US Economic Update 3 November 2023

Q3 GDP growth very strong but not sustainable

- **GDP growth was very strong in Q3, at 4.9% q/q (annualised). The main drivers were consumer and government spending, and inventories. However, business investment stalled.**
- **At the same time quarterly core inflation in Q3 declined to its lowest level since 2020, although monthly indicators have recently lost some of their downwards momentum.**
- **With the Q3 outcome higher than expected, we now forecast GDP growth of 2.4% in 2023 (was 2.3%) and 1.4% in 2024 (was 1.2%). These forecasts still incorporate the view that growth will slow starting in Q4 2023.**
- **The Fed left policy unchanged this month and our baseline view remains that the fed funds rate has peaked, although there remains upside risk.**

GDP data signal rapid growth in Q3

US economic growth was strong in Q3 – at 1.2% q/q (4.9% annualised) and above our expectation (1.0%). Domestic final demand growth was a bit lower, as inventories contributed 0.3ppts to GDP growth, but still robust at 0.9% q/q.

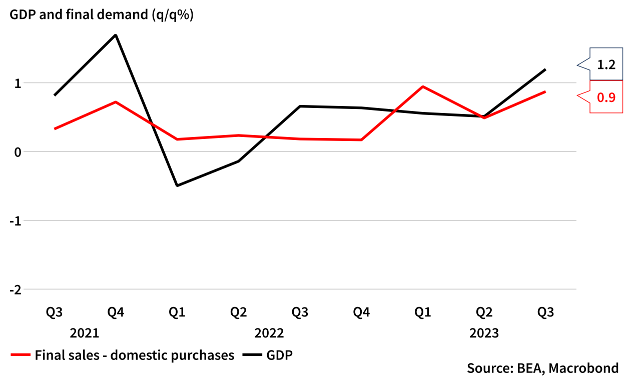
Household consumption grew 1.0% q/q (after a modest 0.2% in Q2). For the September month, consumption was up 0.4% m/m pointing to solid momentum heading into Q4. This occurred despite a fall in real disposable income in Q3 (-0.2% q/q), possibly reflecting the gains in real income and wealth earlier in the year. As a result, the savings rate moved back down and, at 3.4% in September, is very low by historical standards.

Government consumption and investment spending growth was again robust, up 1.0% q/q and 4.5% over the year. This includes growth in Federal government spending of 5.5% y/y; which is considerably higher than Congressional Budget Office financial year estimates of Federal discretionary spending would suggest.

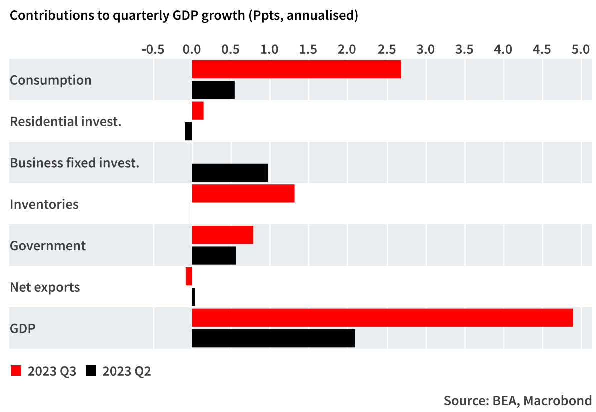
In contrast, there was no growth in business fixed investment, the weakest result in two years. The large boost to investment from tech related investment in manufacturing is clearly moderating – manufacturing structures investment in Q3 grew 4.4% q/q, well down on 31% q/q in Q1 and 17% q/q in Q2. At the same time the drag from mining structures investment intensified (-8% q/q) and the lift to equipment investment in Q2 was short lived, with it falling -1.0%. Equipment investment has fallen in three of the last four quarters.

Residential investment grew for the first time in over two years in Q3, up 1.0% q/q. This was despite a fall in the 'other structures' component (much of which is related to sales activity in the secondary market) so the growth primarily reflects new construction activity.

Strong growth in GDP & domestic demand in Q3



Led by consumption, government, inventories

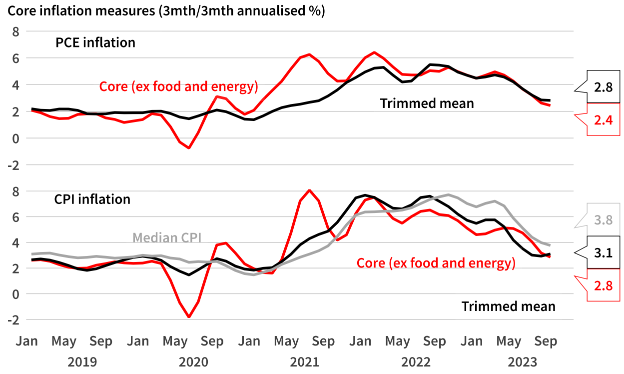


The major surprise relative to expectations was the near neutral contribution to GDP growth of net exports, as partial data had pointed to a large positive contribution, including declines in goods imports. In the event both exports and imports grew by around 1.5% q/q, and the stronger than expected goods import growth is consistent with the strength in domestic demand and stronger inventory accumulation.

On a quarterly basis, core PCE inflation grew by 0.6%, its softest growth rate since 2020. Headline inflation was a bit stronger at 0.7% q/q, reflecting the recent uptick in energy costs.

That said, core PCE inflation in September, at 0.3% m/m was higher than in previous months. Trimmed PCE inflation also picked up. On a 3mth/3mth basis, looking across a range of indicators, the downwards trend in underlying inflation has moderated in recent months. Similarly, while volatile, the PCE core services ex housing measure, a focus of the Fed, has also had some strong prints in recent months. Of less concern was the jump in PCE housing inflation in September (to over 0.5% m/m from 0.4% m/m in August) which will almost certainly resume its downward trend based on leading indicators.

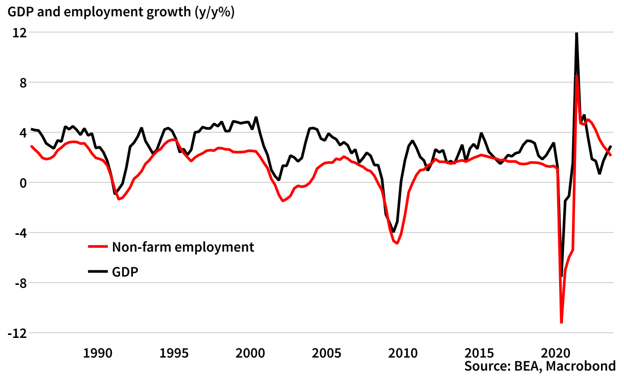
Deceleration in inflation has lost momentum



Labour market

Even with the step up in non-farm employment in September, there has been a trend softening in employment growth as the post-COVID normalisation comes closer to an end. As a result, jobs growth has recently reverted to its typical pattern of growing more slowly than GDP. The recovery in labour supply (through a higher workforce participation rate) has allowed average weekly hours worked to return to its pre-pandemic level, as has the 'quits' rate (voluntary departures from work). However, while job vacancies have declined from their peak, they remain elevated and the unemployment rate is still low, indicating the labour market remains tight.

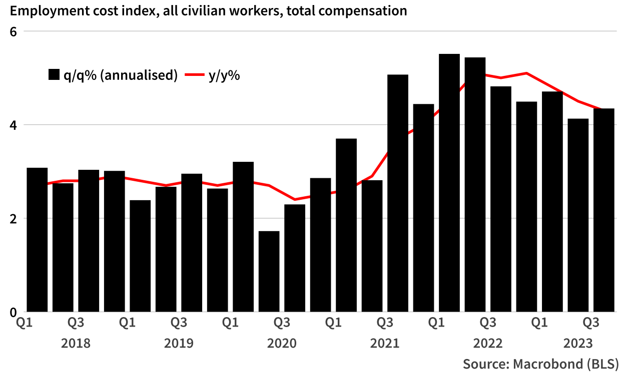
GDP/Employment relationship normalising



From the Fed's point of view, the link from a tight labour market to inflation runs through wages. The Q3 employment cost index (ECI) ticked a little higher on a quarterly basis, but the annual growth rate of 4.3% y/y was the lowest since end 2021 (when wage growth was accelerating). The Fed Chair was sanguine about the tick up in quarterly ECI growth, noting that it validated the shift down that occurred in Q2.

Moreover, the recent strength of GDP growth, relative to employment, mechanically implies stronger productivity and a lower run rate for unit labour costs. While not too much should be taken from movements in these variables over short time periods, at the margin it will provide some reassurance to the Fed regarding upside risks to the inflation outlook.

Wage growth still high but trending down



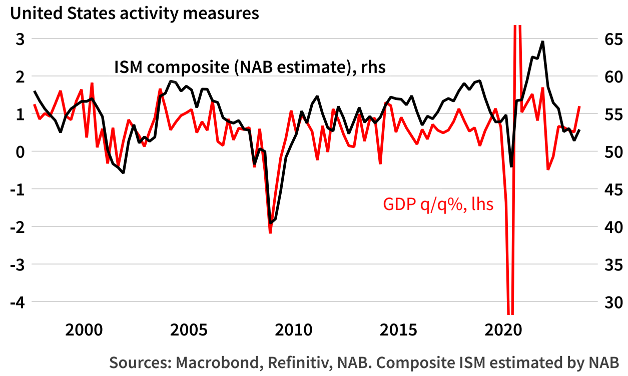
Outlook

We have not fundamentally changed our outlook following the Q3 GDP result. However, because of the strength of consumption growth in September we have revised up our Q4 consumption growth forecast, although this is largely offset by a greater expected detraction from inventories in the quarter. Even with this change, we expect to see consumption grow at a slower pace in Q4, consistent with the pressure on real disposable income in recent months and given the low savings rate.

With the flow through of past monetary tightening likely not complete we continue to expect growth to slow. Moreover, financial conditions have tightened over recent months – with declines in equity prices, increases in business and housing mortgage interest rates and an increase in the dollar. Bank lending standards have likely also continued to tighten.

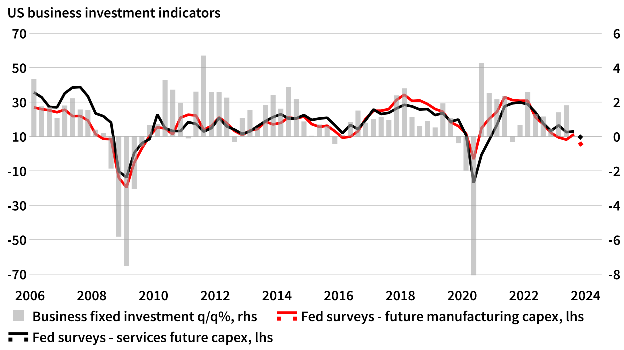
While government demand has been strong, it is unlikely to continue to grow at its recent pace. Moreover, broader measures of fiscal policy point to it turning into a headwind in financial year 2024 (Q4 2023 to Q3 2024).

Surveys not as strong as GDP data



Business surveys continue to suggest that the underlying strength of the economy is not as strong as the GDP data suggest. Moreover, regional Fed surveys of capital expenditure intentions, which have been weak for a while, eased a bit further early in Q4. Relatedly, the boost to investment from Federal government incentives to invest in tech manufacturing is likely to fade even further, although the recent lift in oil prices should at least see mining sector investment stabilise.

Regional Fed surveys point to capex weakness



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

The recent upturn in mortgage rates may also put renewed pressure on housing investment. That said, the recent increase in rates is from an already high level, the number of existing home sales is already low, and the recent upwards trend in building permits suggest new construction activity should increase in coming months. As a result, we don't expect to see a repeat of the large downturn in residential investment that occurred between mid-2021 and early 2023.

Weak external demand and the recent upward move in the dollar may also weigh on net exports. However, we expect that the dollar will depreciate over the forecast horizon and, in the near term, support may come from further normalisation of service sector exports. Travel services exports (tourism, education and business travel) grew strongly in Q3 to be up 22% y/y. Relative to their pre-COVID level travel exports are still down 17% – this suggests that growth in travel exports growth could remain strong for a while yet (in contrast to travel imports which are above their pre-COVID level).

Mainly due to the stronger than expected outcome for Q3, as well as a small upwards revision to Q4 2023 growth, our annual forecasts have been revised slightly higher. We expect growth of 2.4% in 2023 (was 2.3%) and 1.4% in 2024 (was 1.2). The 2025 forecast is unchanged at 1.2%, although in quarterly growth terms we expect growth to recover over 2025 as the impact of an easing in monetary policy comes through.

Risks around this outlook are two-sided in our view. We have been overly pessimistic on US growth prospects this year and it is possible that this remains the case. Continued post-pandemic normalisation, still high corporate profit levels and solid employment growth (which boosts household incomes) may all underpin growth more than we expect. On the downside, the degree of monetary policy tightening that has occurred has historically been followed by a recession; as the full impact of the lift in rates comes through, and as the impact of past fiscal support fades, then the economy may weaken more than expected. A near term risk is that of a government shutdown as current funding arrangements end on 17 November. Beyond the next few quarters, another downside risk is that inflation ultimately settles at a level above the Fed's target, leading to another round of rate increases, further dampening activity. There are also geo-political risks, including the possibility that conflict in the Middle East expands, disrupting energy supplies.

Monetary policy

The Fed remained on hold at its meeting this week. However, Chair Powell indicated the question the Fed is considering is whether they should hike more, not whether they should cut, so there is a tightening bias.

In considering whether any hikes are needed or not, obviously future inflation data will be crucial, although the Fed Chair noted that it won't be a smooth process. He also indicated that if growth persists above potential or if the labour market does not continue to ease, then this could warrant a further tightening of monetary policy. Our forecasts see a clear slowing in growth (to a below potential level) and while we only have a gradual move higher in the unemployment rate, this should translate into a more meaningful easing in other labour indicators, such as job vacancies.

Accordingly, we continue to expect that the federal funds rate has reached its peak. This is conditional on our economic forecasts being broadly realised and so there remains a risk that the Fed moves higher.

Given our economic forecasts, we can still see the Fed cutting rates from mid-2024, as evidence builds that the economy has slowed, the downshift in inflation continues and as the labour market weakens. As policy interest rates are clearly in restrictive territory, and given the lags in monetary policy transmission, we do not expect the Fed to wait till after inflation has reached the 2% mark (but it will want to have a high degree of confidence that is on track to do so before cutting).

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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	2.5	2.3	1.5	1.3	0.9	0.2	1.0	0.5	0.3	0.1	0.2	0.3	0.3	0.4	0.4	0.5
Private fixed investment	1.3	0.3	1.2	1.9	0.8	1.3	0.2	0.3	0.4	0.1	0.1	0.3	0.5	0.7	0.8	0.9
Government spending	-0.9	3.7	1.7	0.8	1.2	0.8	1.1	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Inventories*	0.5	-0.4	-0.1	0.1	-0.6	-0.1	0.3	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.5	0.5	-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	**1.9**	**2.4**	**1.4**	**1.2**	**0.6**	**0.5**	**1.2**	**0.4**	**0.2**	**0.1**	**0.1**	**0.2**	**0.3**	**0.4**	**0.5**	**0.5**
Note: GDP (annualised rate)					*2.2*	*2.1*	*4.9*	*1.4*	*0.8*	*0.4*	*0.5*	*1.0*	*1.3*	*1.6*	*1.8*	*2.0*
US Other Key Indicators																
PCE deflator-headline																
Headline	5.9	3.2	2.2	2.0	1.0	0.6	0.7	0.8	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**	**0.7**	**0.6**	**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	3.9	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

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