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A soft landing requires strong assumptions

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■ Second quarter GDP growth shows a US economy that continues to expand, and June PCE inflation shows price growth that is slowly falling. All this rides on the back of historically rapid interest rate hikes that began early last year. However, for this to continue, strong assumptions need to be made about the relationship between prices, economic growth, and the labor market. Tolerating higher inflation or accepting a recession is still the likely trade-off.

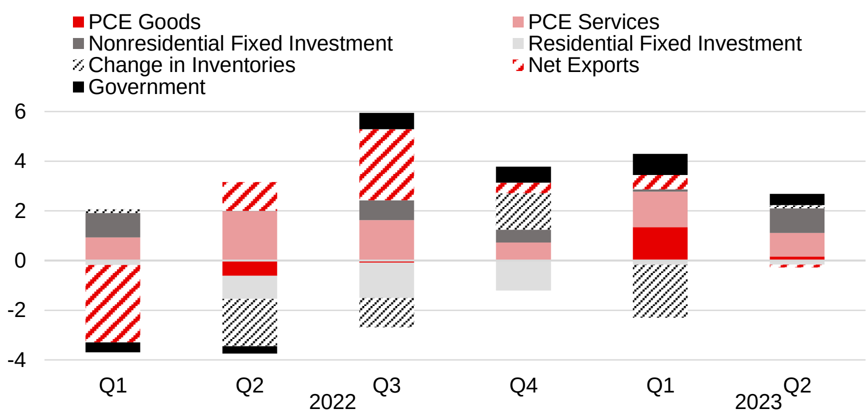
Strong economy and more transactions

Second quarter GDP shows a strong US economy that has defied recession forecasts, with real GDP growing 2.4% at an annual rate, compared to 2% growth in Q1. Services consumption, nonresidential fixed investments, and government expenditure strongly contributed to the growth in real GDP. Goods consumption was also positive in Q2, though less than in Q1. Overall, final sales of domestic product drove most of the expansion in Q2, contributing 2.27 percentage points to real GDP growth.

Residential fixed investment is the only component of GDP that is consistently contracting, and that is a direct result of rising interest rates. Nonresidential fixed investment would likely be more negatively impacted by this tightening cycle if it weren't for fiscal policy, namely the IRA and CHIPS Act, which has pushed constructing spending in manufacturing to record high levels. Fed policy has been much less effective at reigning in growth in other components of the economy, especially consumer spending.

Growth in real PCE (Personal Consumption Expenditures) has been stronger this year despite contractionary monetary policy. Core goods consumption grew an average of 0.7% per month in the first half of this year, compared to 0.5% in the first half of last year. Core services consumption has been consistently strong, growing an average of 0.3% per month in the first half of both this year and last year. And since personal consumption is by far the largest component of GDP and the driver of the US economy, it would be difficult to argue the broad effectiveness of contractionary monetary policy so far.

Service consumption kept growth strong in Q2
Contributions to percent change in real GDP, % points



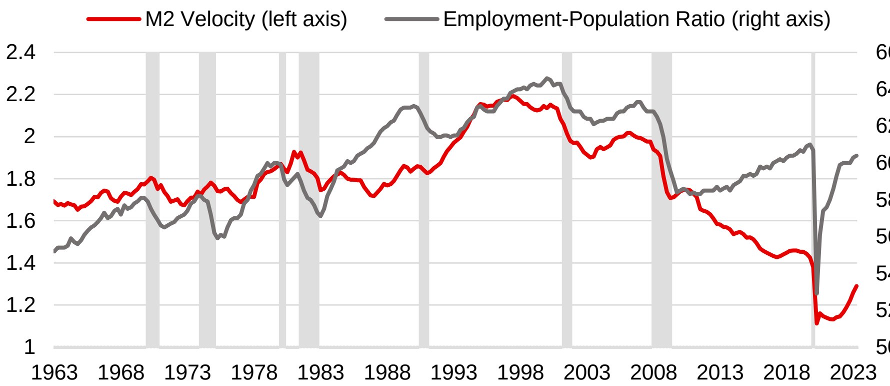
Source: BEA, MUFG Bank Economic Research

That isn't to say that monetary policy isn't effective or that it won't be. But it does call into question our assumptions about both the lag of monetary policy and the level of interest rates. Historical data suggests that monetary policy works with a 12-18 month lag, so there is still time to "wait and see" if the current level of rates is sufficiently restrictive. The problem is, we are coming off the back of a decade of unprecedently low interest rates and unprecedently high money growth in the form of quantitative easing. It's likely that today's contractionary monetary policy will operate with a much larger lag than it has historically, and waiting for it to kick in may come at a cost.

There is a clear appetite to spend in the US. This is evidenced not only by the consumer spending numbers referenced earlier, but also by the rate at which transactions are occurring, or the velocity of M2 money stock. The velocity of money is the frequency at which one dollar is spent to buy goods and services per unit of time and is calculated as the ratio of GDP to M2 money supply.

Transaction frequencies are quickly growing in the US, indicating more spending than saving

Money velocity and employment-to-population ratio, quarterly



Note: M2 Velocity is calculated as the ratio of nominal GDP to M2 money stock
Source: Federal Reserve, BEA, BLS, MUFG Bank Economic Research

Money velocity has accelerated in the last 2 quarters, driven by both expanding economic output and falling money supply from the Fed's "quantitative tightening." This shows that more transactions are occurring between individuals in the economy. On its own, accelerating money velocity does not necessarily mean higher inflation, but it does suggest that more money is being spent than is being saved. Combined with the strong labor market, inflationary pressures are still very strong in the US and the recent disinflation may be short lived.

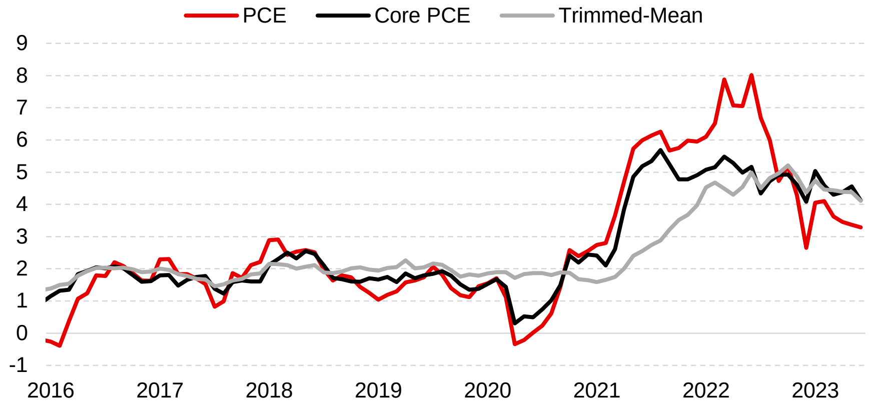
Deceptive disinflation

June's PCE deflator showed its strongest signs of disinflation in months, with core PCE falling to 4.1% at a 6-month annualized growth rate, down from 4.6% in May. This marks a substantial drop, but also a very similar drop that occurred in December of last year when core PCE fell from 4.6% to 4.1% at a 6-month annualized growth rate. Inflation is essentially the same today as it was 6-months ago. This should take away some of the optimism over the trajectory of core PCE, since inflation quickly reversed back then and it could do so again.

June's disinflation, however, may be stronger than what we saw in December 2022. The trimmed-mean PCE, calculated by the Dallas Fed as a way of excluding price growth outliers, fell to 4.1% at a 6-month annualized growth rate, down from 4.4% in December 2022. By this measure, inflation is indeed lower now than it was 6 months ago.

While this is good news, it's unclear how this disinflation has come about. As described earlier, the economy is still expanding at a strong rate and consumers are still spending. There is little evidence that interest rates have substantially slowed the economy, but inflation is still falling. Hope for a soft-landing rests on the expectation that inflation will continue to fall and the economy will continue to expand, consumers will continue to spend, and the labor market will continue to be strong. This assumption flies against long held theories about inflation and the dynamics of prices, unless the Fed is willing to accept inflation that is above 2%.

Core inflation is starting to ease, but remains above 4%
PCE Price Index, 6-month change, % AR



Source: BEA, Dallas Fed, MUFG Bank Economic Research

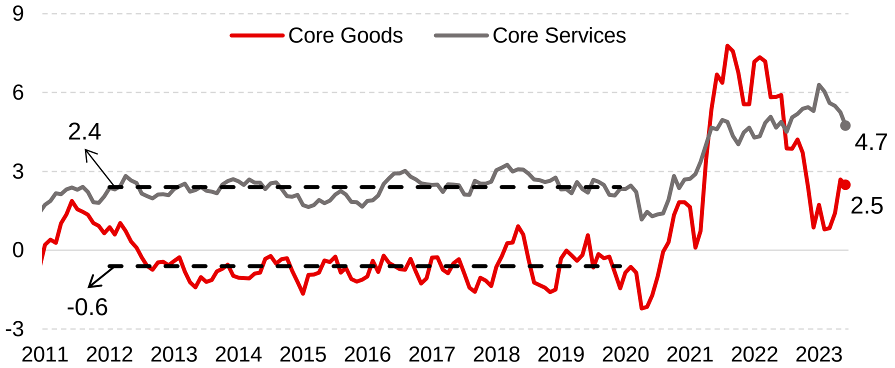
The shrinking money supply, normalizing of consumption habits, and easing of supply side issues have likely been the largest contributors of disinflation so far. And of the three contributors, only the shrinking money supply (i.e., reducing Fed balance sheet) is likely to have a continued impact, absent a shock to the economy.

The only problem is that the money supply is falling at a very slow rate. The Fed is not actively selling off securities, but rather, it is allowing them to mature without reinvesting. At this rate, it will likely take years to undo the monetary and fiscal stimulus that was built up immediately after the pandemic began. From this perspective, a soft-landing is still possible, but the US economy would have to endure a slow burning inflation that remains above 2% for a considerable time.

This is also clearly shown when looking at core goods and core services inflation relative to historical averages. From 2012 to 2019, when inflation was historically most stable around 2%, core goods inflation averaged -0.6% at a 6-month annualized growth rate. In June 2023, core goods grew by 2.5%, well above what would be needed to average 2% for overall price growth.

There still appears to be a trade-off between higher prices and a recession. The US may be able to escape a recession if the Fed is willing to tolerate price growth above 2% for a considerable length of time. But if the Fed hopes to accomplish their goal of price stability as soon as possible, a recession will likely be needed to shock the economy.

Core goods inflation is well above the pre-pandemic average
PCE Price Index, 6-month change, % AR



Note: Dotted lines represent the 2012-2019 average
Source: BEA, MUFG Bank Economic Research

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