US Economic Update 7 December 2023

Growth, inflation & labour mkt all easing

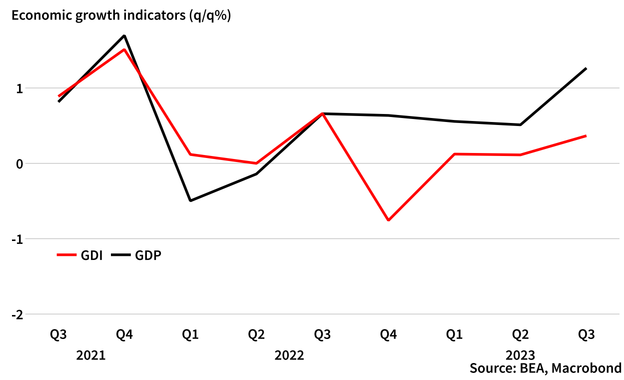
- **Q3 GDP revision sees our 2023 forecast revised up to 2.5% (from 2.4%). However, early Q4 data are consistent with our view that growth will slow in the quarter and our forecasts for GDP growth in 2024 (1.4%) and 2025 (1.2%) are unchanged.**
- **The Fed is set to stay on hold at its meeting next week. With growth set to slow, inflation and labour market pressures easing, the most likely next move by the Fed will be a cut in rates (which we expect to be in mid-2024).**

Q3 Revisions

The second estimate of Q3 GDP saw growth revised up to 5.2% q/q from 4.9% q/q (annualised rate) as a small downward revision to consumption growth was more than offset by upward revisions to business investment. Estimates for Q3 corporate profits were also released, and they are estimated to have increased 3.3% q/q before tax in Q3 but over the year have fallen slightly (-0.7% y/y).

As has been the case recently, there was a substantial gap between real GDI and GDP growth, even though (conceptually) the two measures should equal each other. Reported GDP growth looks high relative to business survey readings, but strong employment growth aligns better with the GDP data, so the truth is likely somewhere between the two measures.

GDP and GDI growth disconnect continues

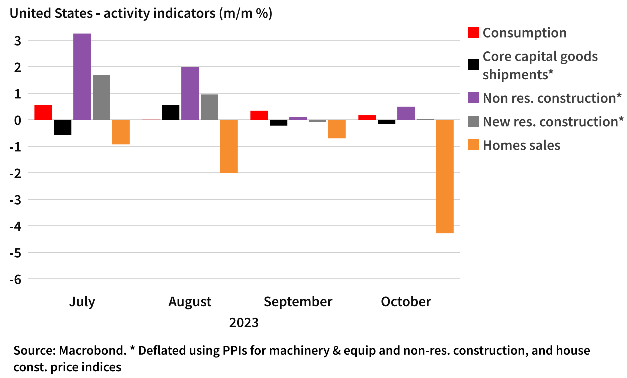


Early data suggest a Q4 slowdown

Our forecasts allow for GDP growth to slow materially in Q4. While still very early days in terms of reported data, initial indicators are consistent with this view.

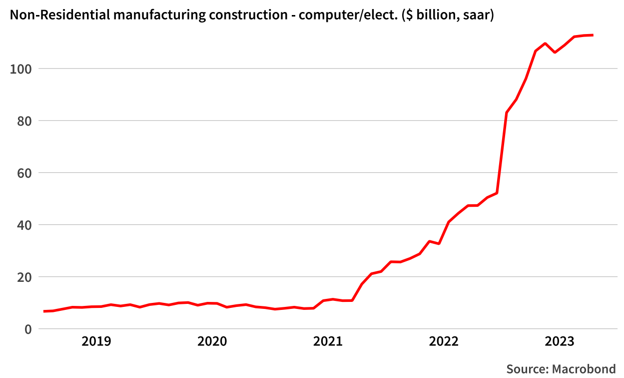
While consumption growth in October – at 0.2% m/m – is still decent, this is a lower monthly growth rate than was seen in Q3, although its possible the boost to household budgets from recent falls in oil prices will provide a short-term boost.

Monthly data have softened into Q4



At the same time core capital goods shipments remain soft, and growth in non-residential construction has clearly weakened. The latter was boosted by a rapid run up in tech related manufacturing structures investment (due to Federal government incentives) – while the level of such investment remains high, growth has slowed appreciably.

Tech related investment – close to peak?



Recent residential investment indicators – which can be volatile have been weak. Sales (total of existing and new home sales) again fell in October, and at a faster pace. New construction expenditure has been growing since May, but the increase in nominal terms in October was the weakest over this period (0.8% m/m) and, after adjusting for prices, was close to flat. On the trade front, in October there was a small fall in real goods exports while imports recorded a small rise, pointing to the risk of a negative contribution to GDP growth (although, for now, we retain our assumption of a minimal net trade impact as the monthly data can be volatile).

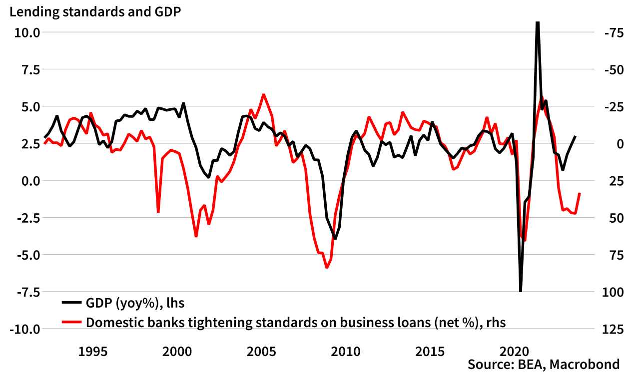
Outlook

As such, we have left unchanged our forecast Q4 GDP growth (1.4% q/q, annualised). However, our forecast for 2023 is slightly higher, at 2.5% (was 2.4%), reflecting the upwards revision to Q3 by the statistician.

We still expect that growth will weaken further into 2024. This reflects the continuing impact of the over 500bps of tightening in monetary policy by the Fed between early 2022 and mid-2023. Year-average growth is expected to decline to 1.4% in 2024 and again to 1.2% in 2025, although the trough in quarterly growth is expected to be in mid-2024.

While there has been an easing in financial conditions since mid-October, the ongoing impact of the policy tightening is still evident in other channels. The Fed's Q3 Senior Loan Officer Opinion Survey indicates that banks further tightened lending standards, albeit to a slightly lesser degree than in previous quarters.

Policy tightening still working its way through – continued tightening in lending standards



Historically, a tightening in lending standards of the magnitude seen has been associated with a downturn in the economy (with a lag). However, this cycle has so far been notable for the resilience of GDP growth. This likely reflects strong tailwinds from the normalisation in activity (including in labour supply) from the pandemic, the large run up in wealth which supported consumption, and, more recently, fiscal support in FY 2023.

However, fiscal policy (at least at the Federal level) is expected to tighten in FY 2024, the surge in wealth ended in early 2022 (and wealth has since declined relative to income) so a further rundown in the savings rate is unlikely, and other pandemic tailwinds will fade. At the same time, external demand is being constrained by weak global growth, although the recovery in tourism may still have a bit further to go.

Labour market

Non-farm employment grew by 150k in October, a still solid increase, particularly given the impact of labour strikes (such as the autoworkers strike which saw motor vehicle and parts manufacturing employment fall by 33k).

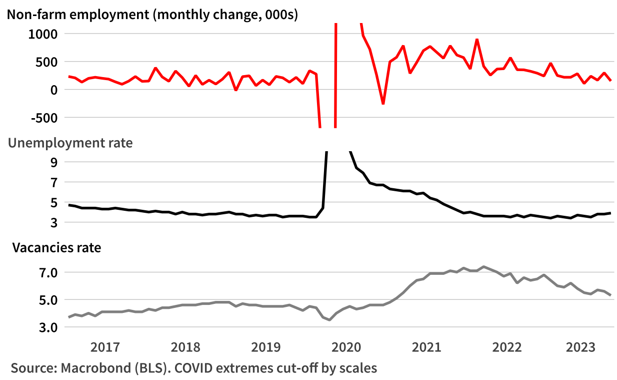
Looking through the monthly volatility, the underlying trend appears to be a slow deceleration in employment growth.

With workforce participation recovering over the last year (and a pickup in population growth), the unemployment rate has gradually risen from its low of 3.4% in January to reach 3.9% in October 2023.

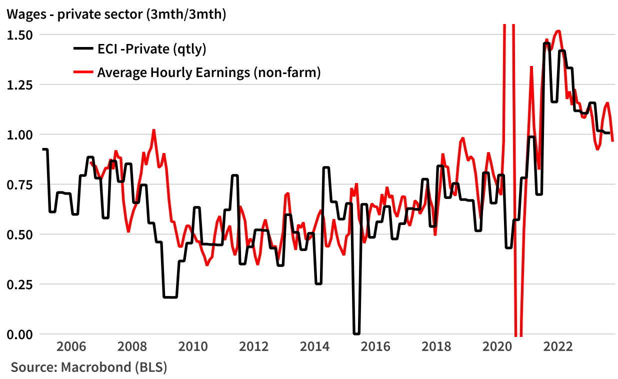
This message of a labour market which is still tight, but gradually loosening, was reinforced by this week's labour flows ('JOLTs' data for October). In particular, job openings declined – but remain high. Layoffs too remain lower than their pre-pandemic level, despite slowly climbing since mid-2022, while the quits and hires rates are around their pre-pandemic level.

In October, private sector average hourly earnings grew by 0.2% m/m – the lowest monthly growth rate since February 2022. These data can be volatile, but as with the quarterly employment cost index, they are consistent with a gradual slowdown in wage growth.

Labour mkt still tight, but slowly loosening



Similarly wages growth gradually easing

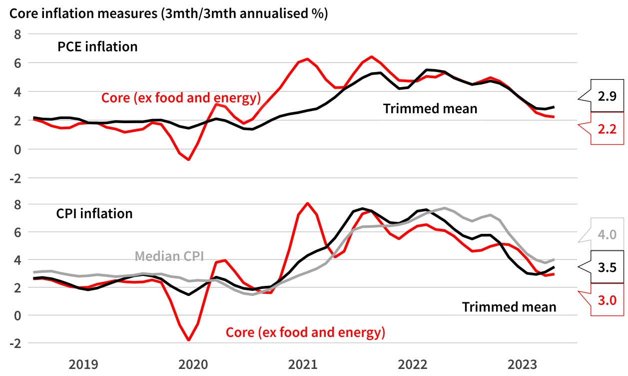


Inflation

In the same vein, October consumer price data indicated that inflation continues to decline.

Headline inflation – both for the CPI and PCE measures – was flat on a m/m basis while the annual inflation rate declined to 3.2% y/y for the CPI (down from 3.7% in September) and for the PCE price index to 3.0% (from 3.6%, and the lowest it has been since March 2021). Core inflation (ex. food and energy) for the month was only moderate – at 0.2% m/m (for both CPI and PCE).

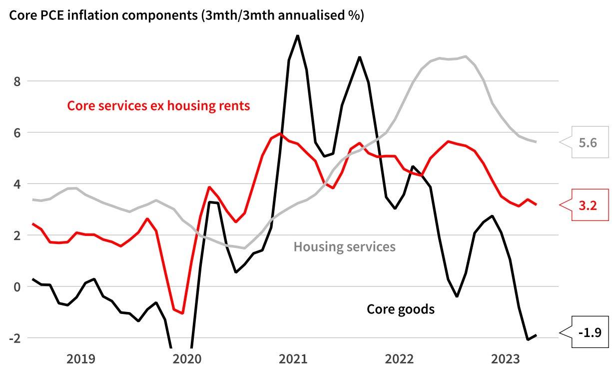
Inflation continuing to trend down



While monthly data can be volatile, core PCE inflation on a 3mth/3mth annualised basis was 2.2% – close to the Fed's 2% inflation target. While measures of underlying inflation are running at a higher level, they too have moved down.

By category, the most recent shift down in core PCE inflation was driven by falls in core goods prices. Housing services inflation also moderated – while it remains elevated, measures of price growth for new leases (rentals) point to this continuing to fall. The Fed has been keeping a close focus on core services ex. housing rents – as these are seen as the prices most influenced by a tight labour market. For this indicator, 3mth/3mth inflation has been tracking sideways for several months, although the October m/m reading was low (0.15% m/m).

Recent downshift due to goods inflation



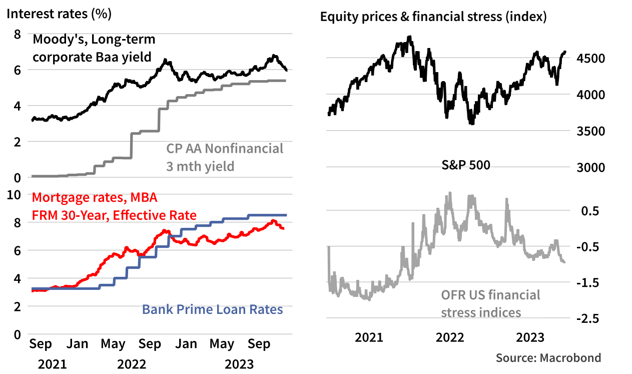
Monetary policy

It was only two months ago that a tightening of financial conditions was seen as staying the Fed's hand on further fed funds rate increases. Since then, yields have declined, equities have recovered and indicators of market stress have fallen but market expectations of the future level of the fed funds rate have shifted down, as the focus turns to when the Fed might cut.

This reflects the progress on lowering inflation, labour market easing, and early indications that growth is slowing in Q4. Against this backdrop, and with policy considered to be at a clearly restrictive level, there is no pressure on the Fed to move rates any higher, even as it publicly retains the option to do so.

Indeed, Fed speakers have also pointed out that, as inflation declines, real interest rates are increasing – meaning that rate cuts would be needed to maintain existing policy settings.

Financial conditions have eased since mid-Oct.



That said, there have been a mix of views expressed by some recent speakers, with some expecting another rate rise will be needed (Bowman) or arguing the need to keep the option or raising rates open (e.g. Barkin), while Waller recently countenanced rate cuts in 3-5 months' time if inflation continues to decline.

Fed Chair Powell, early this month, steered a middle path, noting that "…the risks of under- and over-tightening are becoming more balanced" but that "It would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease. We are prepared to tighten policy further if it becomes appropriate to do so."

As our forecasts see inflation easing further next year, and the unemployment rate continuing to gradually rise, we remain comfortable with our view that the Fed will not increase rates again in this cycle.

As such, we expect the next move will be to reduce rates – which we are pencilling in for June 2024. As policy interest rates 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.

That is not to say there is no risk they raise rates again given uncertainties around the economic outlook. In particular, any sustained stalling (or reversal) of the gains on inflation could see them move again or delay the start of rate cuts. Updated Fed member projections will be released following next week's FOMC meeting. Along with the meeting statement and the Chair's press conference, these will provide an updated guide on the Fed's thinking.

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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	2.2	1.5	1.3	0.9	0.2	0.9	0.56	0.3	0.1	0.2	0.3	0.3	0.4	0.4	0.5
Private fixed investment	1.3	0.5	1.4	1.9	0.8	1.3	0.6	0.3	0.4	0.1	0.1	0.3	0.5	0.7	0.8	0.9
Government spending	-0.9	3.9	1.8	0.8	1.2	0.8	1.3	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**	**2.5**	**1.4**	**1.2**	**0.6**	**0.5**	**1.3**	**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*	*5.2*	*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	3.0	2.0	2.0	1.03	0.6	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Core	**5.1**	**3.4**	**2.2**	**2.0**	**1.22**	**0.9**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.6**	**3.9**	**4.3**	**4.5**	**3.5**	**3.5**	**3.7**	**3.9**	**4.0**	**4.1**	**4.2**	**4.3**	**4.4**	**4.5**	**4.5**	**4.5**
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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