US Economic Update 7 March 2024

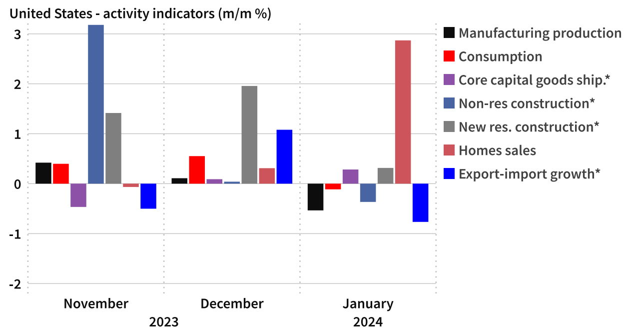
Inflation – two steps forward, one step back

- **January activity data were generally on the soft side, consistent with our view that GDP growth would slow in the quarter. We still expect growth of around 2.0% q/q (annualised) in Q1.**
- **January inflation data – across a range of indicators – were much stronger than expected. January employment data were also stronger than expected.**
- **While we expect inflation is still trending back towards the Fed's target, we have pushed back our expected timing for the first rate cut to June (from May). We now expect the Fed funds target range to be 4.25-4.50% by end 2024 (previously 4.00-4.25%) and to decline further in 2025.**

January data soft, but not alarmingly

Partial indicators of economic activity were generally on the soft side in January. Household consumption declined slightly, by 0.1% m/m, and there were falls in manufacturing production as well as non-residential construction and exports. Imports increased in January, a negative signal for the net trade contribution to GDP. On a more positive note, core capital goods shipments rose and residential investment looks set for a stronger quarter, with new housing sales up strongly in January and residential construction continuing to rise.

January data generally weak

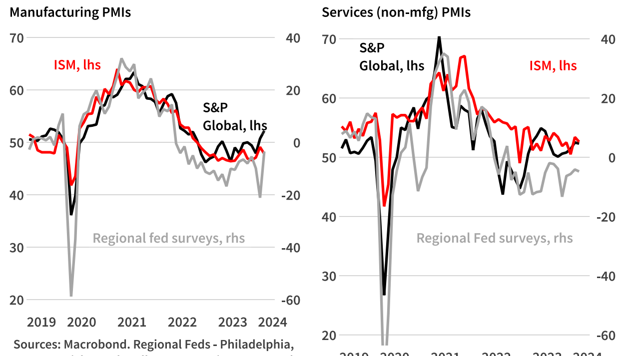


Source: Macrobond. * Deflated using PPIs for machinery & equip and non-res. construction, house const., and export/import price indices

Even with the small fall in January, consumption is still tracking 0.4% above its Q4 level and some rebound over the rest of the quarter is likely given continued growth in household incomes. While machinery and equipment investment is looking weak, non-residential structures investment is still seeing a lift from tech manufacturing, even if this is fading. Similarly, while we expect government consumption and investment growth to moderate from its recent strong prints, we expect this will play out over a few quarters.

Business surveys remain consistent with only modest GDP growth but, if anything, they have shown some improvement over recent months. Another reason for not reading too much into the January activity data is that it may have been affected (temporarily) by severe weather.

Surveys only consistent with modest growth



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

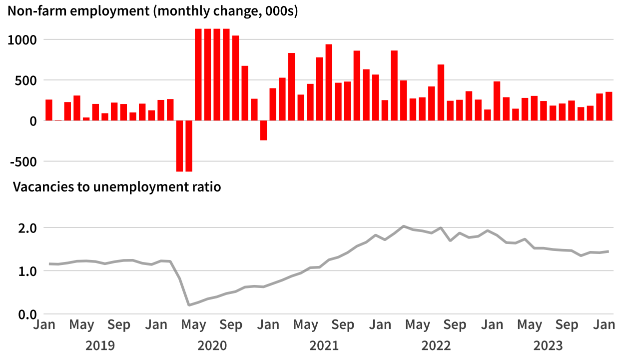
Overall, the incoming data support our view that growth is easing after a strong H2 2023 and we still expect annualised growth of around 2.0% in Q1. For the rest of 2024, we retain our expectation that growth will slow, before recovering over 2025. This reflects interest rate settings which are still at a clearly restrictive level (but expected to ease later this year), less support from fiscal policy, and a fading of the impetus to tech manufacturing investment from government incentives.

Labour market

While our forecasts have an expectation of the labour market easing further in 2024, the data for January and February challenge that view. As strong employment growth is a direct support to household income, this suggests there is some near-term upside risk to our consumption forecasts.

Non-farm employment grew by 353,000 in January with December only a bit softer at around 330,000 after it was revised up by more than 100,000. This compares to monthly average job gains of around 200,000 in the prior six months. The upturn may be indicative of the strength in GDP growth (which peaked in Q3) which tends to impact employment with a lag. That said, the unemployment rate was unchanged in the last two months (at 3.7%), and the data are noisy (even over a two-month period), meaning that it is too early to say there has been a clear change in trend.

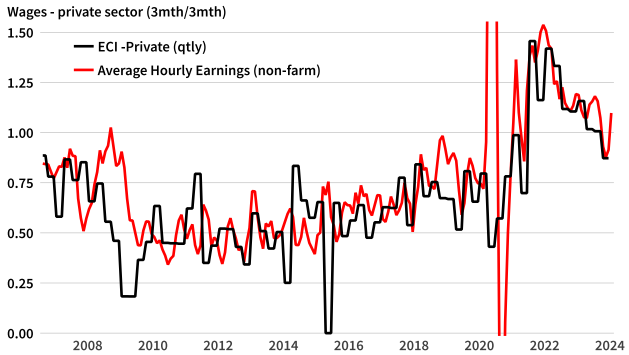
Recent upturn in job growth



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

Some labour market indicators have largely normalised (i.e. back to pre-COVID levels), including the quits rate and the hiring rate), while vacancies have come off substantially, even if they remain elevated. However, wage growth, as measured in the monthly employment report for private non-farm employees, has also ticked up in recent months. It grew by 0.6% m/m in January – the fastest monthly reading since early 2022. The monthly wage data are volatile and the broader downwards trend in growth still appears to be intact.

Wage growth trending down, even with recent strength in monthly indicator



Source: Macrobond (BLS)

Moreover, the Fed places more weight on growth in the quarterly Employment Cost Index, which is clearly easing. The realised fall in inflation to-date will likely place further downwards pressure on wage growth (as wages tend to lag inflation) as will the normalisation in a range of labour market indicators as noted above. The risk is that the upturn in employment growth over the last two months is not just noise as, if sustained, it would imply a tightening in labour market conditions, creating upside risk to the wage outlook.

Inflation – January shock

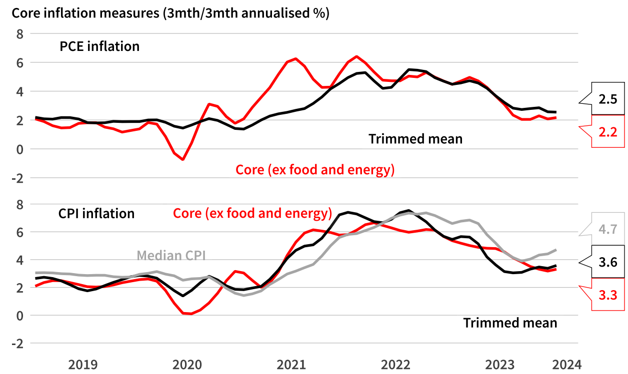
There were major upside surprises in the January inflation data. In particular, core (ex. Energy and food) CPI and PCE inflation both rose 0.4% m/m. Headline inflation growth was a bit lower, at 0.3% m/m, reflecting a fall in energy prices.

Despite the surprise, annual inflation rates generally declined, except core CPI which remained at 3.9% y/y. For PCE inflation – which is what the Fed targets – annual inflation declined to 2.4% on a headline basis, and 2.8% on a core basis.

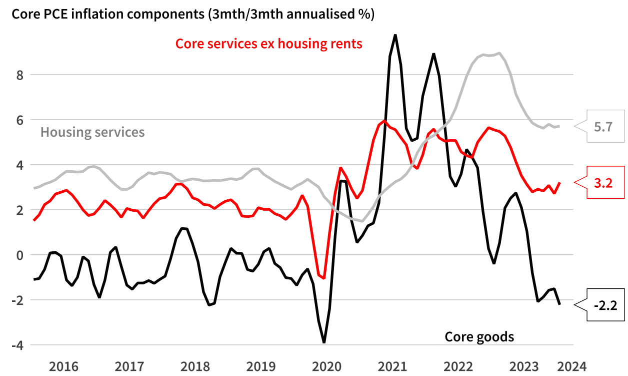
As with most data, there is a degree of volatility month-to-month. Indeed, core PCE inflation prints for November and December (at 0.1% m/m) were on the low side. As a result, on a 3mth/3mth basis core PCE was only up a little, running at an annualised 2.2%, within the range it has been since August.

Other measures of underlying inflation (median CPI, trimmed mean CPI and PCE) also picked up notably in the month. Monthly data for producer and import prices also showed a lift in price pressures.

Underlying inflation…progress has stalled



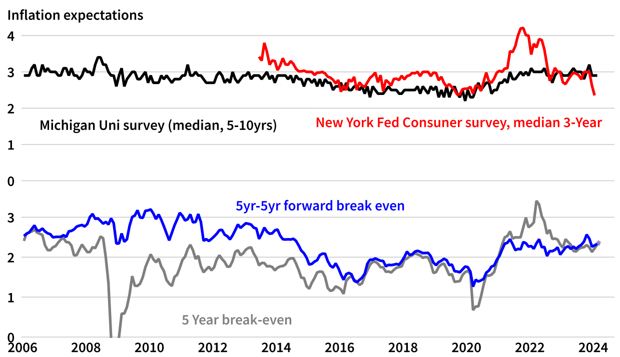
Service inflation remains the issue



Breaking down the core PCE by its main components, goods inflation remains low (flat in m/m terms but down on a 3mthly basis) but housing inflation was at its highest level in four months. There was also a jump in services excluding housing (to 0.6% m/m) – its highest level since March 2022.

The jump in housing mainly related to a spike in the imputed owner-occupied rent category, while growth in tenant rents slowed. While differences in growth rates between the two rent categories can persist over time, directionally (i.e. growth accelerating or decelerating) they normally move together. With growth in rents for new leases – as indicated by Zillow – back to around its pre-COVID level, we remain confident that housing inflation will slow further.

Inflation expectations well anchored



Source: Macrobond

While we think that the high core January inflation outcomes are partly noise, including possibly some payback from soft prints in prior months, our forecasts do not assume that it will fully unwind in coming months. This means our core PCE inflation forecast is a bit higher for 2024, although we still expect annual inflation to more towards the 2% mark. Well anchored inflation expectations, a slowing in economic growth and further easing in the labour market, particularly given wage growth is already trending down, should help restrain inflation. Outside the core index, food and energy price trends are currently benign.

Last month we made an allowance for the impact of large increase in global freight rates in January – reflecting Red Sea shipping disruptions – on goods inflation. Freight rates fell back a little over February, although what happens from here remains highly uncertain.

Monetary policy

At his January post-FOMC meeting press conference, Chair Powell indicated that rate cuts just required a continuation of the improved inflation data seen over the previous six months rather than further falls. He did not indicate for how long they would need to see this, but did push back on the prospect of a March rate cut.

These comments were made before the January inflation and employment data were released. Clearly, there is now no prospect of any change at the March meeting.

The January data also cast considerable doubt on our call last month that the first rate cut would be in May. There will be two more inflation readings before the May meeting – the same number between the January and March meetings when Powell discounted the prospect of a move in March.

At the very least, a May cut would require some clearly low side readings in the next two months. This is possible, with three of the last seven core PCE monthly inflation readings annualising well below the Fed's 2% target (including two near 1%). However, the risk is not one sided – if inflation readings disappoint again in the next 1-2 months, then the timing of cuts could be pushed to much later in the year.

While our preference is generally to take stock of several months of data before changing rate views, the inflation surprise in January was substantial and broad based across indicators. Accordingly, we have pushed back our expectation of the first rate cut to June (back to where we were before our change last month).

The pace at which the Fed moves after the first cut is just as important as the timing of the first cut (if not more so) and there is also uncertainty around this.

Assuming that economic indicators evolve as expected, we expect when they start easing policy the Fed will cut rates at several meetings in a row before any pause to assess the impact.

The basis for this view is that the first rate cut will be part of a decision that the time is right to reduce how restrictive policy settings are (noting that the median Fed member sees neutral as being 2.5%, so they are well into restrictive territory). As this will only start when they have a high degree of confidence that inflation will remain close to target, this should make them less reactive to monthly inflation prints. One or two single 25bps cuts won't have a large economic impact (and it will occur with a lag), so pausing very early on in the process doesn't make a lot of sense in our view.

Even if they do follow this path, how long before they start to slow down (by skipping rate changes at some meetings) is uncertain. Alternatively, they could elect to go at a slower pace at the outset (e.g. every second meeting). The head of the Atlanta Fed this week indicated that he would not anticipate back-to-back cuts.

Against this backdrop, we have adjusted our rate profile to better balance the risks around our forecasts. Previously we had five consecutive cuts to start the easing cycle, before the first (temporary) pause, but we now only factor in four. This would leave the Fed target range 25bp higher at end 2024 than we had before (4.25-4.50%, previously 4.00-4.25%).

There is nothing pre-set about the timing of rate cuts or the pace at which they occur, and market pricing of future rate changes is likely to remain volatile in coming months (barring the unlikely event of all the data being in line with expectations).

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	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	2.5	2.2	1.9	1.4	0.8	0.73	0.5	0.3	0.2	0.3	0.4	0.4	0.5	0.4
Private fixed investment	1.3	0.6	2.5	2.2	0.6	0.6	0.9	0.3	0.3	0.3	0.5	0.7	0.8	0.9
Government spending	-0.9	4.0	2.6	0.8	1.4	1.0	0.7	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	-0.1	-0.1	-0.1	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**	**0.2**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Note: GDP (annualised rate)					*4.9*	*3.2*	*2.1*	*0.8*	*0.6*	*1.1*	*1.4*	*1.7*	*1.9*	*2.0*
US Other Key Indicators														
PCE deflator-headline														
Headline	5.9	2.8	2.1	2.0	0.6	0.5	0.6	0.6	0.4	0.5	0.5	0.5	0.5	0.5
Core	**5.1**	**3.2**	**2.3**	**2.0**	**0.5**	**0.5**	**0.7**	**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	3.7	3.8	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**	**4.50**	**3.00**	**5.50**	**5.50**	**5.50**	**5.25**	**4.75**	**4.50**	**4.00**	**3.75**	**3.25**	**3.00**

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) 422 081 046

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 Research
Corporate & Institutional Banking
+(61 2) 9295 1196

Important notice