July 21, 2023 07:34 PM GMT

Friday Finish – US Economics | North America

Stimulative, Not Necessarily Inflationary

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Investment in industrial structures is booming and factored importantly in our upward revision to GDP forecasts this week. Common pushback has been: "Won't increased activity lead to higher input costs that drive up inflation (and make the Fed's job harder)?" Possible, but not probable.

From the desk of the US Chief Economist

This week we revised our 2023 GDP forecasts sharply higher (+0.9pp to 1.3% 4Q/4Q), and the upgrade did not come from traditional sources. To be sure, our core views remain intact – consumption is slowing, core inflation is sticky but decelerating, job growth is slowing, the housing correction has bottomed, and the Fed is set to deliver a final 25bp hike next week. But industrial policy is fueling a boom in manufacturing and nonresi construction that we had accounted for but underestimated. Won't the boom also push inflation higher? We argue against that conclusion, pointing to moderating construction costs, rising construction labor supply, and potential productivity gains.

Earlier this week we highlighted two key sources behind a sharp upgrade to our GDP forecasts – nonresidential structures investment and public investment in infrastructure. These sources reflect industrial policies addressing what's been persistent underinvestment at the public level, as well as reducing future supply chain risks and boosting US manufacturing competitiveness.

The rebound in nonresidential structures investment has been led by manufacturing, where we are tracking a third straight quarter of double-digit annualized increases through 2Q23. **Manufacturing construction has shown broad strength, with nominal construction spending for "computer, electronic, and electrical" up 235% in the 12 months through May, and other manufacturing spending up 7%.** The data we are seeing jibe with findings from our Multi-Industry equity analysts, who noted this week that electrification drivers such as grid, EV, infrastructure, data center/AI, renewables, near-shoring, and heating confirm that "electrification is real, happening now, and likely to persist through a construction or IP slowdown."

Our LatAm economists and strategists have been highlighting the cross-border benefits between the US and Mexico of "nearshoring," while special questions included in our latest Morgan Stanley Business Conditions Index (MSBCI) revealed that a large majority of our equity analysts noted companies under their coverage are engaging in some combination of nearshoring, "friendshoring," and "onshoring" – most notably the Multi-Industry and IT Hardware sectors.

Rather than increased activity putting upward pressure on inflation, however,

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moderating construction costs have provided an even greater lift to inflation-adjusted nonresi structures investment, with prices rising at an 8.6% annual rate in 1Q – elevated, but only about half the pace of the prior four quarters. **Price data for 2Q show further slowing.** As such, we are tracking a significant acceleration in real nonresidential structures investment in 2Q – a whopping 27.7% annualized pace.

Construction is a labor-intensive endeavor. When demand for labor increases while supply is scarce, nominal wages will increase, but it need not lead to higher inflation. **Our previous research shows that wage-price pass-through to core inflation is low and has been decreasing over time,** especially for goods producers and some parts of services. Nominal wages are simply a less important driver of inflation. **Construction and manufacturing labor supply is rising.**

Finally, infrastructure investment historically carries large multipliers (2X or even greater) and has the ability to meaningfully lift the longer-term trajectory of productivity and potential GDP growth. Forecasting productivity comes with wide uncertainty bands, but it's no fool's game: **productivity increases act as a governor on inflation – higher productivity lowers companies' unit labor costs, reducing upward pressure on prices.**

On monetary policy: We continue to see the peak federal funds rate at 5.375% this year when the Fed delivers a final 25bp hike next week. Core PCE inflation is tracking below its projections and we expect will lead to a downgrade in the Fed's inflation forecasts at the September meeting, prompting a move away from an asymmetric tightening bias toward a more neutral stance. Though our revisions to GDP growth suggest the economy is not tracking soft enough for disinflationary pressures and labor market slack to build more quickly, core inflation and job creation are moving in the right direction. We think this backdrop supports our expectation that policy remains on hold for an extended period, allowing the policy stance to become more restrictive as inflation recedes before the Fed delivers the first cut in March 2024.

Enjoy your weekend.

Ahead of the initial data release on July 27 we are tracking 2Q GDP growth at an annualized 1.8%. See US Economics: GDP Forecast Change: More Than A Mark-to-Market (20 Jul 2023).

Data I'm watching next week: Key Data Watch Calendar.

Conf. Board Consumer Confidence (Tuesday, 10:00am): We forecast Conference Board Consumer Confidence in July to come in at 118.1, an improvement from 109.7 in June. This comes off the back of a stronger report for the University of Michigan Consumer Sentiment, improved stock market performance, and lower gas prices.

Durable Goods (Thursday, 8:30am): We forecast durable goods to rise 0.54%M in June (P), following May's increase of 1.8%M.

GDP (Thursday, 8:30am): We are tracking GDP at 1.8% Q/Q annualized growth in 2Q23, similar to the 1Q pace, but final private domestic demand slows to 2.0% Q/Q from 3.2%. The slowdown is led by consumption (1.5% growth vs 4.2% in 1Q), even as business fixed investment reaccelerates to a solid 5.4% pace. Business structures investment was surging in 2Q (up at an estimated +28% annual rate), offsetting some ongoing decline in equipment spending. We expect less weakness in residential construction—homebuilding has turned upward. Inventories probably were rebuilt in 2Q (a 90bp contribution), reversing a bit less than half of the 1Q destocking. A wider trade gap subtracts 110bps, more than reversing last quarter's improvement.

Employment Cost Index (Friday, 8:30am): We forecast the employment cost index for 2Q23 grew at a 1.1% Q/Q non-annualized pace (4.7%Y) vs. 1.2% in 1Q23 (4.9%Y). This is a slight slowing, but private wages continue to rise rapidly.

Personal Income and Spending (Friday, 8:30am): Incorporating our retail sales forecast we forecast personal spending increased 0.44%M in June vs. 0.12%M in May. Real consumption would increase 0.25%M vs. 0% prior. A solid labor income proxy from the June employment report points to a 0.37%M increase in June vs. +0.40% in May. Altogether, this lowers the saving rate from 4.6% to 4.5%. Final: Incorporating CPI and PPI inputs, we forecast for core PCE inflation at 0.16%M in June vs 0.31% in May, and headline at 0.16%M vs 0.13%M last month.

Weekend Reading/Listening:

- US Economics & Global Macro Strategy: FOMC Preview: July Meeting (20 Jul 2023)
- Thematic Thursday: Rising Regions in the Multipolar World (20 Jul 2023)
- Global Economics & Equity Research: Navigating a Different Housing Cycle (17 Jul 2023)
- Podcast: The Weekly Worldview: Inflation Data Dependence (17 Jul 2023)

Past Friday Finish Commentary:

- Friday Finish – US Economics: Strong Views Are Worth Repeating (14 Jul 2023)
- Friday Finish – US Economics: Focus on Services (7 Jul 2023)
- Friday Finish – US Economics: Risks Beyond July (23 Jun 2023)
- Friday Finish – US Economics: Don't Connect The Dots (16 Jun 2023)
- Friday Finish – US Economics: Answering Your Questions on Jobless Claims (9 Jun 2023)
- Friday Finish – US Economics: The Law of Inertia (2 Jun 2023)
- Friday Finish – US Economics: When Little Pent-Up Demand Is Left

(26 May 2023)
- Friday Finish – US Economics: Roadmap to a June Hike (19 May 2023)

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