US Economic Update 2 February 2024

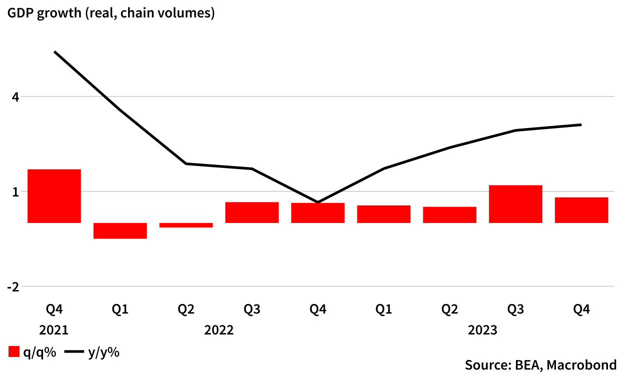
Good news on growth and inflation - rate cut expectations brought forward

- **2023 Q4 GDP was stronger than expected, and signs are also positive for early 2024 consumption. As a result, we have revised up our GDP growth forecast for 2024 to 2.1% (from 1.6%) although we still see growth slowing in 2024.**
- **Quarterly core PCE inflation has been in line with the Fed's 2% inflation target in the last two quarters, although other measures of underlying inflation are tracking higher.**
- **We now expect that the Fed will start cutting rates slightly earlier (May, previously June). We expect the Fed funds target range to be 4.00-4.25% by end 2024 (previously 4.25-4.50%) and 2.50-2.75% by end 2025 (unchanged).**

Q4 – GDP growth slowed but still solid

US GDP grew by 0.8% q/q, or 3.3% annualised, in Q4, above our expectation of 2.1% annualised as well as market expectations. This capped off what has been a surprisingly strong 2023 –GDP grew 3.1% between Q4 2022 and Q4 2023.

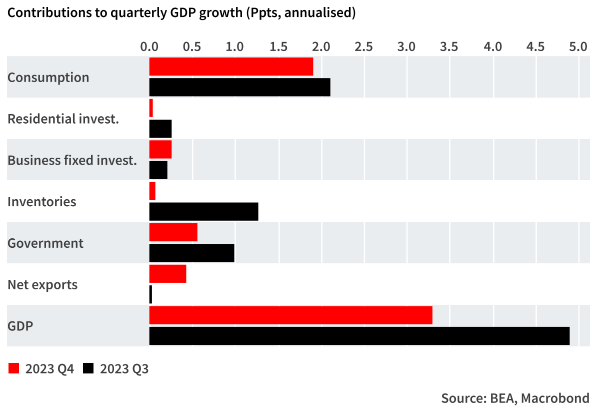
GDP growth ends 2023 on a solid note



Q4 growth was broad based. Household consumption was robust (at 0.7% q/q), as was government consumption and investment (0.8%). Investment grew, even if only modestly, up 0.5% q/q for business fixed investment and 0.3% q/q for residential investment. As a result, domestic final demand, at 0.7% q/q, was also solid. Inventory accumulation was also slightly higher than the previous quarter (defying expectations of a slowdown) and net exports added to growth.

Consumption growth in Q4 was underpinned by gains in real disposable income, although there was also a small decline in the savings rate. The savings rate shifted down to around 4% in H2 from around 5% in H1 as real income growth moderated while consumption strengthened.

Broad based contributions to growth



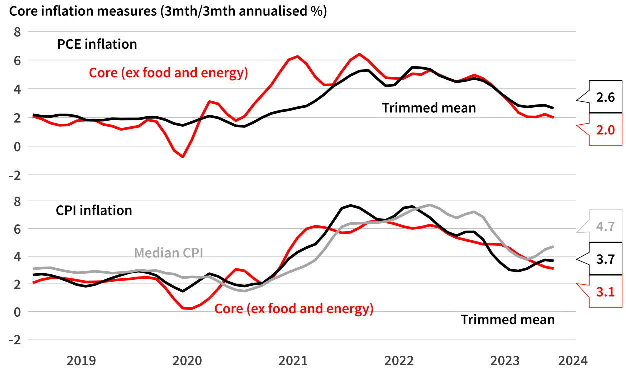
On the business investment side, equipment investment remained weak, up just 0.2% q/q (and down over the year). Intellectual property investment was stronger at 0.5% q/q (as in Q3) but this is a weak result for this category. Non-residential structure investment continued to outperform, but growth of 0.8% q/q was the lowest in over a year. This reflects a slowdown in manufacturing structures investment growth – it grew by over 60% y/y, reflecting the response to government incentives (such as in the CHIPs Act), but by Q4 growth was 4% q/q.

The continued strength in government consumption and investment (0.8% q/q) was evident both at the Federal (0.6%) and state/local level (0.9% q/q). Both sectors were up over 4% over the year, a high rate by past standards.

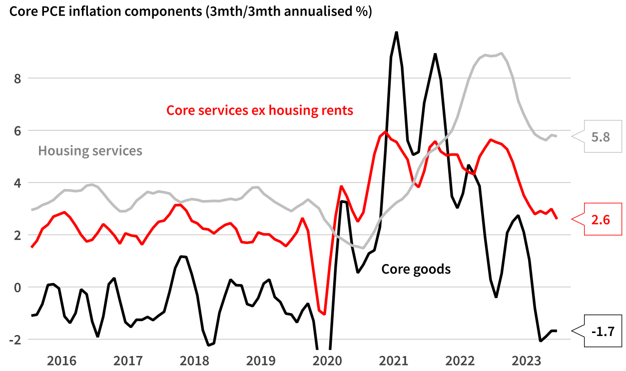
Exports of goods and services grew by 1.5% q/q to be up 2.1% over the year while import growth was more modest at 0.5% q/q (and compared to a year ago it was down 0.2%). Given the relative strength of US growth, the net export contribution to GDP growth of 0.3ppts over 2023 may appear somewhat surprising. In part, it likely reflects a modest easing in the dollar from its 2022 peak and a slower pace of domestic inventory growth weighing on goods imports.

On the inflation front, core PCE inflation was, as expected, 0.5% q/q – basically in line with the Fed's annual 2% target for the second quarter in a row, although the annual rate in December of 2.9% y/y remains elevated. Alternative inflation measures – such as trimmed mean PCE inflation or CPI based – are still on the high side even on a q/q basis.

Core PCE inflation around the inflation target…other measures still on the high side



Core services PCE inflation has eased



Looking at the major core PCE components, the Fed will welcome the downshift that has occurred in core services ex housing. While on a 3mth/3mth annualised basis it is tracking a bit above 2.5%, historically it runs stronger than goods inflation. Taking this into account, this measure is tracking at a level broadly consistent with the Fed's inflation target. Housing rent growth remains elevated, although leading indicators (based on new leases) suggest this should decline over time. Goods prices continue to deflate, and while this may have further to go – particularly for sectors such as autos – it would not be surprising to see a slower pace of deflation, particularly given the large recent increase in international freight rates and if the dollar depreciates from here, as we expect.

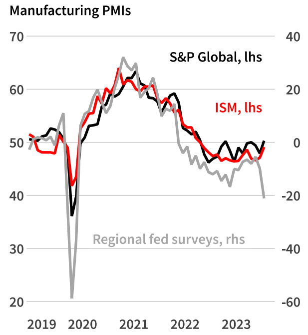
Outlook – 2024 and beyond

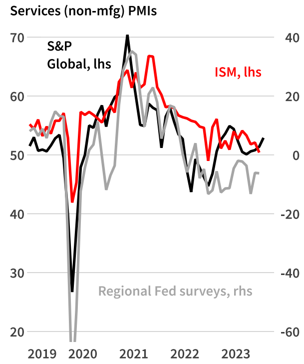
We expect that growth will slow through to mid-2024, although we have raised our expectation for growth over the year.

The upward revisions reflect, in part, the strength in consumption over November and December, which sets up a strong result for Q1. With consumer confidence moving up recently and wealth continuing to rise, a sudden reversal is unlikely, although a still low savings rate and rising delinquency rates on consumer loans suggest recent growth rates won't be sustained. That said business investment indicators remain soft

Business surveys provide a guide on the underlying trends in the economy (although they are not reliable indicators of GDP growth on a quarter-to-quarter basis). While the preliminary S&P Global PMIs showed some further improvement in January, available regional Fed survey data are more downbeat. Overall survey readings remain at a relatively modest level.

Business survey still soft overall





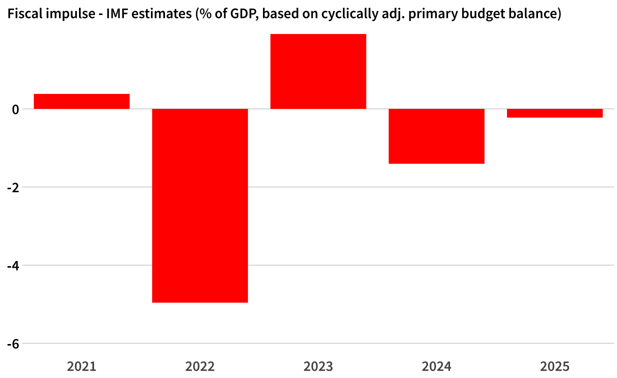
Sources: Macrobond. Regional Feds - Philadelphia, Richmond, Dallas, Kansas City & New York

Our expectation of slowing growth is based on the view that interest rates are still clearly restrictive, and that there will be less support from fiscal policy and other factors that supported growth in 2023. These include the extended recovery from COVID-19 disruptions (including in the labour market) and the impact of government subsidies for tech manufacturing. However, population growth appears set to remain elevated in 2024.

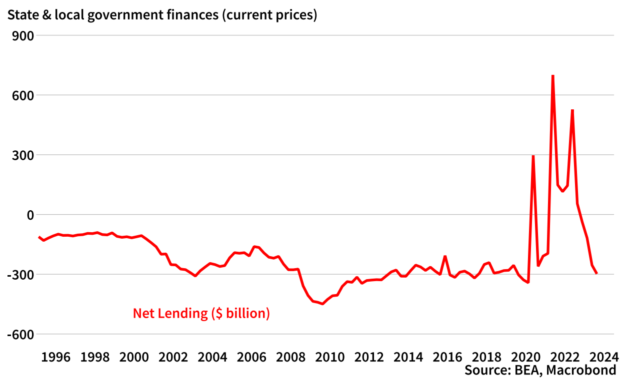
We (and others) expect the Fed to start cutting rates by mid-year – and this has already led to a pullback in market interest rates and improvement in other indicators of financial conditions. The impact of this will flow through to some sectors more quickly than others – for example, the fall in mortgage rates since late October should support residential investment, but the lags in monetary policy apply to both cuts as well as hikes and we see a greater overall impact on GDP growth in 2025 than in 2024.

Fiscal policy supported growth through much of 2023. However, estimates of the Federal government fiscal impulse by the IMF suggest that it will be a drag on growth in 2024. As already noted, state & local (S&L) spending on consumption and investment was also robust over 2023. This was also reflected in employment growth of 3.0% y/y, double that of the private sector. However, the big boost to S&L government finances following COVID-19 has now passed and spending is likely to ease from current growth rates, although when, and how rapidly, is uncertain.

Fed. fiscal policy impulse negative in 2024

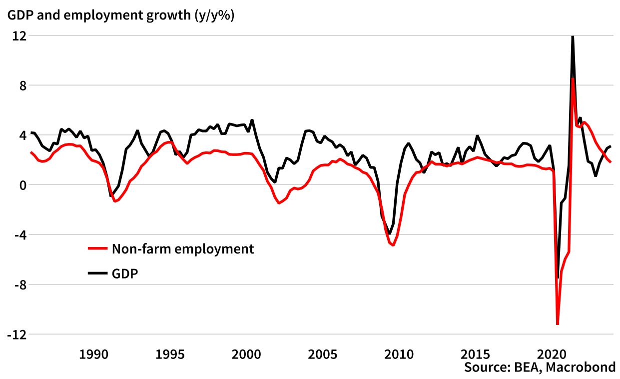


Reduced state & local govt fiscal capacity



On the labour market side, the impetus to employment from the post-COVID-19 readjustment – driven by elevated vacancy rates and enabled by a recovery in labour force participation and stronger population growth – is fading. After tracking well above GDP growth for an extended time, the more normal differential between GDP and employment growth has come back into view (with the gap between the two reflecting productivity growth). Job vacancies still remain above pre-COVID levels, but they have fallen, while hires and quits are at or below their pre-COVID-19 levels as are layoffs. Moreover, there are tentative signs that the recovery in labour force participation is nearing its peak.

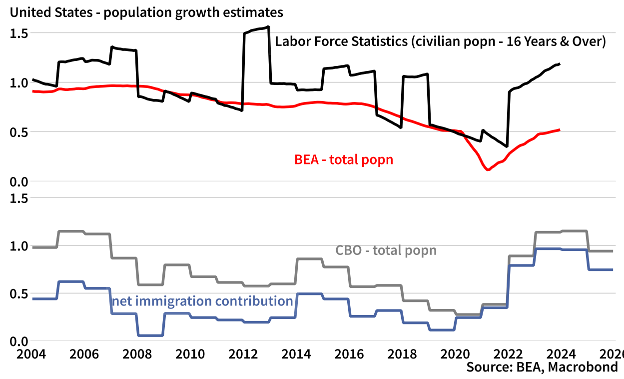
Employment growth slowing



Employment growth (on a quarterly basis) has been trending down since Q3 2021. The easing in labour market pressures, as well as the fall in inflation, is also leading to a slower pace of wage growth. The Employment Cost Index in Q4 grew by 0.9%, the first time since mid-2021 it has been below the 1% mark and other wage indicators have eased. Compensation of employees represents 60% of household income and these trends point to a slowdown in real income growth if our inflation forecasts – which see inflation stabilising around its recent pace – are realised.

As already touched upon, one factor that likely helped sustain growth in recent years – and is likely to continue into 2024 – is strong population growth. High frequency population data for the US is currently providing mixed signals but it appears there has been a notable increase in population growth.

Population growth helps explain resilience



The population estimates in the BEA's personal income report suggest that growth is back around pre-COVID levels at around 0.5% y/y. In contrast, the BLS' monthly labour market report suggests that growth in the aged 16 and older population is over 1%, although the annual correction to this series (due in the February employment report) could materially change this.

A report released this month by Congressional Budget Office also indicates that there has a been a material lift in population growth driven by net immigration. Border security and enforcement of immigration laws will likely be an issue in the Federal Election later this year but, unless there is a change to current policies before this time, net immigration is likely to remain high this year. This would support both demand in the economy and, as already noted, labour supply.

Overall, we expect GDP year-average growth of 2.5% in 2024, revised up from 2.1%. This in part reflects the stronger than expected Q4 result but we have also raised our quarterly growth profile for 2024, particularly in H1. We now expect year-ended growth (Q4/Q4) of 1.1% (up from 0.7%). Year-ended growth should pick up over 2025 as the impact of rate cuts come through, although in year average terms growth will decline to 1.4% (previously 1.2%).

Growth at this pace would still see a rise in the unemployment rate – which we now see peaking at around 4.3% in early 2025. On the inflation rate, we expect core PCE inflation on a q/q annualised basis to remain around 2.0% or a bit higher (partly due to expected dollar depreciation over the forecast period) with risks around this broadly even.

Monetary policy

The Fed kept rates on hold this week but the meeting statement removed the previous hiking bias. The December statement reference to “the extent of any additional policy firming” was removed and the January statement indicates what will be needed for a rate cut – “The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent.”

In his press conference, Fed Chair Powell indicated that the for the Fed to have “greater confidence” just requires a continuation of the improved inflation data seen over the last six months rather than further falls. However, he pushed back against the likelihood that they will have achieved this by the next meeting – “I don’t think it’s likely that we’ll reach a level of confidence by the time of the March meeting…that’s to be seen…probably not the most likely case or what we would call the base case”.

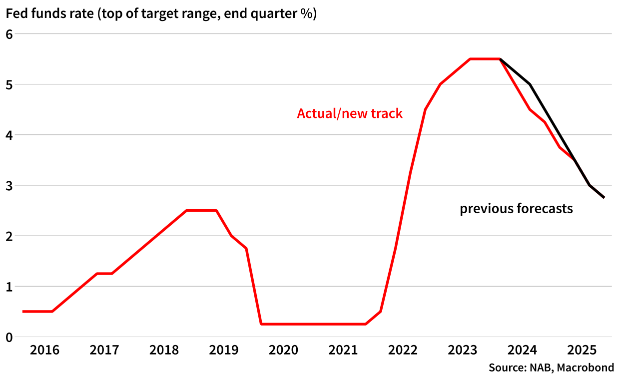
This does not rule out a rate cut in March, but suggests a high bar. It would probably require some unexpectedly low prints for a range of inflation and activity indicators.

We had been expecting the Fed to make its first move in June but, with core PCE inflation over the last six months tracking in line with the Fed’s target, and further evidence of wage growth slowing, we think May is now the more likely date. While growth has been stronger than expected, this is only a problem if it is causing high inflation outcomes. While growth expectations factor into the Fed’s forecasts for inflation and its risk assessments, as we see growth slowing to a below trend level in 2024, we don’t think this factor will prevent rates normalising but it will support the case.

We also think the initial pace of rate hikes will be faster than we had previously projected. We are now pencilling rate cuts in each meeting between May and November, before slowing the pace down as they start to evaluate the impact on the economy and how close they are to ‘neutral’.

As Powell indicated, the Fed sees policy as clearly being restrictive. He also noted that the decision to start easing policy is a “highly consequential” one. Therefore, barring an unexpected turn in the data (e.g. notably higher inflation readings), once they start to reduce rates it will be part of a decision that the time is right to reduce how restrictive policy settings are. Given where inflation is (and is expected to be) tracking, and that a single 25bps cut won’t have a large impact, pausing very early on in the process won’t make a lot of sense.

Revised fed funds rate track



Powell also indicated that in the January meeting there was a discussion about the run-off of the Fed’s balance sheet which is occurring as existing bond and mortgage-backed security holdings mature (subject to a limit) or ‘QT’. He indicated that they will have a more in-depth discussion at the March meeting, suggesting that the Fed will make an announcement in March or May which would likely see at least a slowdown in the pace of QT (and a timeline around its ultimate end).

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U.S. economic forecasts

					Quarterly Chng %									
					2023		2024				2025			
	2022	2023	2024	2025	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	2.5	2.2	2.1	1.4	0.8	0.70	0.7	0.3	0.2	0.3	0.4	0.4	0.5	0.5
Private fixed investment	1.3	0.5	2.0	2.1	0.6	0.4	0.7	0.2	0.2	0.3	0.5	0.7	0.8	0.9
Government spending	-0.9	4.0	2.3	0.8	1.4	0.8	0.5	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Inventories*	0.5	-0.4	-0.1	0.0	0.3	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.5	0.6	0.0	-0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**1.9**	**2.5**	**2.1**	**1.4**	**1.2**	**0.8**	**0.5**	**0.2**	**0.1**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Note: GDP (annualised rate)					*4.9*	*3.3*	*1.9*	*0.8*	*0.6*	*1.1*	*1.4*	*1.7*	*1.9*	*2.1*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.9	2.7	2.0	2.0	0.6	0.4	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.5
Core	**5.1**	**3.2**	**2.1**	**2.0**	**0.5**	**0.5**	**0.6**	**0.6**	**0.5**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.6**	**3.8**	**4.2**	**4.3**	**3.7**	**3.8**	**3.8**	**3.9**	**4.0**	**4.2**	**4.3**	**4.3**	**4.3**	**4.3**
US Key Interest Rates														
Fed funds rate (top of target range)	**4.50**	**5.50**	**4.25**	**2.75**	**5.50**	**5.50**	**5.50**	**5.00**	**4.50**	**4.25**	**3.75**	**3.50**	**3.00**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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