US - On borrowed time

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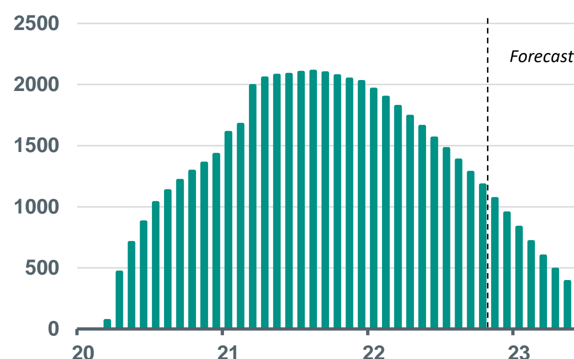
- **The US consumer has exhibited surprising resilience for much of 2022**
- **However, the twin headwinds of falling real incomes and dwindling excess savings are now expected to exert a powerful drag on consumption. This will help inflation along its downward-sloping trend…**
- **…while labour hoarding is likely to give way to a rise in the unemployment rate**
- **The Fed will continue raising rates in the near-term, but we expect 125bp in rate *cuts* by end-2023**

The reckoning is approaching for the almighty US consumer. From a lofty stimulus-fuelled peak in March 2021, real per capita incomes have been on a near constant decline ever since, and are now running around 5% below where incomes would have been absent the pandemic. For most of this period of falling real incomes, consumers have maintained above trend goods consumption by drawing on their extraordinary build-up of excess savings. For the bottom 20% income group, this excess had already been exhausted by the middle of 2022. For the remainder, we estimate excess savings have fallen to around half their peak as of October. With the savings rate now far below normal levels, at just 2.3% in October (the pre-pandemic normal was 7-8%), and surging interest rates pre-empting a credit binge, consumers are rapidly running out of room to accommodate still-elevated inflation. We don't expect a 'Wile E. Coyote'-style freefall in the economy that former Treasury Secretary Larry Summers recently suggested as a possibility, but we do expect a mild recession over the coming year, with stagnant domestic demand driving a rise in the unemployment rate to 5% by the end of 2023. Combined with an expected decline in inflation, this should give the Fed the confidence to take its foot off the brakes after an aggressive rate hike campaign, and we continue to expect significant rate cuts towards the end of 2023 and into 2024.

Real incomes are around 5% below trend…

Source: Datastream, ABN AMRO Group Economics

…while excess savings are being rapidly run down



Source: Datastream, ABN AMRO Group Economics

From a growth angle, 2022 has been a messy, mixed bag. Headline GDP stagnated over Q1-Q3, with an unexpected decline in the first half of the year followed by a modest recovery in Q3. For the most part, headline GDP growth was driven by a still heavily disrupted supply-side, with swings in inventories and net exports reflecting the difficulty businesses have faced in predicting both consumer behaviour and the availability of goods and other inputs. Underlying domestic demand has tracked our expectations more closely, with modest growth in the early part of the year followed by stagnation in Q2 and Q3. Where domestic demand has surprised has been in its composition: consumption has been remarkably resilient in the face of historically low consumer confidence and falling real incomes, while investment has been unexpectedly weak, driven by a rapid downturn in housing investment. Indeed, following the historical pattern as one of the most interest rate sensitive parts of the economy, the housing market is already now in a correction that is likely to persist well into next year.

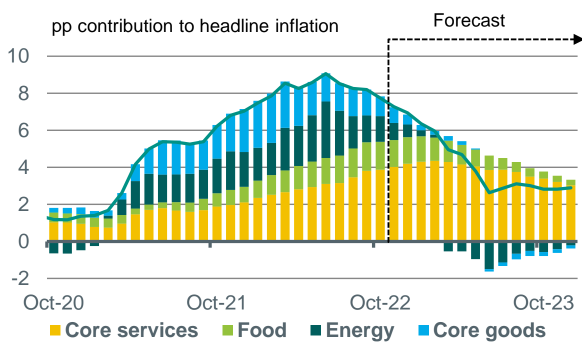
How will the economy fare going forward? Consumption data for the start of Q4 suggests continued resilience for the time being. Net exports are also likely to remain a growth support, as the supply-side recovery comes alongside increased demand for US energy exports (particularly from Europe). However, as we move into 2023, we expect the twin consumer headwinds of depressed real incomes and a further rundown in excess savings to put increasing downward pressure on consumption, with an expected decline in goods consumption in particular offsetting a continued (though increasingly sluggish) services recovery. Business investment is also likely to remain relatively weak given high interest rates and

recession worries. All told, we expect GDP growth to slow sharply from an expected 1.9% outturn in 2022, to 0.5% in 2023. For 2024, we expect rate cuts by the Fed to drive a rebound in consumption and investment, with growth to average 2%.

Naturally, a critical underpinning of this growth outlook is how inflation – and in turn monetary policy – evolves. Headline inflation marked a high point of 9.1% y/y in June, and we judge this to have been the peak. Since then, inflation has fallen back to 7.8% as of October, and we expect that declining trend to persist over the coming months. Almost all of the expected decline in inflation in the near term is expected to be driven by falling prices for energy and goods (particularly used cars and clothing). By contrast, core inflation is expected to remain elevated, reflecting continued pass through from earlier rises in housing rents, as well as strength in services, reflecting higher input costs and the tight labour market. However, here too we expect a significant cooling, but with most of that taking place in the second half of 2023. Real-time data on new leases suggests housing rents are now falling following a stunning rise over the past two years, but due to the CPI methodology, this likely won't show up in the inflation data for some months yet. The Fed, however, is fully aware of this and we do not expect these lags to be a barrier to rate cuts. All told, we expect the Fed's preferred PCE inflation measure to be within touching distance of the central bank's 2% target by the end of 2023, with both headline and core measures back at target in the course of 2024.

Inflation to continue its declining trend

% y/y



Source: Refinitiv, ONS, ABN AMRO Group Economics

Job layoffs have begun to tick higher

Monthly announced job layoffs

Source: Refinitiv, ABN AMRO Group Economics

The key long-run determinant of inflation – alongside inflation expectations – is ultimately the labour market. The labour market has remained exceptionally tight this year, despite the general cooling in the economy, with 1.7 job vacancies per unemployed person as of October (in more normal times, this figure is below 1). However, there are cracks under the surface: job vacancies peaked in March and have since been on a declining trend, and we have also seen a modest rise in layoffs. According to the Fed's latest Beige Book report, contacts in November had expressed "a reluctance to shed workers in light of hiring difficulties, even though their labor needs were diminishing." This situation of labour hoarding is unsustainable, in our view, and as it becomes increasingly clear how weak growth is expected to be in 2023, we expect layoffs to accelerate, payrolls growth to turn negative, and the unemployment rate to start rising. A persistent rise in unemployment is likely to be sufficient for the NBER to declare a recession, even if headline GDP does not meet the technical recession definition of two consecutive quarterly contractions.

In the near term, the ultra-tight labour market and the ongoing risk of a drift higher in inflation expectations means the Fed is likely to continue raising interest rates at the coming three FOMC meetings. Following an expected 50bp hike in December, we expect two further 25bp hikes in February and March; this will take the upper bound of the fed funds rate to 5%. The risk in the near-term to rates remains to the upside, as labour market tightness could still put further upward pressure on wage growth, raising worries over the medium term inflation outlook. However, by Q3 2023, we expect monthly core inflation readings to be much closer to normal, and the unemployment rate to be on solidly rising trend. This, we think, will be enough to convince the Fed that monetary policy is too restrictive at that point, and as such we expect the first of a series of rate cuts to take place at the September FOMC meeting. Rate cuts should take the fed funds upper bound back down to 3.75% by the end of 2023, while the full expected normalisation in inflation in 2024 should lead to further rate cuts back to the estimated neutral level of 2.5%.

Key forecasts for the United States

	2020	2021e	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	-2.8	5.9	1.9	0.5	2.0
- Private consumption	-3.0	8.3	2.7	1.0	2.1
- Fixed Investment	-2.3	7.4	-0.1	0.0	2.2
- Net exports (pp contribution)	-0.2	-1.7	-0.7	0.3	-0.3
Inflation (PCE)	1.1	4.0	6.2	3.1	1.9
- Core inflation (PCE)	1.3	3.5	5.0	3.4	2.1
Unemployment rate (annual average, %)	8.1	5.4	3.7	4.4	5.2
Interest and exchange rates (eop)					
Fed funds rate (eop, upper bound)	0.25	0.25	4.50	3.75	2.50
10y yield	0.85	1.70	3.50	3.00	2.75
EUR/USD	1.18	1.14	1.05	1.08	1.12

Source: ABN AMRO Group Economics

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