US Economic Update 8 May 2024

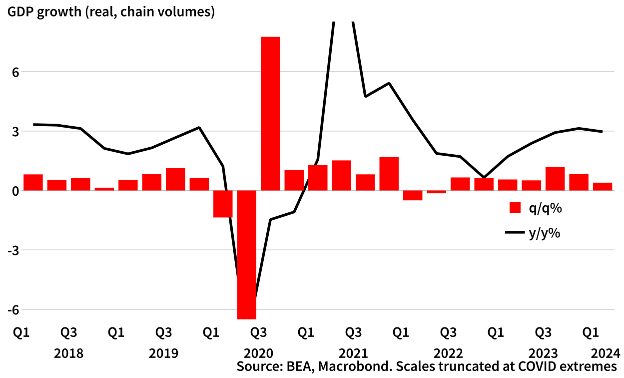
To cut, or to hold, that is the question

- **US GDP growth moderated in Q1, but it was still a solid result. While a bit lower than we expected we have left our 2024 GDP forecast unchanged.**
- **Overall, the various indicators continue to point to a gradual softening in labour market pressures, although the Employment Cost Index grew more strongly than expected in Q1.**
- **Q1 core PCE inflation was well above the Fed's target. We still consider that inflation will ease from here and track back towards the Fed's 2% target.**
- **The Fed left rates on hold at its May meeting. We expect the next move will be a cut, most likely in September. If there are further inflation disappointments, the Fed's initial step will be to remain on hold for longer as it considers policy to be clearly restrictive, setting a high bar for rates to be hiked.**

Growth slowed in Q1, but still solid

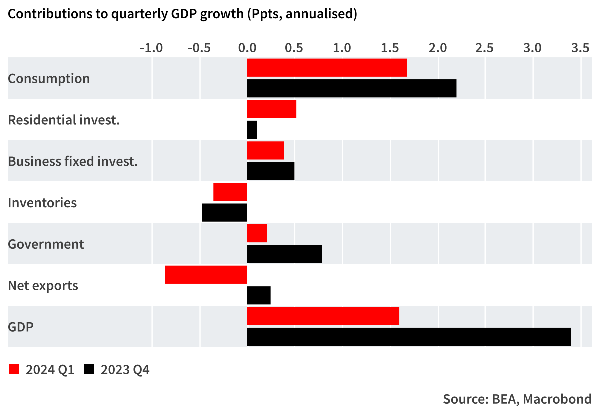
US GDP grew by 0.4% q/q, or 1.6% annualised in Q1 2024, a bit below our expectation of 2.2% annualised. While this was the lowest quarterly growth rate since mid-2022, the details were more positive, and growth over the year was a robust 3.0%.

GDP growth slows again in Q1



Domestic final demand (DFD) growth was stronger at 0.7% q/q, down on the two previous quarters but still solid. Private sector DFD was even stronger at 0.8% q/q. The weaker GDP growth reflects a net export detraction from growth and a slower pace of inventory accumulation.

Details stronger than headline



Household consumption grew by a solid 0.6% q/q, again a little bit softer than the two previous quarters. For the third quarter in a row, this was well above growth in real disposable income, leading to a further fall in the saving rate. This likely reflects a delayed flow through to spending from the large boost in income in H1 2023, as well ongoing increases in household wealth. At 3.6%, the savings rate is low by historical standards, but still a bit higher than it was in mid-to-late 2022.

Private fixed investment (1.3% q/q) grew at its strongest pace in three quarters.

This reflected much stronger residential investment (3.3%) with strong growth in both construction and sales activity, helped by the fall in mortgage rates that occurred in late 2023.

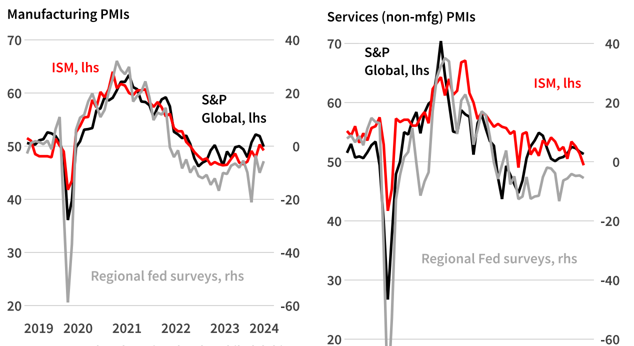
Business fixed investment grew by 0.7% q/q. This included a modest increase in equipment investment – after declines in the two previous quarters – helped by a surge in computers and peripheral equipment (almost 10% q/q). In contrast, structures equipment was essentially flat – ending a streak of very strong growth (it increased 17% over the previous four quarters). Manufacturing structures investment, at 3.3% q/q was still strong, but well down on recent growth rates, suggesting the boost to the manufacturing investment from government incentives (such as the CHIPS Act) may be peaking. The recent strengthening in intellectual property products (including software) continued, with solid growth of 1.3% q/q recorded.

We have been expecting government consumption and investment growth to slow at some point and this was finally realised in Q1. Growth of 0.3% q/q was well below recent growth rates. While this partly reflects a fall in Federal defence spending, which can be volatile, growth in Federal non-defence, as well as state & local government, demand was also well below recent levels.

The large net export detraction from growth reflects modest export growth in the quarter (0.2% q/q) coupled with much stronger (1.8% q/q) import growth. Even with this, import growth has been modest despite the strength of US demand, having only risen by 1.3% over the last year.

An alternative signal on the state of the economy comes from business surveys. They showed some improvement early in 2024, but this has been unwound over the last two months, to the point where our composite measure of the S&P Global and ISM surveys is at its lowest level since late 2022.

Surveys soften again in April



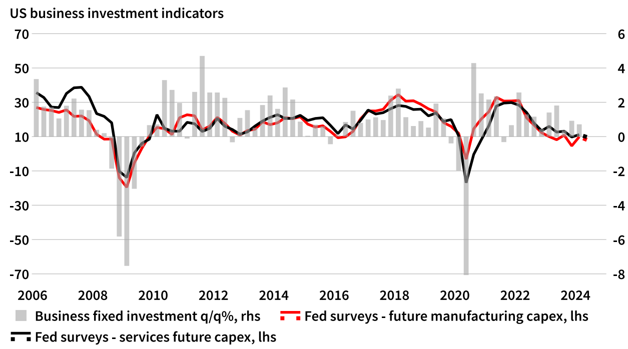
Sources: Macrobond. Regional Feds - Philadelphia, Richmond, Dallas, Kansas City & New York

We have kept our forecast for 2024 GDP year-average growth unchanged at 2.4%. While Q1 was lower than expected, we have lifted our forecast for Q2 to 2.0% q/q annualised. This mainly reflects the implications for Q2 consumption growth from the very strong 0.5% m/m increase in March. While we don't think such growth rates, well above real income growth, are sustainable, even if consumption is unchanged from here to June, Q2 consumption would be up 0.5% q/q due to base effects.

Overall, taken together with the Q1 result, this doesn't alter our expectation that growth over 2024 will materially slow from that seen over 2023. Between Q4 2023 and Q4 2024 we expect growth of around 1.5%, compared to around 3% the previous year. This view is based on monetary policy settings being restrictive, soft global growth, a fading boost from tech sector manufacturing investment and still weak broader investment intention indicators. Moreover, Federal government fiscal policy – a tailwind last year – will act as a headwind this year, although the various indicators differ on the extent of the shift. State government fiscal positions have also largely normalised, which should curb growth in spending going forward.

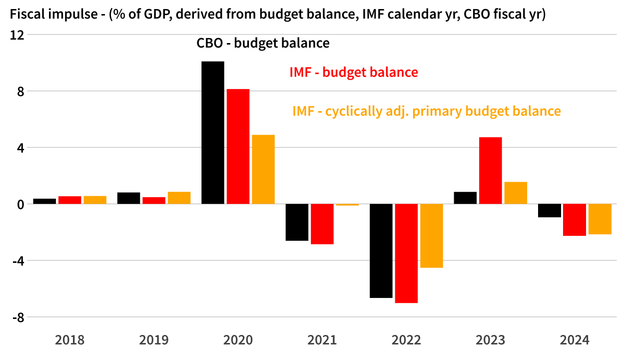
Based on this we expect the unemployment rate to rise only gradually, with a peak close to 4.5%.

Business capex intentions are soft



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

Fiscal policy a headwind in 2024



Fiscal impuluse = -(ppt change in budget balance (% of GDP))

An upside risk to our forecasts is that a still tight labour market, as well as healthy balance sheets, could support consumption more than expected. Similarly, corporate balance sheets and profits remain healthy and may sustain a higher level of activity. Conversely, the impact of higher rates to profits has been delayed but when it bites it might cause businesses to pull back further. While tech sector manufacturing growth is slowing there is considerable uncertainty around what the path forward will be (with risks dual-sided). Population growth appears to be currently elevated; the uncertainty around its true level causes risks for GDP growth projections, but as immigration affects both demand and supply, it has fewer implications for inflation or unemployment rate forecasts.

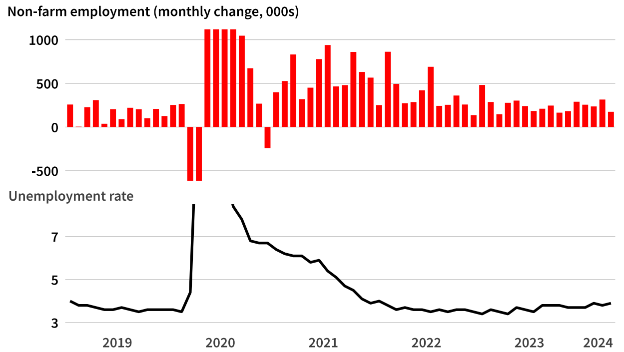
Federal government policy has the potential to materially change the level of immigration. In this respect, the November 2024 elections are potentially important, and they could also see material changes in trade and fiscal policy, as well as to how the Federal Reserve conducts monetary policy.

Labour market

Labour market pressures continue to show signs of easing, but only gradually. The unemployment rate rose to 3.9% in April from 3.8%, reversing last month's decline. Non-farm employment increased by 175,000, a decent result, but the softest growth since October last year. There was also a small net downward revision to prior months estimated job gains.

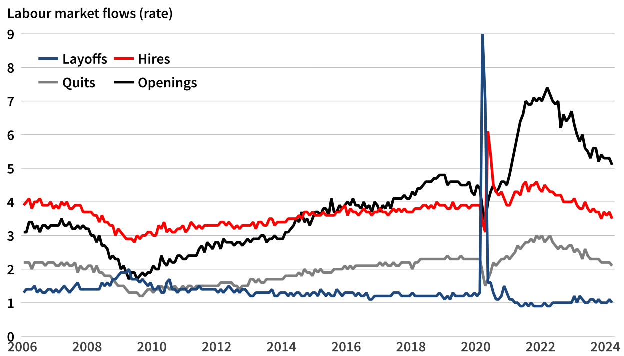
Other indicators of labour market conditions are around or below their pre-pandemic level, including the quits rate and average hours worked. While still elevated, job vacancies are trending down, and hiring and voluntary job departures are back to, or below, their pre-COVID levels. Job layoffs, however, remain low according to BLS data, although corporate layoffs reported by Challenger and Gray show more of a pick-up.

Job growth moderated in April



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

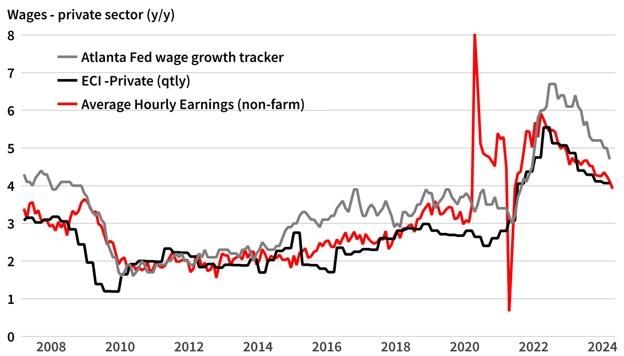
Other indicators point to labour mkt easing



Source: Macrobond (BLS)

While some indicators point to an easing in labour market pressure, the Employment Cost Index (ECI) for all workers grew by 1.2% q/q in Q1, up from 0.9% in Q4, leaving the annual growth rate unchanged at 4.2% y/y. While this is still well off its recent peak of just over 5%, this level of wage growth, if sustained, would likely be considered too high by the Fed.

Wages – ECI stalls but trend still likely downward



Source: Macrobond (BLS, Atlanta Federal Reserve)

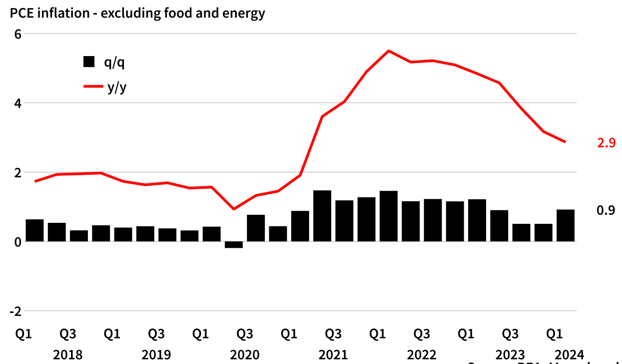
One data point is not enough evidence to say that the downwards trend in wage growth is at an end, and we expect some further easing this year. Consistent with this, April private non-farm hourly earnings only grew by 0.2% m/m, with the annual growth rate slipping below 4% for the first time since 2021.

Inflation

Core PCE inflation was unchanged at 0.3% m/m in March. While close to expectations, given the March CPI outcome, there were upward revisions to the two prior months. This left the annual rate at 2.8% y/y, also unchanged from February, only slightly higher than the headline measure of 2.7% y/y.

On a quarterly basis, the core PCE price index grew 0.9% q/q – a notable lift from the 0.5% growth rates of the two previous quarters. The uplift in inflation was broad based with other measures of underlying inflation also increasing (such as trimmed mean/median CPI) and producer and imported price inflation also rose. Breaking down core PCE inflation into its main groupings, housing (rent) services inflation was steady in the quarter, but still high, while core services inflation lifted and core goods prices continued to fall, but at a slower pace and so provided less of an offset to the services side.

Q1 saw a clear acceleration in inflation



Source: BEA, Macrobond

We still expect annual core PCE inflation to head back towards 2% as economic growth slows and labour market pressures ease further (resulting in lower wage growth), given that inflation expectations remain well-anchored. Chinese export prices have also been declining, which should help keep imported goods inflation down.

A risk for 2025 and beyond is the potential for large scale tariff increases if Donald Trump is elected President in November. He has floated a universal 10% tariff on imports (current average tariff rate is around 2% according to WTO trade weighted data), a 60% tariff on imports from China and a 100% tariff on motor vehicles. Even if elected, the impact on inflation will depend on whether the increases are staggered over time, whether there are exemptions (and their extent) – both of which occurred in the trade war with China when Trump was President.

Monetary policy

The Fed left rates unchanged at its May meeting, as universally expected, although it did slow the pace of balance sheet reduction (‘QT’). The meeting statement again outlined the condition that would need to be met for rate cuts – greater confidence that inflation is moving sustainably toward 2 percent – but not what would cause rate hikes. In that sense the statement retained an easing bias.

In Chairman Powell’s press conference, he noted that they had not gained that confidence in Q1 and, in light of the higher expected inflation in Q1, gaining the additional confidence will take longer than previously expected.

He was asked several times about the possibility of rate hikes. He considered a rate hike as ‘unlikely’ and would need “persuasive evidence” that current policy is not restrictive enough to bring inflation down to 2%. However, he stated several times that policy was restrictive.

In describing the possible paths that the economy might take, none of the examples given by Powell led to a rate hike. One path was persistent inflation and labour market strength – this led to rates being on hold. There were two paths to a rate cut – one where they gained confidence that inflation was sustainably moving back to 2% and one where the labour market weakened unexpectedly.

So, for now, hikes are not on the Fed’s agenda, with the main consideration being how long to keep rates on hold before reducing rates.

All that said, Powell stated many times that their policy decision will depend on incoming data (with the outlook – which will also be influenced by the data – and risks also factors).

We expect the Fed’s next move to be a rate cut, most likely in September. The risk around this is that it occurs later rather than sooner; confidence, once lost, can be hard to regain.

Like Powell, we see the chance of a rate hike as low, but forecasting is an imprecise business, and it is certainly within the bounds of possibility. The main risk is that inflation settles at an above target level, despite the range of measures indicating inflation expectations are well anchored, which could force the Fed’s hand. This year’s election – and any policy changes that result – add to the uncertainty around the outlook.

At its May meeting, the Fed announced changes which will slow the pace at which its balance sheet declines. The Fed has not been reinvesting maturing securities – up to a specified cap. Where the cap is breached, the Fed reinvests the excess redemptions, and so limits how quickly the balance sheet can fall. The cap for Treasury securities, was reduced from $60 billion/month to $25 billion, but the monthly cap on mortgage-backed securities redemptions was left unchanged at $35 billion.

Continuing QT, even at a slower pace, still represents further policy tightening. However, at this stage only large, unexpected changes, will have any material effect on broader interest rates, and a reduction in the pace of QT had been clearly flagged. Moreover, the Fed is portraying the change as one which does not change the end balance sheet size; rather it makes reaching the end point more gradual with the hope that this limits the risk of financial market disruptions.

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U.S. economic forecasts

					2024				2025			
	2023	2024	2025	2026	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components												
Household consumption	2.2	2.4	1.6	1.8	0.6	0.6	0.4	0.3	0.3	0.4	0.4	0.4
Private fixed investment	0.6	3.2	2.0	3.0	1.3	0.5	0.3	0.3	0.5	0.6	0.7	0.8
Government spending	4.1	2.4	0.9	0.9	0.3	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	-0.2	-0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.5**	**2.4**	**1.4**	**1.8**	**0.4**	**0.5**	**0.3**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*1.6*	*2.0*	*1.2*	*1.0*	*1.2*	*1.5*	*1.8*	*1.8*
US Other Key Indicators												
PCE deflator-headline												
Headline	2.8	2.5	2.0	1.9	0.8	0.7	0.5	0.5	0.4	0.5	0.5	0.5
Core	**3.2**	**2.6**	**2.1**	**2.0**	**0.9**	**0.7**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**4.0**	**4.4**	**4.3**	**3.8**	**3.9**	**3.9**	**4.0**	**4.1**	**4.2**	**4.3**	**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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