US Economic Update 12 April 2024

Inflation disappointment pushes out Fed cuts

- **Partial data for Q1 point to solid GDP growth, albeit slower than the robust pace of H2 2023.**
- **We have marked up our GDP forecasts for 2024 to 2.4% (from 2.1%) and revised down 2025 a notch (1.3% from 1.4%).**
- **Inflation data moderated in February but were still on the high side, as was the March CPI, disappointing Fed hopes of achieving 'greater confidence' that inflation is tracking back to 2%. That said, we still consider that the conditions are in place for inflation to ease from here.**
- **We continue to expect that the Fed will cut rates this year, but we now see September as a more likely start date (previously June).**

Q1 growth still looking solid

Some of the weakness in the activity indictors for January was unwound in February. After falling in January, manufacturing production and consumption bounced back strongly in February (up by 0.9% and 0.4% m/m respectively). Over the last three months, consumption has grown by an average of 0.2% per month, pointing to solid growth for Q1 (around 0.6% q/q), even if down on the robust 0.8%q/q in Q4 2023.

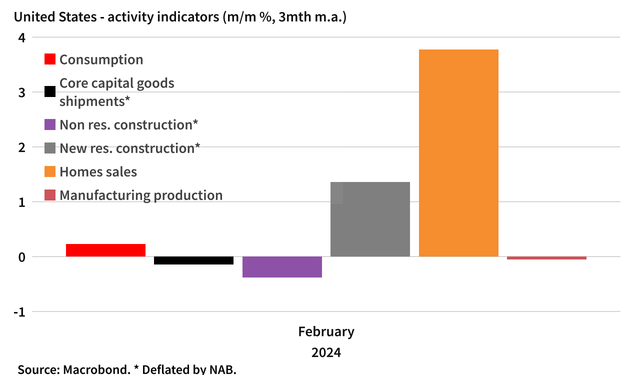
New residential investment looks set to grow strongly in Q1, driven by rapid growth in housing sales but also ongoing solid construction gains.

However, parts of business investment are struggling. Capital goods shipments remain weak, while the strength evident in non-residential construction last year has faded, with declines in each of the last two months. However, total business investment growth is likely to remain positive due to growth in intellectual property (which includes software). Net exports and inventories also look set to detract from growth this quarter.

Overall, we expect GDP growth of 2.2% q/q (annualised) for Q1, marginally up from our forecast last month (2.1%) but a step down from 3.4% q/q growth in Q4. While, if realised, this is nominally higher than the Fed's (and our) view of the long-run growth trend of around 1.8%, with population growth seemingly elevated right now such an outcome is probably closer to par.

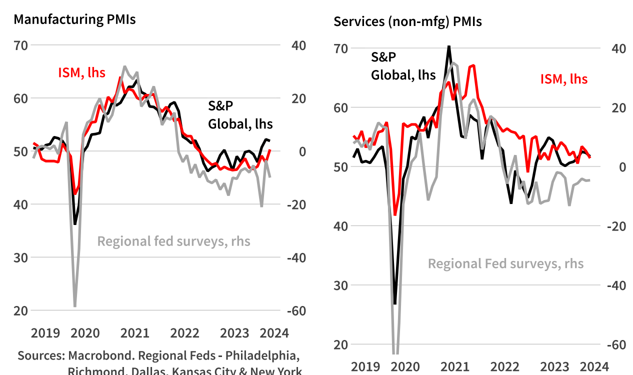
Business surveys provide an alternative indicator of how the economy is tracking. The surveys have recently shown some improvement, driven by the manufacturing sector. However, the survey indicators remain at levels consistent with only modest growth.

Partials mixed over recent months



Source: Macrobond. * Deflated by NAB.

Surveys –mfg picking up but overall still modest



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

Real personal income growth has softened since mid-2023, averaging around 0.1% m/m since June, with a run down in the savings rate enabling robust growth in consumption over this period. While the savings rate remains above its 2022 trough, it is still low by historical standards. The recent strength in employment growth will continue to underpin consumption growth – and has led us to modestly upgrade our expectations.

On the business side, the third estimate of Q4 GDP saw the release of estimates of business profits. According to the BEA, pre-tax corporate profits have increased by 8% over the last two quarters. Relative to net value-added by the corporate sector, this leaves profits at a high, and growing, level.

However, a different story emerges when looking at domestic non-financial businesses. Profits are at a high level but have basically tracked sideways over the last few years (relative to value added). This still strong result owes a lot to a large fall in net interest payments by non-financial corporates despite the large rise in interest rates seen since early 2022. This outcome is widely attributed to corporates switching to longer dated debt,

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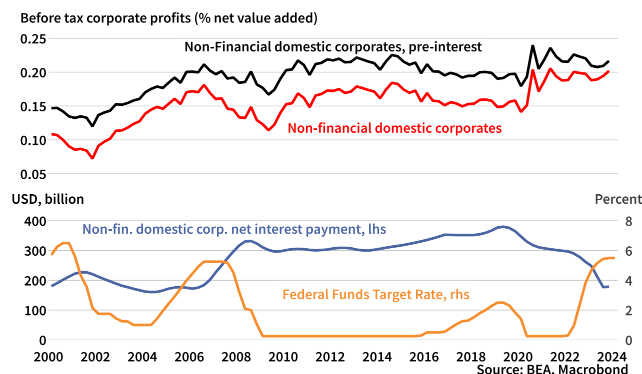
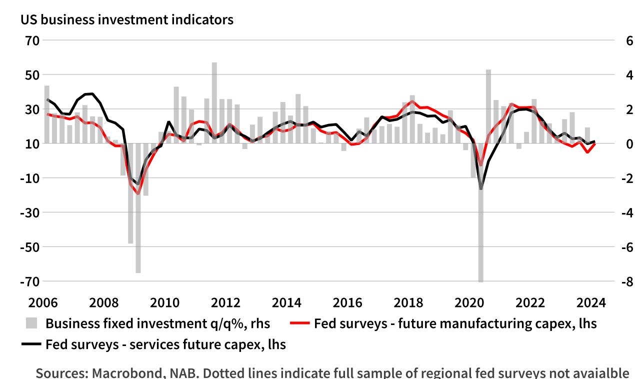
locking in the low interest rates seen during the pandemic. However, at some point net interest payments will increase as debt is rolled over and re-financed at a higher rate. Indeed, there are tentative signs that this might be about to start with a rise in net interest payments in Q4 – while it was very small it was the first increase in over four years.

Profits and net interest payments



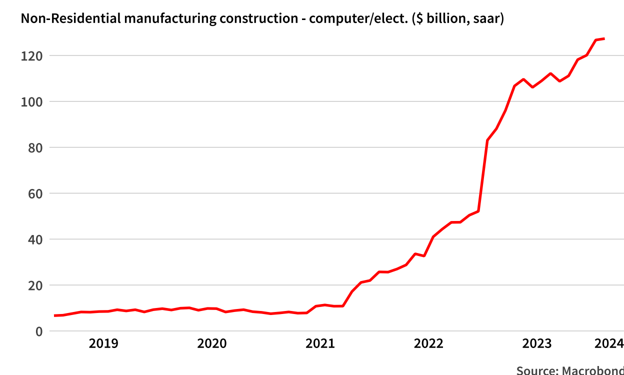
Looking at pre-interest profits – which measure the return to debt and equity holders – we can see that they have been trending down from their pandemic period although only gradually and they remain solid. Developments in corporate profitability are important as they impact investment and staffing decisions. An environment of falling profits/margins can see corporates pull back and start to cut costs and has often preceded US recessions. While, in aggregate, US corporates remain in good shape (including healthy balance sheets and low levels of loan delinquency) capex investment expectations remain soft.

Capex intentions remain weak



Significant support for business investment last year came from tech related investment in manufacturing structures, likely driven by various financial incentives put in place by the US government. Manufacturing investment in structures accounted for 40% of the growth in business investment that occurred over 2023 even though its share of investment was below 3%. While this source of investment looked like it was levelling out around mid-to-late 2023, it has taken another leg up. At some point this is likely to plateau, if not unwind, but the timing is a considerable source of uncertainty.

Tech related mfg investment still strong



We have made an upwards revision to our forecasts for growth over 2024, although we still expect it to be below potential (with growth over 2024 expected to be 1.5%). Apart from raising consumption growth to reflect the impact of recent strong employment data, we have also lifted Q2 expectations for public demand (with no slowdown yet evident in local government job growth) and non-residential construction. In year average terms we now expect growth of 2.4% compared with 2.1% (with the upwards revision to Q4 growth by the BEA also a contributing factor). Our forecast for 2025 is a bit lower (1.3% compared to 1.4%) reflecting the now higher expected interest rate path.

The view that growth will slow reflects interest rate settings which are still at a clearly restrictive level – and we now expect this to be the case for longer – less support from fiscal policy, soft global growth and a fading of the impetus to tech manufacturing investment. Upside risks to our forecasts comes from still healthy household and corporate balance sheets while risks around population growth are two-sided. When public demand growth slows is also uncertain. A key event later this year are US elections, which could see changes to trade policies (including the possibility of tariff increases), fiscal policy and migration depending on who is the President and who controls Congress.

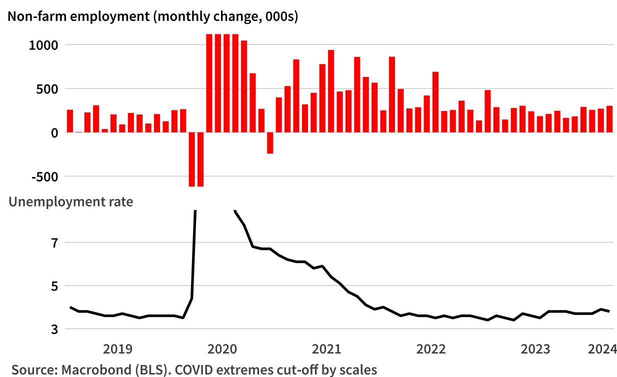
Labour market

Labour market pressures continue to show signs of easing, but only gradually, and employment growth remains strong.

The unemployment rate rose to 3.9% in February (from 3.7%), a new high since the early 2023 trough of 3.4%, but this was partially reversed in March (back to 3.8%). Some indicators of labour market conditions are also around or below their pre-pandemic level, including the quits rate and average hours worked.

That said, job vacancies remain high (even if off their peaks) and have tracked sideways recently, while employment growth has also strengthened over recent months.

Job growth has picked up recently



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

According to the Bureau of Labor Statistics (BLS), the adult civilian population grew by 0.6% over the year to March 2024, while the annualised growth rate for the last two months is around 0.8%. Simply applying this to the level of non-farm employment, suggests that monthly job gains of only around 80k-100k are needed to accommodate the growing population – well below the current run rate.

However, a study by the Congressional Budget Office suggests that population growth is stronger than the BLS estimate (around 1.1-1.2%), due to high levels of net immigration. Drawing on this work, a recent Brookings (Hamilton Project) paper estimates that the lift in immigration now means that 160-200k jobs are required each month to keep the unemployment rate stable.

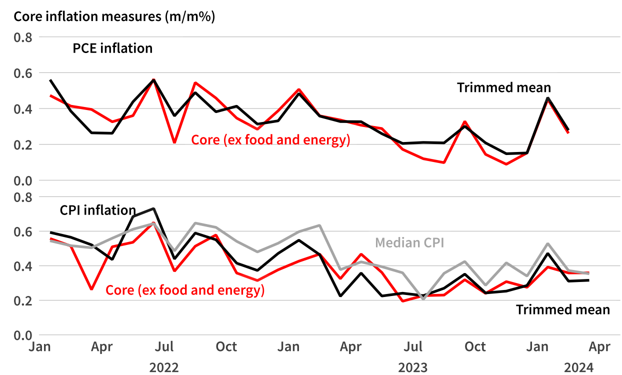
There are other factors that feed into the level of jobs growth needed to keep the unemployment rate constant, including changes in workforce participation. The 0.4ppt rise in the unemployment since early 2023 has occurred in a period where the average monthly increase in non-farm employment has been around 250k.

It is the interaction of labour supply and demand – and how this feeds into wage growth –that is salient to the Fed. Growth in monthly average hourly earnings is volatile but still appears to be easing. The employment cost index – the measure which the Fed places more reliance on – has also been trending down, with another update (for Q1) due late this month.

Inflation

Measures of underlying Inflation generally moderated in February, but remained high as did the March CPI. While the CPI ex food and energy ('core CPI') grew by 0.4% m/m in each of the first three months this year, core PCE inflation eased to 0.3% m/m (from 0.5%) in February but this is still above where it was in the second half of 2023. Trimmed mean CPI and PCE measures have a similar pattern (pointing to an uplift in inflation this year so far) although median CPI growth over the last two months has been around where it was at the end of 2023.

Monthly inflation has lifted so far this year



We still expect annual core PCE inflation to head back towards 2% as economic growth slows, labour market pressures ease further, wage growth moderates and given inflation expectations remain well-anchored. However, three months of higher inflation readings can't be dismissed as just noise and likely contain some signal. Accordingly, we have lifted our core PCE inflation forecast for this year and now see annual core PCE inflation of 2.6% by Q4 (previously 2.3%).

Monetary policy

The Fed has been indicating that it expects to reduce the federal funds rate at some stage this year if the economy evolves as expected.

In a speech last week Fed Chair Powell reiterated his view that the higher January/February inflation and employment prints did not materially alter the overall picture which he characterised as "…one of solid growth, a strong but rebalancing labor market, and inflation moving down toward 2 percent…". However, he noted that it is too early to be sure that recent inflation data do not represent more than a 'bump' and the subsequent March CPI result provided no reassurance on this point.

As per the communications following the January/March FOMC meetings, the Fed Chair again indicated that the Fed is looking for 'greater confidence' that inflation is sustainably tracking back to 2%. Powell also noted in his March meeting press conference that an unexpected labour market weakening could also see the Fed ease policy.

The Fed member projections released following the March meeting indicated that the median view is for 75bps of cuts this year, although only one member changing their view would be sufficient to change the median to 50bps so the bias is towards doing less.

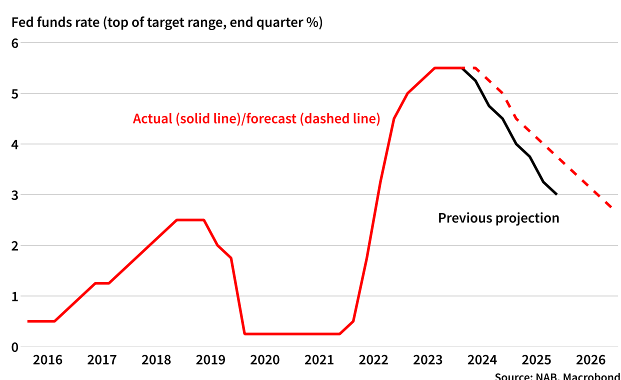
We had been expecting the Fed to start reducing rates at its June meeting – but the two CPI reports, and one PCE inflation report, since our last forecast update have disappointed, and make this unlikely. The strength in jobs growth so far this year also reduces any urgency for the Fed to start moving rates down.

We now don't expect the first rate cut to occur until September. The run of disappointing inflation results means that the Fed, rather than gaining confidence that inflation was on track to move back to target, has probably lost some confidence. A run of better inflation data will likely be required before they move.

Nor are they likely to feel pressured to move by the labour market, at least until later in the year. While the unemployment rate has (gradually) lifted from its trough, it remains at a low level and below the median Fed view of its sustainable level. With Q1 GDP growth looking solid, given the lags between GDP growth and labour market variables, we don't see the unemployment rate starting to shift clearly higher until Q4 this year.

Beyond September, the pace of monetary easing will likely be gradual (by historical standards).

Revised fed funds rate projections



We consider the risks around our latest track are two-sided. It is possible to see a scenario where the Fed cuts rates sooner (some low inflation numbers, or faster than expected growth slowdown) or later (more high inflation prints). The risk of a rate hike still appears low – if there are further high inflation prints in coming months then the default response will be to tighten policy by signalling that rates will be kept at their current level for longer. However, if inflation were to persist through this year at a level well above target, inflation expectations rise, growth come in above trend and the labour market shows signs of re-tightening then it may become possible.

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U.S. economic forecasts

	2023	2024	2025	2026	2024 Q1	Q2	Q3	Q4	2025 Q1	Q2	Q3	Q4
US GDP and Components												
Household consumption	2.2	2.2	1.5	1.8	0.6	0.5	0.3	0.3	0.3	0.4	0.4	0.4
Private fixed investment	0.6	3.2	2.0	3.0	1.4	0.4	0.3	0.3	0.5	0.6	0.7	0.8
Government spending	4.1	2.7	0.8	0.9	0.6	0.3	0.2	0.2	0.2	0.2	0.3	0.3
Inventories*	-0.4	-0.1	0.0	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.6	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.5**	**2.4**	**1.3**	**1.8**	**0.6**	**0.4**	**0.3**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*2.2*	*1.5*	*1.1*	*1.0*	*1.2*	*1.5*	*1.8*	*1.8*
US Other Key Indicators												
PCE deflator-headline												
Headline	2.8	2.4	2.0	1.9	0.8	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Core	**3.2**	**2.6**	**2.0**	**2.0**	**0.9**	**0.7**	**0.5**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**4.1**	**4.4**	**4.4**	**3.8**	**3.9**	**3.9**	**4.1**	**4.2**	**4.3**	**4.4**	**4.4**
US Key Interest Rates												
Fed funds rate (top of target range)	**5.50**	**5.00**	**3.75**	**2.75**	**5.50**	**5.50**	**5.25**	**5.00**	**4.50**	**4.25**	**4.00**	**3.75**

Source: NAB Group Economics

*Contribution to real GDP growth

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