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# Growth is unlikely to last

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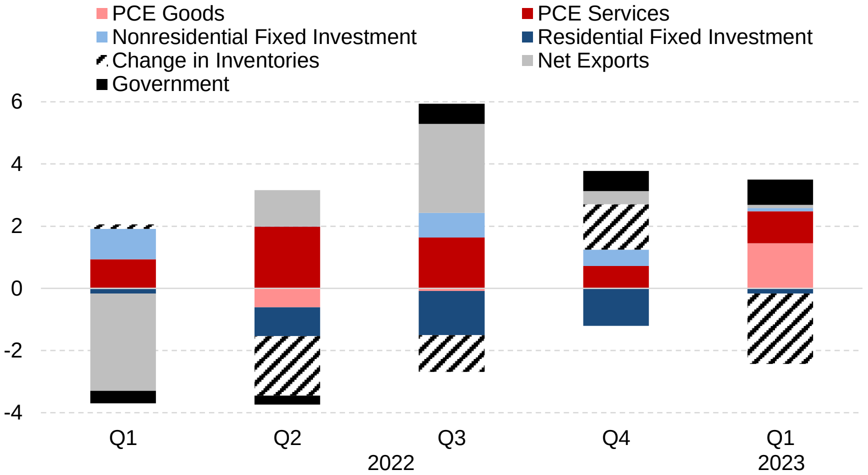
- Changes in durable goods inventories weighed down GDP growth in Q1. January's strong growth in real personal consumption carried overall economic output, but subsequent months reflect a broader slowdown in spending. The US may experience intermittent bumps in consumption in Q2 if fiscal year end bonuses and pay raises are larger than normal, but overall, trends in consumer spending and savings indicate less economic activity this quarter.
- The Fed's preferred inflation measure showed stubborn price growth in March, with their explicit 2% target becoming increasingly out of reach in the near-term. For price growth to average 2%, a non-trivial share of spending categories will need to be deflationary. Core goods carried that hope with strong disinflation in 2022, but price growth has since been flat and remains positive. Additionally, the Employment Cost Index (ECI) showed strong growth in wages and salaries in Q1, especially in goods industries. Slowing consumption and upward cost pressures will likely impact corporate margins in 2023.

### The economy started off strong, but it likely won't last

First quarter real GDP came in below expectations at 1.1%, but growth was strong in nearly all major components including personal consumption, net exports, nonresidential fixed investments, and government consumption. Final sales of domestic product signal a much stronger Q1, with annualized growth at 3.3%. However, much of this growth was concentrated in January and the remaining months indicate slower output in Q2.

Growth in government consumption will likely continue throughout 2023 and 2024. Negotiations on the US debt ceiling are ongoing, but the war in Ukraine and increased tensions with China are drawing bipartisan support for more national defense spending. The aging population also ensures continued spending growth on Medicare and Social Security both in the short and long-term.

**Inventory changes brought down output in Q1**
*Contributions to percent change in real GDP, % points*



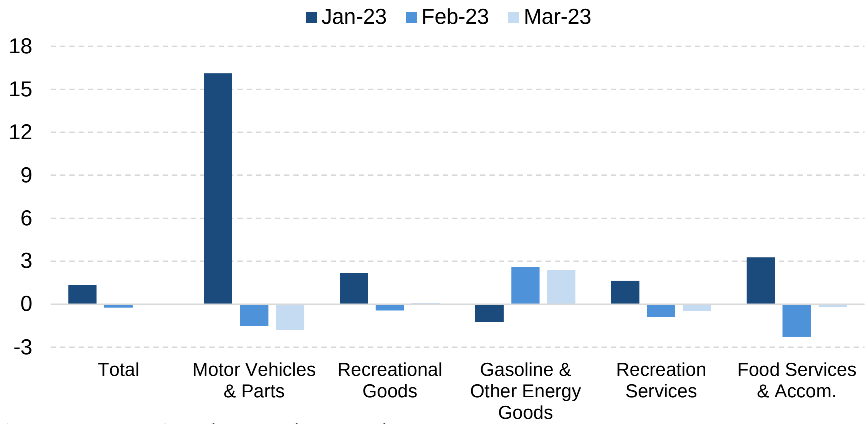

Source: BEA, MUFG Bank Economic Research

Growth in nonresidential fixed investment was slightly positive in Q1, contributing 0.1 percentage points to real GDP. Residential fixed investment was slightly negative, but much less so than in previous quarters. Construction starts for single-family homes may have reached their trough in Q1, with sales of new homes potentially at a new equilibrium in relation to mortgage rates. Growth is not likely as long as interest rates are expected to stay elevated for much of 2023, but significant housing shortages may limit further declines.

The largest positive contributor in Q1 (and overall driver of the US economy) was personal consumption. Goods consumption contributed 1.45 percentage points to overall GDP growth, a stark contrast to the last 4 quarters of negative growth, and services consumption continued their positive contribution (1.03 percentage points).

**Strong spending growth in January carried overall Q1 growth**

*Growth in real personal consumption, %*



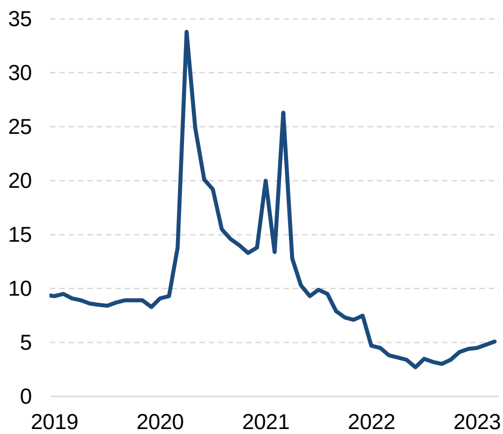

Source: BEA, MUFG Bank Economic Research

January was a particularly good month for the economy, with real personal consumption growing by 1.35%. Warmer than usual weather helped contribute to increased consumption in discretionary spending categories such as food services and accommodation, recreational goods and services, and potentially even durable goods. Motor vehicles may have benefitted to some degree from these factors, though improvements in auto inventories and pent up demand were likely the main drivers.

In the rest of Q1 (February and March), growth in real personal consumption was negative. Some of this decline can be viewed as a correction in spending from when the transitory effects of January wore off, but February and March were also unusually warm, so weather doesn't fully explain the difference. Robust growth in January likely also came from the historically large Cost of Living Adjustments (COLAs) for Social Security recipients (which are tied to annual changes in the CPI-W), pent up demand for certain goods, and just plain noise in the data.

**Growing savings will weigh on future spending**

*Personal savings rate, %*



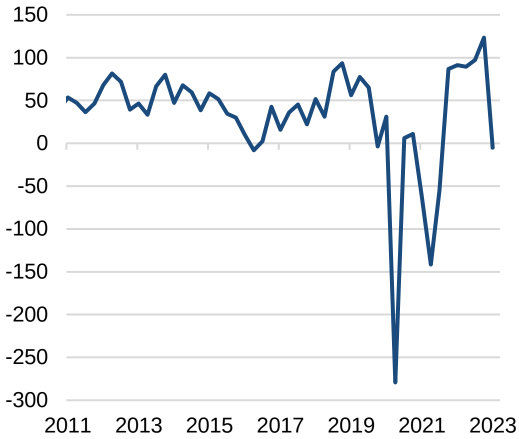

Source: BEA, MUFG Bank Economic Research

The second quarter of 2023 will likely show much slower spending growth than in Q1, evidenced by the trend in the personal savings rate. Though still lower than the pre-pandemic rate, the personal savings rate has been growing since June of last year and it now stands at 5.1% as of March, up from 4.8% in February and 4.5% in January. This upward trend is expected to continue, and consumption will come at the expense of increased savings. But like COLAs in January, fiscal year end salary increases and bonuses may be large by historical standards if employers take inflation into account, so isolated bumps in consumption may occur in Q2 for specific spending categories.

Growth in Q1 was weighed down by changes in inventories, specifically in durable goods which contributed -2.38 percentage points to overall real GDP growth. Though significant, this drop is likely not a distress signal on its own for durable goods industries. Typically, inventory shortages (like in 2020 and 2021) are followed by gluts (like in 2022). The start of 2023 is, to some extent, a correction of the glut that followed the shortage. Inventory challenges, however, are unlikely to be fully resolved in 2023. Supply chain issues still impact certain industries and recession uncertainty which will likely sustain volatility in inventories.

**Gluts in durable goods inventories are clearing out**

*Inventory changes, durable goods, billions*




Source: BEA, MUFG Bank Economic Research

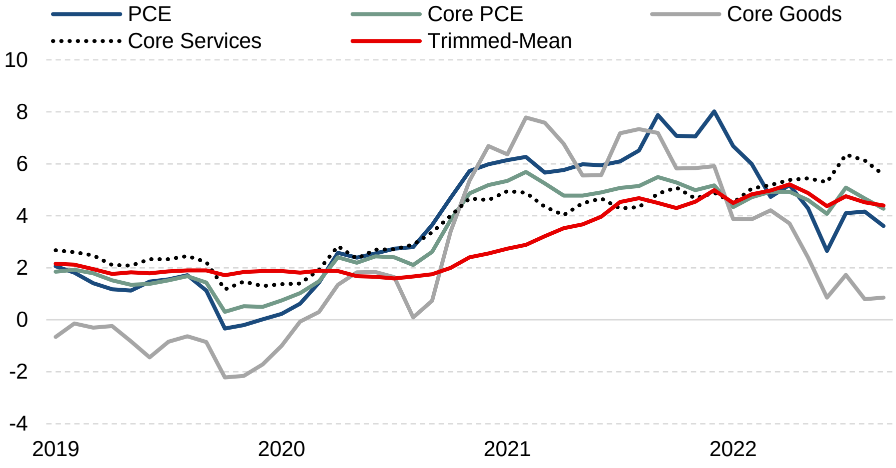
**The Fed's inflation target is unlikely to be met soon**

There is no clear path to reach the Fed's explicit 2% inflation target. Indeed, certain spending categories from the Fed's preferred measure (PCE Price Index) have been strongly disinflationary and others, like housing, will predictably be so this year. On an annual growth basis, core PCE is also somewhat promising, with 4.6% growth in March, down slightly from 4.7% in February.

However, outliers can often cloud the signal. The Dallas Fed's trimmed-mean PCE attempts to correct for outliers, and it shows a much more stubborn inflation picture. The trimmed-mean PCE grew 4.4% in March at a 6-month annualized basis. Since January of last year, the index has hovered between 4-5% with no apparent downward trend.

**Core inflation is struggling to fall below 4%**

*PCE Price Index, 6-month % change, AR*




Source: BEA, Dallas Fed, MUFG Bank Economic Research

For inflation to average 2%, there need to be spending categories that experience deflation (or negative price growth). In the years before COVID, price growth for core goods regularly landed below 0, which helped counterbalance slightly higher core services inflation. Core goods carried this hope with strong disinflation in 2022, but price growth has since stopped falling. Core goods inflation has been flat at around 0.8% on a 6-month annualized basis since December 2022.

Inventory issues for autos will apply upward pressures on core goods, despite the anticipated drop in consumption in Q2, and high wage growth will apply upward cost pressures. The Q1 Employment Cost Index (ECI) showed that wages and salaries grew by 5.3% on a 2-quarter moving average annualized basis in good-producing industries, and by 4.6% in service-providing industries. Wage growth at this level, given today's productivity growth, is consistent with 4% price inflation.

**ECI wage growth is consistent with 4% inflation**

*Employment Cost Index (ECI), 2-quarter moving average, % AR*


Source: BLS, MUFG Bank Economic Research

### Another hike in May

Accelerating labor costs and waning demand in goods will likely impact corporate profit margins in 2023, and job losses usually follow. Goods industries experienced virtually no employment growth in March, and they may begin to show employment losses as soon as Q2. Despite this, the Fed will likely interpret Q1 GDP and ECI, and March PCE as the economy needing further demand restriction. The unemployment rate remains historically low and wage growth too high for inflation to fall to their 2% target. An additional 25 basis point hike is the most likely scenario in May's FOMC meeting.

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