US Economic Update 10 October 2023

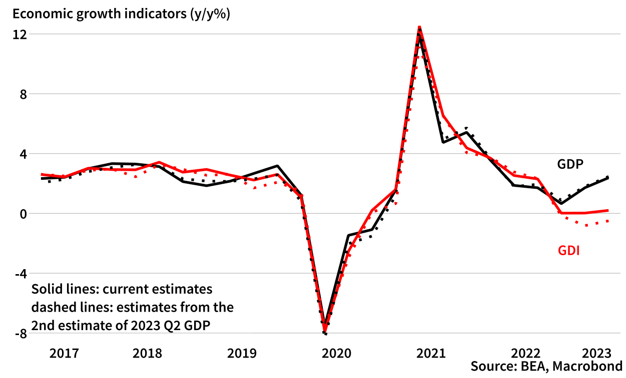
Revising up short-term growth; Fed cuts delayed

- **Upwards revisions to past data for household income and profits, as well as partial data pointing to strong growth in Q3, see us revise up our outlook for GDP growth out to mid-2024.**
- **For the full year, we see GDP growth of 2.3% (from 2.1%) in 2023 and growth in 2024 and 2025 of 1.2% (previously 0.8% and 1.7% respectively).**
- **We have maintained our view that the Fed won't hike again this year, but acknowledge it is possible, particularly if upcoming inflation data are on the high side.**
- **We now don't see the Fed cutting rates until June 2024 (previously March 2024).**

The past looks better

The third estimate of US GDP for Q2 2023 was released in late September. We have noted in previous US Economic Update reports the large difference between real GDP and GDI growth (which conceptually should be equal). GDP growth over the year to Q2 was revised down only slightly (-0.1ppts) and GDI growth over the same period was revised up 0.7ppts. Even after these changes, the two measures continue to offer very different takes on the strength of the economy. As normal, we continue to take the GDP numbers at face value (and they also seem more in line with labour market indicators) but it may be that GDP is overstating growth.

GDP/GDI gap has narrowed but still large

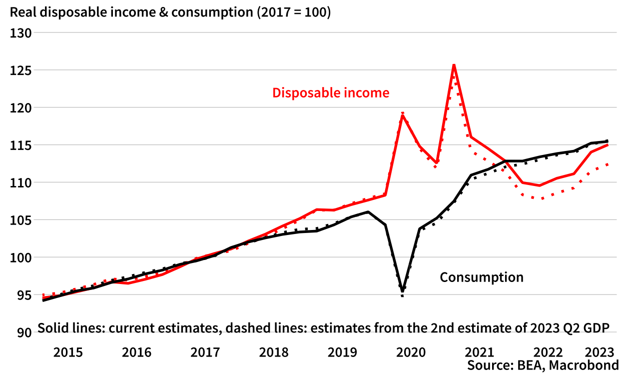


The income side revisions included noteworthy changes to household incomes and corporate profits.

For households, while consumption was little changed, the level of disposable income over the last two years was revised upwards. The weakness in the level of income relative to consumption had been a factor in our view that consumption growth was set for a correction.

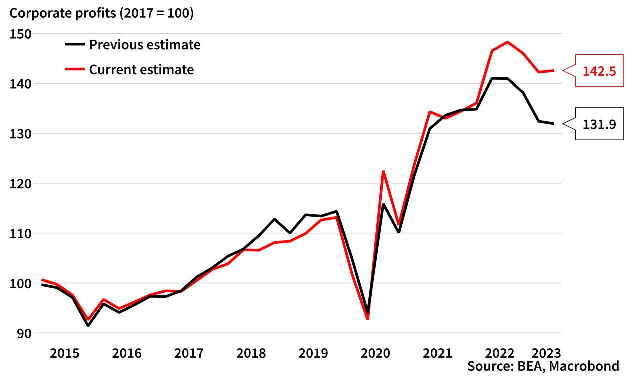
This changed picture can also be seen in the savings rates – not only has it been revised upwards in recent quarters, but the pre-COVID-19 level was also revised down.

Recent consumption appears more sustainable



Similarly, corporate profits have been revised substantially higher (the Q2 level between the 2nd and 3rd estimate moved up over 10%). Profits are still estimated to have declined from their peak, but the fall is smaller than previously estimated.

Corporate profits revised up substantially



Q3 looking even stronger

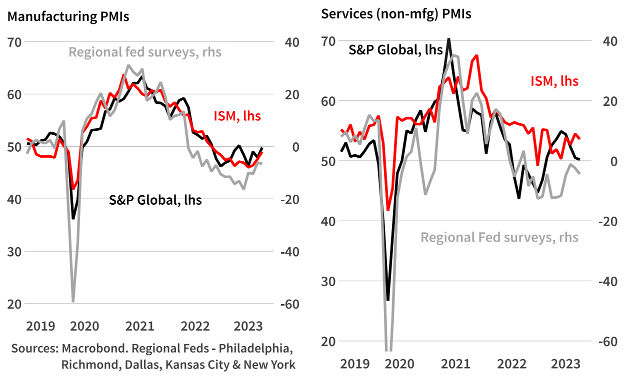
Incoming data continue to point to strong GDP growth in Q3. Last month we revised up our forecast for Q3 and this month we take it higher again (to 4.1% q/q annualised from 2.9% q/q).

As expected, consumption growth slowed materially from the boomy 0.6% m/m growth seen in July, growing by 0.1% m/m in August. However, we had expected a small correction over August/September and with auto sales up in September this is looking less likely.

More significant are recent net trade and inventory data. Real goods imports declined 1.9% m/m in August, while exports rose 0.1% m/m. This means the most likely result is a solid net trade contribution to Q3 growth. Similarly, inventory data available for July/August point to stronger inventory accumulation in Q3.

The strength in Q3 is somewhat at odds with the business surveys. The business surveys are not reliable indicators of quarterly GDP growth but over time do tend to follow the same trend, and so provide an independent signal of how the economy is performing. Of note, while still weak in level terms, the PMIs for the manufacturing sector have shown some improvement in recent months. The services sector remains stronger, although may have come off in recent months, although there are wide differences across the various surveys.

Surveys – signs of manufacturing stabilising



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

Outlook

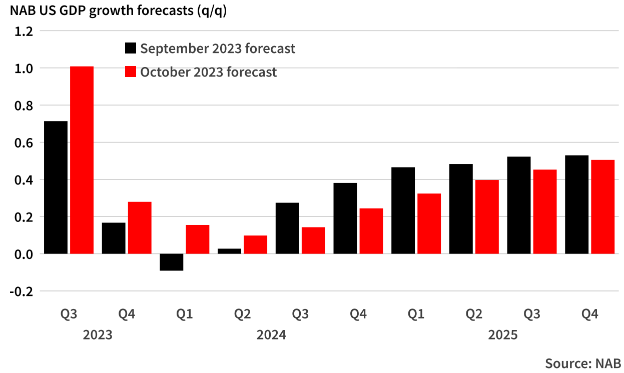
As a result of the revisions to the household income and corporate profit data, as well as the underlying strength of incoming data (suggesting greater momentum in the economy), we have lifted our forecasts for GDP growth over the four quarters to Q2 2024. We still expect growth to slow materially, as the full impact of past monetary tightening comes through, but with mid-2024 the point where it is likely to be softest (previously early 2024). Beyond that we expect growth to start recovering, albeit a bit more slowly than before, partly because we now expect rates to be on hold for longer.

In year average terms, these changes see higher growth in 2023 (2.3% from 2.1%) and growth of 1.2% in both 2024 and 2025 (previously 0.8% and 1.7% respectively).

As noted above, consumption growth was soft in August, in part reflecting the renewed pressure on household incomes from a lift in petrol prices. Further pressure on household spending power will come from the re-start of student loan interest and principal repayments. As a result, we expect materially lower consumption growth in Q4.

Similarly, the run up in tech related manufacturing construction appears to have peaked (so even it remains elevated, a further large boost to growth appears unlikely).

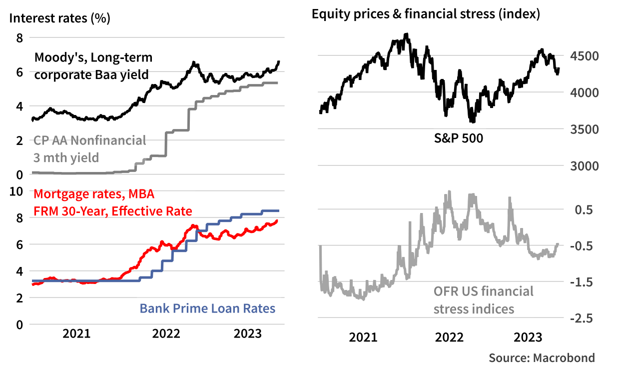
Changes to NAB US growth forecasts



Source: NAB

The resilience in the economy – and the resulting expectation that the Fed will keep rates high for longer than previously thought – has also seen a lift in interest rates with corporate bond yields, mortgages rates, bank loan rates all shifting higher. Importantly, however, measures of market stress remain muted. At the same time, there has been a fall in equity prices, reversing some of the gains in wealth that households experienced over the first half of the year.

Renewed pressure on rates and equities



Source: Macrobond

The rise in interest rates (and fall in equities) represents a tightening in financial conditions, which, if sustained, will constrain future activity, particularly in interest rate sensitive sectors such as residential investment and durables consumption. It can also impact business investment where surveys of business capex intentions remain soft even with some recent improvement.

Strike activity has come to the fore this year, notably the Writers strike (May-September) and the current auto workers strike (started mid-September). The impact of the former on intellectual property investment is highly uncertain and a downside risk to Q3 (and upside risk to Q4) intellectual property investment. The impact of the auto workers strike is also hard to determine – September auto data held up but depending on the duration (and breadth across manufacturing plants), it may hold down Q4 activity.

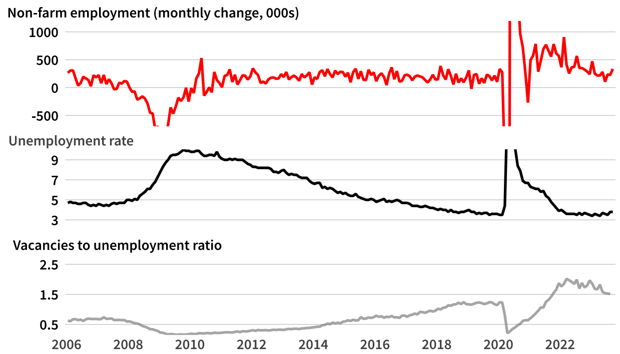
There is also the possibility of a US Federal Government shutdown later this year. A shutdown was only just recently averted but funding was only extended to 17 November.

Labour market and inflation

There was notable 336k increase in non-farm employment in September, with a solid upwards revision to the two previous months (albeit entirely in public sector employment). In contrast, the unemployment rate remained at 3.8% (after jumping up to this level in August from 3.5%) and average hourly earnings growth was again low at 0.2% m/m.

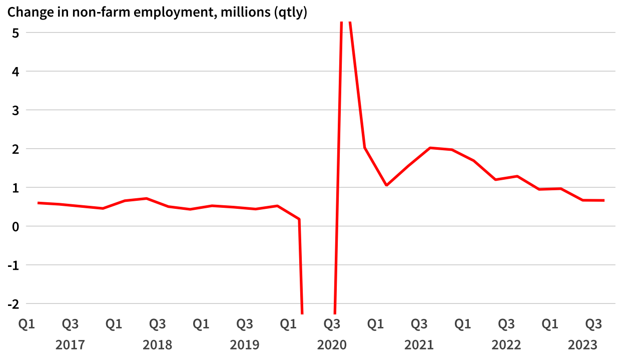
Job vacancies for August also jumped higher, although relative to the number of unemployed they continue to move down.

Strong jobs growth in Sept, but unemployment has edged up…



Source: Macrobond (BLS). COVID extremes cut-off by scales

…and on quarterly basis, a break in the downwards trend is less clear



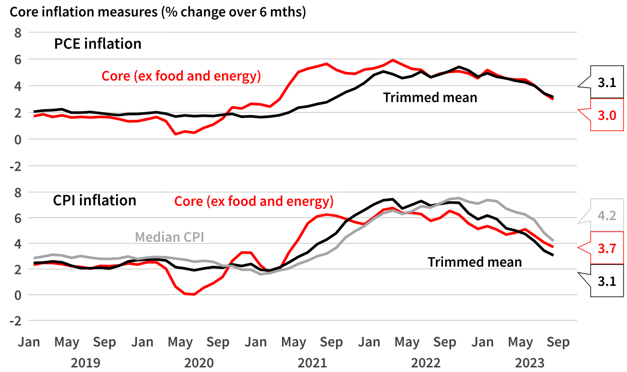
Source: Macrobond (BLS)

Overall, data over the last month were mixed. Monthly data are volatile; on a quarterly basis non-farm employment growth was little changed in Q3. It is not the first time there has been a pause in the downwards trend in job creation evident since early 2022. That said, even if conditions are still easing, it is only slowly and the labour market remains tight. The Fed's concern with a tight labour market is that it feeds into wages growth (and then onto prices) but the modest growth in the August and September hourly earnings data possibly indicates that wage cost growth has come off further (although again, a couple of readings are not enough to be definitive).

On the inflation front there was mixed news for August. Headline CPI grew 0.6% m/m – its highest level since mid-2022. This was largely due to a rise in gasoline prices, although the core CPI, at 0.3% m/m, was also up on the previous two months. The Fed's preferred inflation measure – PCE inflation, also rose to 0.4% m/m, but the increase in the core measure was only 0.1% m/m, its lowest level since late 2020.

In his September FOMC press conference, the Fed Chair, noted that monthly data can be volatile and that it is important to look at longer time frames. While noting that this is why they tend to look at price changes over a 12-month period, he indicated that when there has been a turn in inflation they also look at inflation over 3 and 6 month periods. Importantly, regardless of how it is examined, inflation is shifting down across the range of underlying inflation measures.

Inflation trending down



The changes to our GDP outlook now mean that, while we still expect the unemployment rate to rise over the next two years, it will occur more gradually. We still expect it to rise to around 4½%, but for this level to be reached in H1 2025 (previously H2 2024).

In contrast, we have not made material changes to the inflation outlook. While a stronger near-term outlook for growth and the labour market should mean, other things equal, stronger inflation, inflation has broadly matched our expectation in Q3. The disinflationary effects coming from supply chain normalisation on goods prices still has further to run – most notably for auto prices where inventories have not fully recovered – especially when coupled with the softness in the global economy. Housing services inflation will almost certainly continue to decline given trends in rents for new leases.

A key uncertainty remains at what level inflation will settle once some of these (dare we say 'transitory') factors pushing inflation down subside. However, with most measures of inflation expectations still well anchored, we retain our forecast that inflation will move close to the Fed's 2% target.

Monetary policy

At its meeting this month the Federal Reserve maintained the target range for the federal funds rate at 5.25% to 5.50%.

New Fed member economic projections were released following the meeting. The Fed median projections for GDP growth over 2023 and 2024 were revised up.

Consistent with this, the expected unemployment rate was lowered. The median inflation forecasts did not shift much – slightly lower in 2023 and, for core PCE inflation, slightly higher in 2025 but the 2024 forecast was unchanged.

For the federal funds rate, the median projection for end 2023 remains at 5.50-5.75% (i.e. one more hike this year). While retaining an expectation of rate cuts next year, the amount has been halved (50bps compared to 100bps previously). Despite the resilience in the economy to-date in the face of the large lift in rates, the Fed's view of the long-run level of the funds rate ('neutral') remains at 2.5%. That said, even while projecting inflation, the unemployment rate and GDP growth to be at their long-run level in 2026, the fed funds rate projection at the end of the year is 2.9%, above 'neutral'.

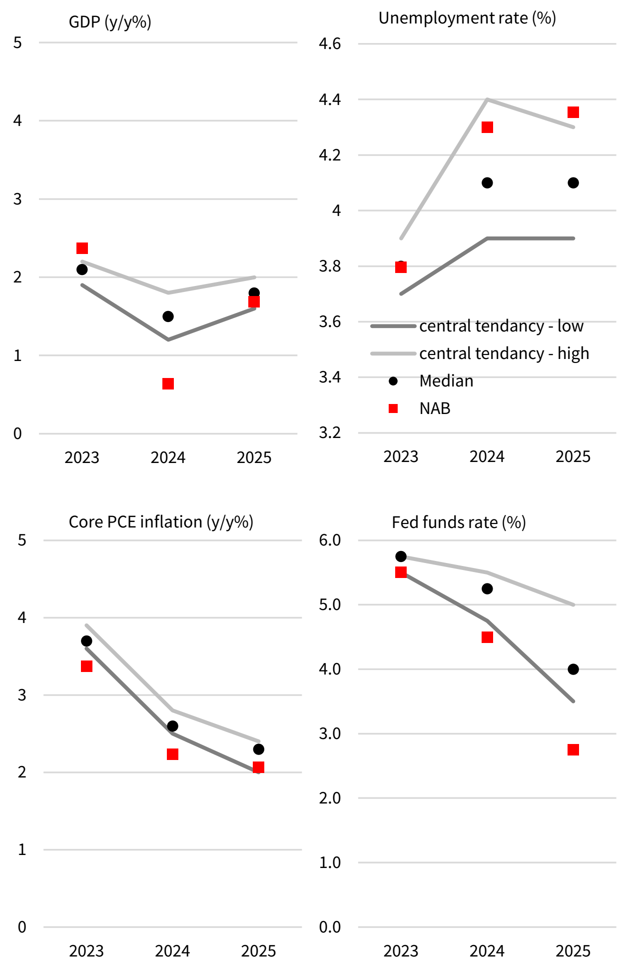
In terms of whether the Fed will increase rates one more time this year, this is clearly possible, but we retain our view that it will remain on hold given the better run of inflation data of late.

In August, the Fed Chair stated that "Evidence that the tightness in the labor market is no longer easing could also call for a monetary policy response." So it was little surprise that the strong jobs growth reported for September lifted market expectations of the chance of a rate hike, but it subsequently fell back. At the time of writing, market pricing implies around a 25% chance of a rate hike by the end of this year. The improvement in inflation outcomes may be enough to stay the Fed's hand – but clearly, if the next 1-2 months of inflation data are on the high side, the chance of a rate hike will go from possible to probable. The Employment Cost Index for Q3 will also be an important marker, with the Fed looking for further signs that wage growth is moderating. Given the inherent volatility in monthly data around its underlying trend, the decision could go either way.

With the change to our economic forecasts, we have pushed out when we expect the Fed to start cutting rates to June 2024 (previously March 2024). We also expect a slower pace of cuts to start – one a quarter – initially but as unemployment rises further and it is clear the moderation in inflation is entrenched then we think they are likely to start cutting at each meeting.

This still leaves a lower track for the fed funds rate than in the median Fed member projections. This is consistent with our more pessimistic view for GDP growth and the unemployment rate, and our forecast that inflation will be lower in 2024 than the Fed expects.

NAB and Fed member projections (end year)



More broadly, the risks around this rate call mirror the uncertainties around our economic projections. Inflation outcomes will be central to this and there are upside and downside risks to the inflation outlook. Moreover, rates may end up lower than expected over the forecast period if, as is the historical experience for monetary policy tightening of the magnitude experienced, the economy goes into recession. Conversely if growth, and the labour market, continues to out-perform expectations, particularly if this adds to inflation pressures, then rates could be on hold for longer (or even move higher). Growth outperformance would also see the Fed revise up its view of 'neutral' which may affect the extent of rate cuts.

Contact the author:

Tony Kelly
Senior Economist
Antony.Kelly@nab.com.au

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	2.5	2.1	1.1	1.3	0.9	0.2	0.9	0.2	0.2	0.1	0.2	0.3	0.3	0.4	0.4	0.5
Private fixed investment	1.3	0.4	1.5	1.9	0.8	1.3	0.3	0.5	0.5	0.1	0.1	0.3	0.5	0.7	0.8	0.9
Government spending	-0.9	3.4	1.3	0.8	1.2	0.8	0.5	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Inventories*	0.5	-0.4	0.0	0.1	-0.6	-0.1	0.2	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.5	0.6	0.1	-0.1	0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**1.9**	**2.3**	**1.2**	**1.2**	**0.6**	**0.5**	**1.0**	**0.3**	**0.2**	**0.1**	**0.1**	**0.2**	**0.3**	**0.4**	**0.5**	**0.5**
Note: GDP (annualised rate)					*2.2*	*2.1*	*4.1*	*1.1*	*0.8*	*0.3*	*0.5*	*1.0*	*1.3*	*1.6*	*1.8*	*2.0*
US Other Key Indicators																
PCE deflator-headline																
Headline	5.9	3.1	2.2	2.0	1.0	0.6	0.7	0.7	0.6	0.7	0.5	0.5	0.5	0.5	0.5	0.5
Core	**5.1**	**3.4**	**2.2**	**2.1**	**1.2**	**0.9**	**0.6**	**0.6**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	3.6	3.8	4.3	4.4	3.5	3.5	3.7	3.8	3.8	4.0	4.2	4.3	4.4	4.4	4.4	4.4
US Key Interest Rates																
Fed funds rate (top of target range)	4.50	5.50	4.50	2.75	5.00	5.25	5.50	5.50	5.50	5.25	5.00	4.50	4.00	3.50	3.00	2.75

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

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

Skye Masters
Head of Markets Strategy
Markets, Corporate & Institutional Banking
+(61 2) 9295 1196

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