

## US: Inflation risks to drive earlier policy tightening

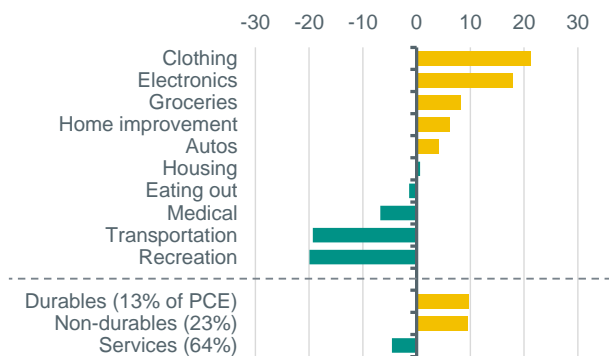
Bill Diviney – Senior Economist | [bill.diviney@nl.abnamro.com](mailto:bill.diviney@nl.abnamro.com)

- ▶ **The economy grew strongly in 2021, and above trend growth should continue in 2022**
- ▶ **However, the continued tilt in goods vs services consumption is keeping inflation risks firmly to the upside. The spread of Omicron could – if anything – intensify those risks**
- ▶ **We expect this, combined with an unexpectedly tight labour market, to trigger rate rises from June**

Looking purely at headline growth figures, the US economy has performed remarkably close to our expectation [laid out in February](#), following the crucial Democrat Senate majority win; GDP is likely to have grown 5.6% in 2021, just shy of our 5.8% estimate back then. GDP has comfortably surpassed its pre-pandemic peak, and will return to the pre-pandemic trend – i.e. the output gap will have closed – by Q2 next year. Where the economy has surprised is in the composition of growth, and the implications that this has had for inflation. Goods consumption, initially boosted by successive rounds of stimulus cheques and unemployment benefit top-ups, has stayed strong for far longer than we expected. At the same time, the rapid spread of the Delta variant over the summer months – while not leading to any meaningful new restrictions on activity – nonetheless put a dampener on the services recovery. The net result is that private consumption growth overall has actually outperformed our expectation from February, but this persistent excess goods consumption has conspired with unexpected supply-side bottlenecks to push inflation to the highest it has been in 30 years.

### Consumption remains heavily tilted towards goods...

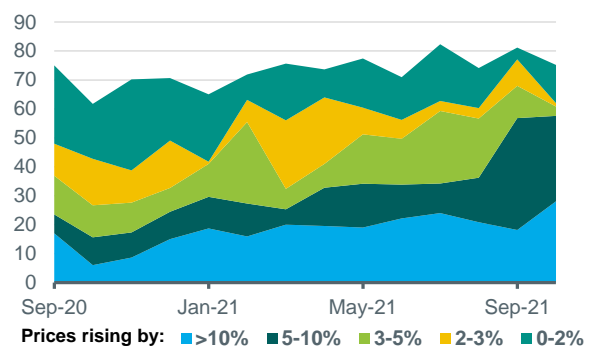
Private Consumption Expenditure (PCE), % vs pre-pandemic trend



Note: As of October 2021. Yellow bars = goods categories, green = services categories. Source: Refinitiv, ABN AMRO Group Economics

### ...driving a broadening in inflationary pressure

% distribution of inflation categories (weighted share) by price rise



Source: Dallas Fed, ABN AMRO Group Economics

When inflation initially began picking up in the spring, much of it could be explained as catch-up from the undershoot periods during lockdown in 2020. The next leg of acceleration was largely on the back of used car prices. Car production has been hampered globally by a shortage of semiconductors, but in the US this shortage in supply met a stimulus-fuelled surge in demand, and this drove astronomical rises in used car prices: as of October, prices are 43% higher than February 2020 levels. In recent months, inflationary pressure broadened well beyond used cars; according to Dallas Fed estimates, some 60% of weighted PCE inflation categories are rising by more than 5% annualised as of October, and half of those are rising at a 10%+ annualised pace. This rapid broadening of price pressures comes alongside historically unprecedented rises in pipeline producer prices, both in the US and globally, as well as wage growth driven by an unexpectedly tight labour market.

### Outlook for 2022: Recovery to continue, aided by an easing in supply-side bottlenecks

While growth in the 2021 has been somewhat weaker than expected, this is not for lack of demand, but rather supply: the drags on growth have come mainly from an inventory drawdown, and weak investment on the back of component and labour shortages. On some measures – for instance, shipping freight tariffs and port congestion – some supply-side bottlenecks look to have peaked, but a full recovery of the supply side looks unlikely before end-2022, and the spread of the new Omicron variant could well prolong that process. Nonetheless, growth should still see support from a gradual easing in supply-side bottlenecks, and we expect a pickup in investment alongside a rebuild of inventories to be tailwinds for the economy in 2022. Fiscal policy is also likely to remain broadly supportive, with the recently-passed Bipartisan Infrastructure Deal and President Biden's upcoming Build Back Better plan set to lift investment in infrastructure and renewable energy.

On the consumption side, based on the experience of the Delta wave, we are unlikely to see a re-imposition of restrictions on economic activity, while consumers themselves also seem to be increasingly undeterred by the spread of new virus variants. As such, while Omicron could dampen near-term consumption growth, it looks unlikely to derail it.

**Continued upside inflation risks are likely to trigger an early rise in interest rates**

Perhaps a bigger implication of Omicron could be its impact on the composition of consumption rather than growth, i.e. it could further delay the shift from goods consumption back to services. This would add to already elevated risks to inflation. We still expect inflation to come down significantly in the course of 2022, with core CPI inflation expected to peak at just over 5% in February, falling to 2.4% by end 2022. However, there is significant uncertainty surrounding this forecast, and the risks are primarily to the upside. First, the broadening in inflation raises the risk that recent price-setting behaviour becomes entrenched, i.e. that inflation expectations rise more broadly. Recently, consumer survey-based measures of inflation have hovered around the top end of the range of the past decade or so. However, the longer that broad and elevated inflation persists, the bigger the risk that these expectations drift beyond recent historic ranges. Even more importantly, indicators of labour market tightness have risen to historically elevated levels, despite employment itself still being below the pre-pandemic level, with the quit rate at an all-time high of 3%, and some measures of wage growth at multi-decade highs. This suggests that the unemployment rate consistent with low and stable inflation – or the NAIRU – is higher than it was before the pandemic, driven at least in part by a significant fall in labour force participation. Indeed, following research by the Fed suggesting that much of the current shortfall in participation has been driven by early retirees – i.e. people who are unlikely to return to the labour force – we have brought forward our expectation for when the Fed will reach its full employment goal of c.4% unemployment to Q2 2022, from Q4 previously. Labour force participation should still increase somewhat over the coming year, potentially aided by the proposed support for childcare under Build Back Better, but we do not expect this to be enough to fundamentally change the dynamics we are now seeing in the labour market in the near term.

**Labour cost growth is accelerating sharply**



Source: Refinitiv, ABN AMRO Group Economics

**Economy might already be at full employment**

Unemployment, % (Period after dotted line is our forecast)



Note: 'Non-inflationary unemployment' refers to the NAIRU estimate by CBO. Source: Refinitiv, ABN AMRO Group Economics

The combination of upside risks to inflation expectations and an unexpectedly tight labour market has led us to bring forward our expectation for interest rate rises. With the Fed now likely to end asset purchases by March next year – brought forward from the previous June expectation – we expect the Fed to begin raising the fed funds rate in June, half a year sooner than our previous, early 2023 expectation. In total, we expect three 25bp rate hikes in 2022, and three more such hikes in 2023, taking the target range of the fed funds rate back to the pre-pandemic level of 1.5-1.75% by end 2023. We think the goal of this accelerated pace of policy tightening will be to keep a lid on longer run inflation expectations, and to be in a better position to tighten policy further should inflation remain higher than expected in the medium term. However, we do not at this stage expect a policy tightening that bears down aggressively on demand. As such, and given the lags with which monetary policy typically affects the economy, we have not made adjustments to our growth forecast for 2022, which we expect to remain well above trend at 4.1%. For 2023, we expect a significant slowdown in growth, on a combination of fading post-pandemic catch-up effects and tighter monetary policy. While our headline growth forecast for 2023 is 2.3%, this will be flattered by carry-over strength from 2022, with quarterly annualised growth expected to average 1.4% – well below trend.

## Key forecasts for the United States

	2020	2021e	2022e	2023e
<b>Economic outlook (% yoy)</b>				
GDP	-3.4	5.6	4.1	2.3
- Private consumption	-3.8	8.0	3.1	2.0
- Fixed Investment	-2.7	7.9	6.0	5.2
- Net exports (pp contribution)	-2.3	-1.0	-0.5	-0.4
Inflation (PCE)	1.2	3.8	3.2	1.9
- Core inflation (PCE)	1.4	3.2	2.9	2.0
Unemployment rate	8.1	5.4	4.0	3.3
Fed funds rate (eop, upper bound)	0.25	0.25	1.00	1.75

## DISCLAIMER

*This document has been prepared by ABN AMRO. It is solely intended to provide financial and general information on economics. The information in this document is strictly proprietary and is being supplied to you solely for your information. It may not (in whole or in part) be reproduced, distributed or passed to a third party or used for any other purposes than stated above. This document is informative in nature and does not constitute an offer of securities to the public, nor a solicitation to make such an offer.*

*No reliance may be placed for any purposes whatsoever on the information, opinions, forecasts and assumptions contained in the document or on its completeness, accuracy or fairness. No representation or warranty, express or implied, is given by or on behalf of ABN AMRO, or any of its directors, officers, agents, affiliates, group companies, or employees as to the accuracy or completeness of the information contained in this document and no liability is accepted for any loss, arising, directly or indirectly, from any use of such information. The views and opinions expressed herein may be subject to change at any given time and ABN AMRO is under no obligation to update the information contained in this document after the date thereof.*

*Before investing in any product of ABN AMRO Bank N.V., you should obtain information on various financial and other risks and any possible restrictions that you and your investments activities may encounter under applicable laws and regulations. If, after reading this document, you consider investing in a product, you are advised to discuss such an investment with your relationship manager or personal advisor and check whether the relevant product—considering the risks involved—is appropriate within your investment activities. The value of your investments may fluctuate. Past performance is no guarantee for future returns. ABN AMRO reserves the right to make amendments to this material.*

© Copyright 2021 ABN AMRO Bank N.V. and affiliated companies ("ABN AMRO")