US Economic Update 16 July 2024

Foundation for Fed cuts almost in place

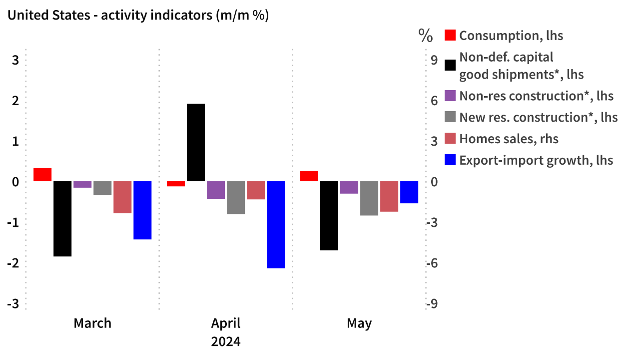
- **Benign inflation in May and June firms our expectation the FOMC will cut come September.**
- **A cut at the Fed's 31 July meeting remains unlikely, but we continue to expect two cuts this year.**
- **Jobs growth remains solid but the unemployment rate has risen; Fed Chair Powell now considers the labour market to be balanced.**
- **We expect Q2 GDP on 25 July of 0.4% q/q, another quarter of only moderate growth. We now expect 2024 year-average growth of 2.2% (was 2.3%).**

Modest growth outlook

The US economy is set to record another quarter of moderate growth in Q2, similar to that seen in Q1, but well down on the robust rates of H2 2023.

Household consumption increased by 0.3% m/m in May, following a small decline in April. With some modest growth in June, consumption would be up 0.4% q/q in Q2, again similar to Q1. Other indicators of private sector activity have been weaker. Construction spending has fallen in recent months (even as tech related manufacturing continued to rise), net trade is set to detract from growth and the April lift in non-defence goods shipments was unwound in May.

Private sector non-cons. indicators weak in May



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

However, intellectual property investment is likely to maintain its solid growth rate, and partial indicators point to robust government spending in the quarter. The net trade detraction from growth is also likely to be at least partly offset by a faster pace of inventory accumulation.

The first release of US Q2 GDP is 25 July, and we now expect growth of 0.4% q/q or 1.6% annualised (previously 0.5% q/q). With little data available for June, the risks around this central projection remain wide, but we think they are balanced on either side. The change to our Q2 forecast also lowers our 2024 growth projection to 2.2% (from 2.3%).

We have made essentially no change to our growth forecast beyond Q2 and expect a further modest slowdown in H2 2024 before a pick-up over 2025 and into 2026. This view is based on monetary policy settings being restrictive (but to become less so over time), soft global growth and a fading boost from tech sector manufacturing investment and state/local government spending. Federal government fiscal policy is also a headwind this year; for now we assume a fairly neutral stance in 2025 and 2026 until we get a clearer picture after November's elections.

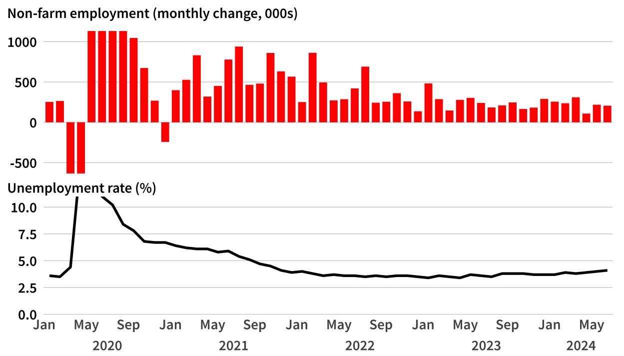
The elections may also impact migration (which is currently elevated), trade policy and how monetary policy is conducted.

While growth is expected to be soft, we do not see recession risk as high. Financial market conditions are not stressed, household balance sheets are relatively healthy and corporate profits have also held up, reducing the risk of a sharp cut back in activity and employment.

Labour market – gradual cooling

The labour market continues to cool. While non-farm employment gains were again robust in June – at 206k – the two previous months were revised down by 111k. The average monthly increase in non-farm employment so far this year has been 222k, but this has not been enough to prevent the unemployment rate rising. The unemployment rate rose to 4.1% in June, the third consecutive monthly increase and contrasted against a median FOMC participant projection for an unemployment rate of 4.0% at the end of 2024. On a three-month basis it is up 0.4ppts over the last year; it appears job growth is insufficient to absorb the expansion in the labour force coming from a high level of migration. Layoffs remain low, but rising jobless claims point to some pressure here as well.

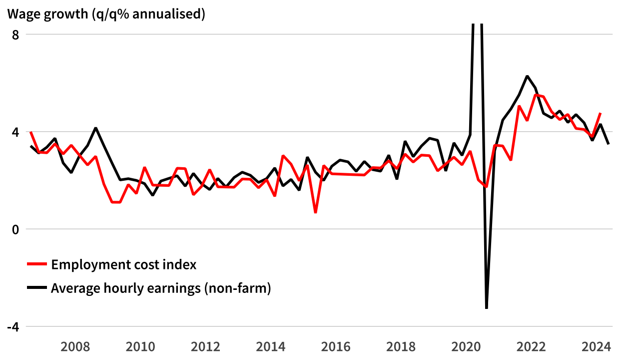
Labour mkt – jobs gains but unemployment up



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

Moreover, it appears the fall in inflation to-date, and easing labour market pressures, are leading wage growth to drift down further. Hourly average earnings growth eased in Q2 and, while the Fed favours the mix adjusted quarterly employment cost index (ECI) which rose at a faster pace in Q1, the two measures do tend to track together over time. In addition, other measures (such as the Indeed job posting wage measure) show a similar trend.

Wage growth also easing



Source: Macrobond (BLS)

The easing in labour market indicators has progressed to the point that Fed Chair Powell, in his Congressional testimony last week, stated that the labour market "appears to be fully back in balance." A bit of un upgrade on his June FOMC press conference that it had "come into better balance".

Inflation – back on track?

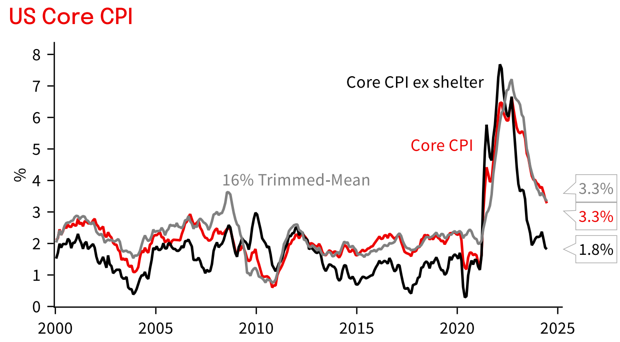
The unhelpful inflation readings of Q1 began to moderate in April and have given way to more thoroughly benign prints in May and June. May PCE inflation was just 0.08% m/m, and estimates for June are likely to firm up around 0.15% m/m on the back of the CPI and PPI last week.

Between June and December 2023, monthly core PCE inflation averaged 0.16%, so anything above this will push the annual inflation rate up. But the y/y rate doesn't need to be falling for the FOMC to be building confidence in the outlook. The June median FOMC projection for 2.8% core PCE at the end of the year implied an average core PCE print of 0.18% m/m and was described by Powell as an expectation for 'good but not great' numbers that reflected 'conservatism'.

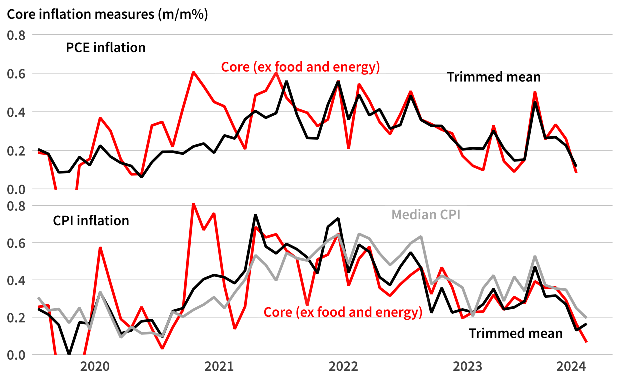
A couple of volatile categories including airfares were helpful for CPI over the past 2 months and mean that June's 0.06% m/m outcome for the core measure shouldn't be extrapolated, but overall the detail was supportive of our expectation for ongoing progress on disinflation. Of note was a moderation in shelter inflation. Rents inflation was 0.27%m/m, its lowest print since mid 2021 and not far from pre-pandemic levels.

CPI rents reflect conditions for new rents with a lag, and while moderation in indicators of new rents have pointed to a slowing in shelter inflation for some time, the exact timing, and the extent of catch up still to come, is uncertain. The cooler June shelter outcome is a tentative sign that stubbornness in shelter inflation may be starting to give way more durably.

May & June see better inflation outcomes



Source: National Australia Bank, U.S. Bureau of Labor Statistics (BLS), Federal Reserve Bank of Cleveland, Macrobond



We still expect annual core PCE inflation to head back towards 2% over time as economic growth slows and labour market pressures ease further – resulting in lower wage growth and taking the pressure off services inflation – given that inflation expectations remain well-anchored.

Progress across services components has resumed, but downward pressure from goods prices has moderated after being a key driver of inflation easing in the second half of last year. Freight rates have risen again, but looking forward we expect any read through to a reacceleration in end consumer goods prices to be moderated by continued easing in Chinese export prices, and a more modest domestic demand environment that makes it more challenging for firms to pass cost increases downstream.

Monetary policy

Speaking at the Economics Club of Washington overnight, Fed Chair Powell noted that the last three months of inflation readings “do add somewhat to confidence” that inflation is slowing sustainably. Powell characterised the inflation and employment mandates as being ‘in much better balance’ and noted an unexpected weakening in the labour market could be a reason to act. With rate settings being well into restrictive territory, this suggests that we are nearing the time when the Fed will seek to ease policy.

We are currently projecting only a slightly better inflation (-0.1ppt), and somewhat worse unemployment rate (+0.2ppts) outcome than the Fed’s June median forecast. However, while the June median FOMC view was that only one cut this year would be justified, amongst members projecting a cut it was a close split between one or two. With the labour market now seen as ‘balanced’, increases in the unemployment rate will be of even greater concern than they have been to-date.

We think a cut at the July meeting is too soon. The volatility in the monthly inflation data means the Fed will be wary of reading too much into a few months better data. Powell’s qualifier overnight that recent inflation reads have ‘somewhat’ added to confidence suggests the Fed want to see more data before moving. Moreover, it will want to tee up a rate cut rather than surprise markets. Accordingly, we remain comfortable with our view that the Fed will cut rates in September, with a follow up cut in November.

Once the Fed starts easing, with the economy expected to still be growing, and inflation above target this year, we expect the Fed will be somewhat gradual with the pace of cuts but think initially they may go faster than once every two meetings, given rates are well above their perceived neutral level.

If the economy, or inflation, were to soften more than we expect (or financial conditions significantly deteriorate) more rapid cuts may extend further into next year, but equally it is not hard to see a slower pace (e.g. inflation progress slower than expected). It is worth remembering that earlier this year, it was widely expected that the Fed would be cutting rates by mid-year, if not earlier, but these hopes were derailed by subsequent high inflation prints and that risk remains.

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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	2.0	1.5	1.8	0.4	0.4	0.4	0.3	0.3	0.4	0.4	0.4
Private fixed investment	0.6	3.8	2.2	3.0	1.7	0.7	0.4	0.3	0.5	0.6	0.7	0.8
Government spending	4.1	2.9	1.0	0.9	0.4	0.7	0.2	0.2	0.2	0.2	0.3	0.3
Inventories*	-0.4	0.0	0.0	0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.6	-0.3	-0.2	-0.1	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.5**	**2.2**	**1.4**	**1.8**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*1.4*	*1.6*	*1.2*	*1.0*	*1.3*	*1.5*	*1.7*	*1.7*
US Other Key Indicators												
PCE deflator-headline												
Headline	2.8	2.6	2.1	1.9	0.8	0.7	0.5	0.5	0.5	0.6	0.5	0.5
Core	**3.2**	**2.7**	**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**	**4.2**	**4.5**	**4.4**	**3.8**	**4.0**	**4.1**	**4.2**	**4.3**	**4.4**	**4.5**	**4.5**
US Key Interest Rates												
Fed funds rate (top of target range)	**5.50**	**5.00**	**3.75**	**3.00**	**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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