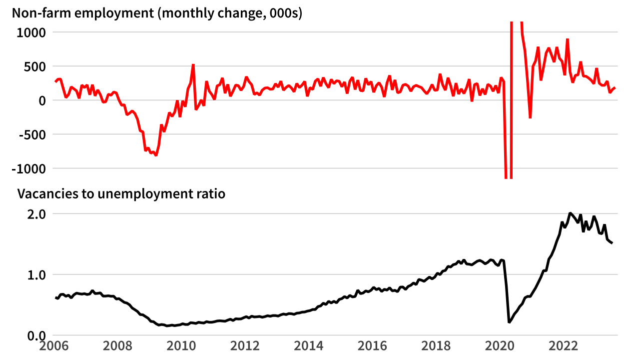
Upstream inflation indicators are also positive. While, on a 3mth/3mth basis core PPI has stopped falling it remains relatively low at 1.6% (annualised) and import used car prices have declined recently. The Zillow new leases rents growth indicator is also only growing at a soft rate, and CPI/PCE rents indices (which are for all leases and so lag) are set to move down much further.

Non-farm employment growth remained strong in August, growing by 187k (even with a drag from the Hollywood writers' strike). That said, there were net downward revisions to the prior two months of 110k, and employment growth has been trending down.

The unemployment rate jumped to 3.8% from 3.5% because of an increase in workforce participation. While the unemployment rate can be somewhat volatile, it was between 3.5 and 3.7% over the year to July, the August outcome is the highest since February 2022.

This points to an easing in labour market pressure, which was also evident in the July JOLTS report which reported a further fall in job vacancies, with a quits rate back to around its pre-COVID level.

Labour market pressures easing



Source: Macrobond (BLS). Scale truncated around COVID extremes

Average hourly earnings also moderated in August, growing by 0.2% m/m, the lowest monthly growth since February 2022. However, this followed strong growth in prior months and it has picked up on a 3mth/3mth basis in recent months. As with the quarterly employment cost index, the message is that wage growth is moderating, but only gradually.

Monetary policy

Our view that the Fed funds rate has peaked for this cycle is unchanged. That said the Fed still has a tightening bias. The Fed Chair noted in his Jackson Hole speech that additional evidence of persistently above trend growth or evidence that labour market tightness is no longer easing could call for a further tightening of policy. The first of these criteria is under some pressure with GDP growth again looking strong (and above trend) in Q3. However, the easing in labour market and inflation indicators should be enough to keep rates on hold at the Fed's meeting later this month, although the upcoming CPI (for August) could also be important.

That said, the risk of the Fed further lifting rates is not just limited to the next meeting. Growth this year has surprised us by its resilience, and if it does not slow as we expect, and the labour market remains tight, the Fed could raise rates further as flagged by the Chair.

Also uncertain is when the Fed might cut rates and how far they might take them down.

It is easy for the Fed to talk about keeping them on hold for an extended time when unemployment has been broadly flat at a very low level and GDP is growing strongly. However, when the unemployment rate starts to rise, and growth falter, then the conversation will be different. Measures of underlying inflation have been around 0.2% m/m over last couple of months – not that far from the Fed's target, and slower growth/rising unemployment will decrease the risk that it has 'done too little' and raise the risk that it has done 'too much'. At this point, with the Fed viewing current policy settings as clearly restrictive, the prudent course would be to start cutting rates.

We currently have this pencilled in to start in March 2024, but the risk is that this starts later even if our forecasts for activity and inflation broadly play out.

Our forecasts see the Fed funds rate moving back to 2.5% by the end of 2025. This is the current Fed median view of what the 'neutral' rate of interest is. However, there is a debate underway as to whether it might be higher. Ultimately, views of the neutral rate – whether model driven or more subjective – will be determined by how the economy performs relative to the level of interest rates. Given the resilience seen so far in the face of significant monetary tightening, the risk is that the perceived 'neutral rate' moves higher, although the debate could quickly change once growth slows.

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U.S. economic forecasts

					Quarterly Chng %											
					2023				2024				2025			
	2022	2023	2024	2025	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components																
Household consumption	2.7	2.4	1.0	1.5	1.0	0.4	0.8	0.2	0.1	0.1	0.2	0.3	0.4	0.5	0.5	0.5
Private fixed investment	-0.2	-0.7	0.2	3.4	-0.1	1.0	0.3	0.1	-0.6	-0.1	0.5	0.8	1.0	1.0	1.1	1.1
Government spending	-0.6	3.2	1.0	0.8	1.2	0.8	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Inventories*	0.7	-0.6	0.0	0.1	-0.7	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.6	0.7	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.1**	**2.1**	**0.8**	**1.7**	**0.5**	**0.5**	**0.7**	**0.2**	**-0.1**	**0.0**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)					*2.0*	*2.1*	*2.9*	*0.7*	*-0.4*	*0.1*	*1.1*	*1.5*	*1.9*	*1.9*	*2.1*	*2.1*
US Other Key Indicators																
PCE deflator-headline																
Headline	5.7	3.1	2.2	2.0	1.0	0.6	0.7	0.7	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Core	**4.8**	**3.4**	**2.1**	**2.1**	**1.2**	**0.9**	**0.7**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.6**	**3.7**	**4.6**	**4.6**	**3.5**	**3.5**	**3.6**	**3.7**	**3.9**	**4.2**	**4.4**	**4.6**	**4.6**	**4.6**	**4.6**	**4.6**
US Key Interest Rates																
Fed funds rate (top of target range)	**4.50**	**5.50**	**3.75**	**2.50**	**5.00**	**5.25**	**5.50**	**5.50**	**5.25**	**4.75**	**4.25**	**3.75**	**3.25**	**3.00**	**2.75**	**2.50**

Source: NAB Group Economics

*Contribution to real GDP growth

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