

# US Economic Update 8 August 2024



## Labour market weakness points to a more aggressive Fed easing cycle

- **The rise in the unemployment rate will accelerate the Fed's easing cycle, which we still expect to start at the September meeting.**
- **We now expect 100bps of cuts this year (previously 50).**
- **We pencil in a 50bp cut in September, but a 25bp cut is still possible with two CPIs and one Payrolls ahead of the meeting.**
- **We continue to expect slower growth through H2, but do not forecast a recession. While the Sahm-rule recession signal has been triggered, the rise in unemployment has not been driven by layoffs to the same extent as in the past.**

### View Change

NAB now expects 100bps of cuts by the end of the year (previously 50). While we expect some near-term stabilisation in the unemployment rate, and wouldn't be surprised if it ticked back to 4.2% in August, even this would leave a troubling trend, despite recent strength in activity growth.

Powell said ahead of the July data that "I don't now think of the labor market in its current state as a likely source of significant inflationary pressures" and that he would not like to see material further cooling.

Our forecasts were already for an ongoing cooling in the labour market that outpaced the FOMC's median expectation. We now see the unemployment rate ending 2024 at 4.5% and end 2025 at 4.7% (previously 4.2% and 4.5%) and a more aggressive cutting cycle. We expect the FOMC to cut by 50bp in September and then by 25bps per meeting to 2.75-3.0% in Q3 2025.

The unemployment rate is now (just) above the Fed's view of its long-term sustainable level and likely to rise further. This points to a policy stance closer to neutral being appropriate.

A key uncertainty is how quickly the economy will respond as the level of restriction is eased back toward neutral. Less benign inflation prints, or a sustained stabilisation (if not a recovery) in the labour market combined with a continuation of the surprising resilience in US growth, would slow the cadence of cuts. On the other hand, when unemployment has moved up this much in the past, it has tended to continue sharply higher. That would result in an even more aggressive cutting cycle. While we note the risk, we explain below why that is not our central case this time.

### Labour market and the Fed

The labour market in June looked balanced. Wages growth had decelerated, openings were getting close to their pre-pandemic levels, while the quits rate was already there. Moreover, the unemployment rate was around the Fed's view of its long-term sustainable level. Our own forecasts were for an unemployment track that notably outpaced the Fed's expectations, rising to 4.2% by year end and 4.5% by the end of 2025. That outlook supported our expectation for a meaningful cutting cycle beginning in September.

The two-tenths rise in the unemployment rate to 4.3% in July came as a surprise. It was a surprise to us, other analysts, and given the tone of the post-meeting statement mere days earlier, the FOMC. The jump in the unemployment rate came after three consecutive months of increases, setting up an expectation for some stabilisation even if the trend was for gradual ongoing labour market cooling. No analyst expected a 4.3% unemployment rate in the Bloomberg Survey, 3 analysts picked a 4.2%, the other 66 saw an unemployment rate at 4.1%, or a tick back down to 4.0%.

Speaking after the data, Richmond Fed's Barkin said "the question is, of course, are we normalizing or are we weakening?"

At face value, the renewed leg higher says weakening, not least because it triggered the Sahm-rule recession indicator. Historically, when the 3-month average of the unemployment rate has risen 0.5ppt above its low in the past 12 months, the unemployment rate has accelerated higher and a US recession has eventually been determined to have started around the time the threshold was triggered.

That is far from a foregone conclusion. This cycle so far has been unusual in that the move higher in the unemployment rate had been due to expanding labour supply outpacing robust employment gains, rather than increasing layoffs. That has different implications for the read through to economic growth, but it doesn't change the fact that spare capacity has been opening up.

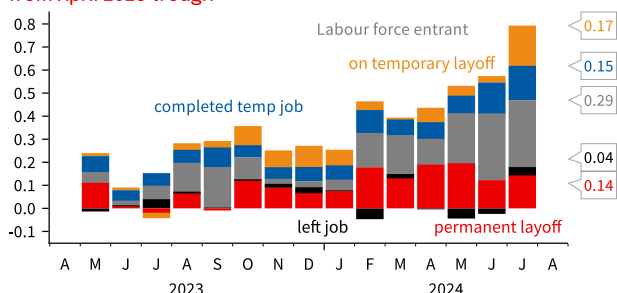
In the July data specifically, a full 15bp of the 20bp rise in the unemployment rate was the result of a jump in temporary layoffs that may yet reverse next month. It's tempting to blame the impact of Hurricane Beryl, but the BLS noted the data did not show any regional patterns associated with the hurricane. However, hurricane

impacts may have contributed to the softer payrolls jobs gains.

### Rise in unemployment not driven by layoffs

#### Contribution to rise in unemployment

from April 2023 trough

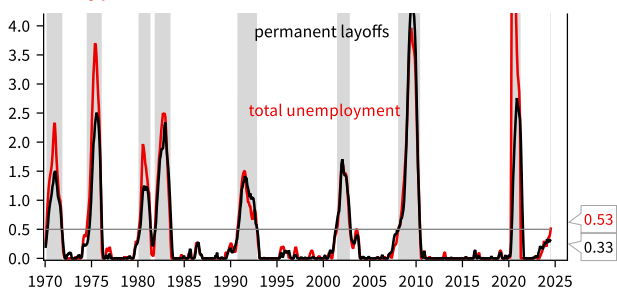


Source: National Australia Bank, U.S. Bureau of Labor Statistics (BLS), Macrobond

Permanent layoffs, in contrast, have been flat for around 6 months. Overlaying unemployment due to temporary layoffs against the standard Sahm rule flashes a much less compelling signal and, at least so far, stands apart from previous episodes.

### Sahm indicator an historical regularity not an immutable rule

#### Sahm-type recession indicator



\*3 month average of unemployment rate, or the rate of unemployment due to permanent layoff, relative to its trough of the trailing 12 months

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

For us, that is enough to temper the read through to our growth forecasts (see below) but doesn't change the assessment that the labour market cooling has sharply outpaced the FOMC's expectation, and they have work to do to shift policy accordingly. It doesn't take a recession to justify less restrictive policy.

We have brought forward our forecast increase in the unemployment rate, now expecting an unemployment rate of 4.5% by the end of 2024 and 4.7% by the end of 2025 (from 4.2% and 4.5% previously).

Powell said on Wednesday that what the FOMC "think we're seeing is a normalizing labor market," though if "it starts to show signs that it's more than that, then we're well positioned to respond." The soft Payrolls data on Friday means the question now is what shape the response takes.

The Fed doesn't meet again until September 17-18. There is one more Payrolls report and two CPI reports before then. We would need a very large surprise to stop the Fed cutting in September, and a 50bp move to kick

off the cycle is now our base case, to be followed by cuts of 25bps at each meeting until the fed funds rate target range reaches 2.75-3.00%, as the Fed seeks to move rates back to neutral.

If the August employment report has a notable correction to the July weakness (or there is a material upside inflation surprise), then it is possible that the Fed will limit itself to 25bp rate cuts at each meeting this year. Conversely, if activity data softens unexpectedly or labour market indicators weaken again in August, it is possible there will be more than one 50bp cut.

Indeed, market pricing has flirted with the prospect of an intra-meeting cut. We don't think that's justified by the data, and if it were to occur it would be about financial stability concerns or the prospect of spillback from financial markets to the real economy.

### Q2 GDP and growth outlook

The weakness in the labour market is emerging even as US GDP grew 0.7% q/q in Q2 (2.8% annualised), which was stronger than in Q1 and above expectations.

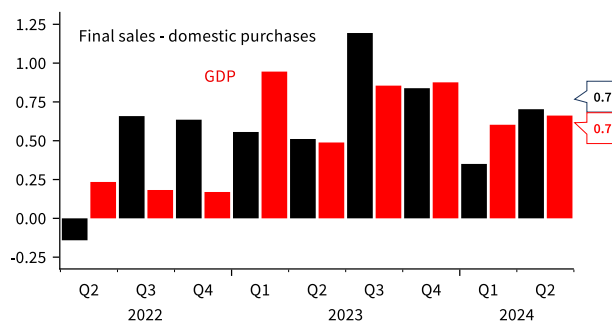
Consumption grew by 0.6% q/q (up from 0.4%) and business fixed investment also picked up again (to 1.3% from 1.1%), while government spending accelerated to 0.8% q/q (from 0.4%). One area of weakness was residential investment, which after growing strongly in Q1, declined by 0.3% q/q.

The increase in business investment growth has been partly met by imports of capital goods, contributing to still robust import growth (1.7% q/q) while export growth remained modest (0.5% q/q). Overall, the negative net export contribution to growth was similar to that in Q1 but this time around – as if often the case – it was offset by a positive inventory contribution to growth (0.2ppts).

In light of some large contributions to growth from some typically volatile components (transport equipment and Federal defence spending), and the major contribution to the Q1 slowdown from net exports and inventories, Q1 and Q2 are best considered together.

### Growth slowdown in H1 2024

#### GDP and domestic final demand (q/q%)



Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond

Annualised growth in H1 was 2.1% – still solid but a clear step down from 4.1% growth seen in H2 2023. Domestic final demand growth also slowed over this period, but not to the same extent as GDP.

This suggests somewhat stronger momentum in the economy than we had expected. While the strong growth evident last year in areas such as manufacturing structures investment and state/local spending have eased, it remains solid. Moreover, the Congressional Budget Office's (CBO) latest fiscal projections suggest a more benign impact from federal fiscal policy this year than previously thought.

The other issue – which is hard to get a handle on – is population growth, as official estimates appear to be underestimating it. We had based our expectations on population growth for 2024 and into 2025 on CBO estimates but pencilled in a quicker return to normal migration levels. While some indicators point to lower movements across the border, they still appear high.

While these factors are sending a more positive signal for the outlook, the signs that labour market is weakening more quickly than expected acts in the opposite direction. Softer employment and wage growth will constrain consumption growth. While consumption growth has been running above disposable income growth recently, this may be due to wealth effects. The correction in equity prices since mid-July, if sustained, and some signs that house price growth is slowing, suggest this dynamic will not continue (with the risk that it moves into reverse).

Balancing out these divergent factors, we have made little overall change to our near-term forecast, but further out we have lifted our growth expectations to allow for the more aggressive Fed easing cycle now underlying our forecasts.

The triggering of the Sahm rule (see labour market discussion above) has raised the issue of whether the US is in, or about to move into, recession. This is not our central call, although we continue to expect growth to soften further in H2 2024 before stabilising in 2025.

Household balance sheets – even with the correction in the share market – remain in good shape and corporate profits remain high. This makes a large, sudden, pull back in activity hard to see. The apparent strength of population growth also adds support to activity. It is the case that if employment were to start falling that the downwards momentum could become self-reinforcing; however, employment typically lags GDP growth and with economy growing 2% (annualised) in H1 positive jobs growth is the most likely outcome.

We now expect 2024 year-average GDP growth of 2.5% (previously 2.2%), while 2025 (up 0.1ppts to 1.5%) and 2026 (up 0.4ppts to 2.2%) have also been revised up.

## Inflation

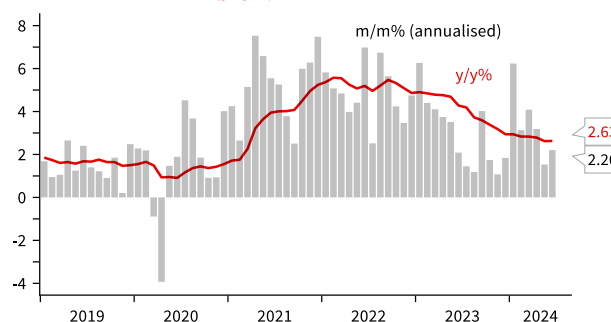
As expected, the June PCE inflation data provided further confirmation of a shift down in inflation from the high Q1 readings. Core June PCE inflation was 0.18% m/m, following 0.13% m/m in May (revised up from 0.08%). This left annual core PCE inflation unchanged at 2.6% while the headline indicator ticked down to 2.5% from 2.6%.

Importantly, the improvement in inflation is now more broad-based, with core services ex. housing inflation lower in recent prints, while housing services inflation eased notably in June.

The easing in wages growth and signs of labour market weakness support our view that inflation will track close to target over the rest of the year. As this was also the case in the second half of 2023, this would mean that the annual inflation rate stays around its current level through the rest of the year, before falling early in 2025, as the Q1 spike falls out of the annual calculation.

### June PCE inflation another positive report

Core PCE inflation (y/y%)



Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond

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## U.S. economic forecasts

	2023	2024	2025	2026	2024	2024	2024	2024	2025	2025	2025	2025	2025	2025	2025	2025
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>US GDP and Components</b>																
Household consumption	2.2	2.2	1.6	2.3	0.4	0.6	0.5	0.3	0.3	0.3	0.5	0.6	0.6	0.6	0.6	0.6
Private fixed investment	0.6	3.9	2.6	3.8	1.7	0.9	0.1	0.4	0.8	0.8	0.8	0.9	0.9	1.0	1.0	1.0
Government spending	4.1	3.1	1.1	0.9	0.4	0.8	0.4	0.2	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Inventories*	-0.4	0.0	0.0	0.0	-0.1	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.6	-0.3	-0.2	-0.2	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Real GDP</b>	<b>2.5</b>	<b>2.5</b>	<b>1.5</b>	<b>2.2</b>	<b>0.4</b>	<b>0.7</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.4</b>	<b>0.5</b>	<b>0.6</b>	<b>0.6</b>	<b>0.6</b>	<b>0.6</b>	<b>0.5</b>
<i>Note: GDP (annualised rate)</i>					1.4	2.8	1.2	1.1	1.3	1.5	2.0	2.2	2.3	2.3	2.3	2.2
<b>US Other Key Indicators</b>																
<b>PCE deflator-headline</b>																
Headline	2.8	2.6	2.0	1.9	0.8	0.6	0.6	0.5	0.5	0.5	0.6	0.5	0.5	0.5	0.4	0.5
Core	3.2	2.7	2.1	2.0	0.9	0.7	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5
<b>Unemployment rate - qtly average (%)</b>	<b>3.8</b>	<b>4.5</b>	<b>4.7</b>	<b>4.5</b>	<b>3.8</b>	<b>4.0</b>	<b>4.3</b>	<b>4.5</b>	<b>4.6</b>	<b>4.7</b>	<b>4.7</b>	<b>4.7</b>	<b>4.7</b>	<b>4.7</b>	<b>4.6</b>	<b>4.5</b>
<b>US Key Interest Rates</b>																
Fed funds rate (top of target range)	5.50	4.50	3.00	3.00	5.50	5.50	5.00	4.50	4.00	3.50	3.00	3.00	3.00	3.00	3.00	3.00

Source: NAB Group Economics

\*Contribution to real GDP growth

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