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Strong consumption, weaker investment

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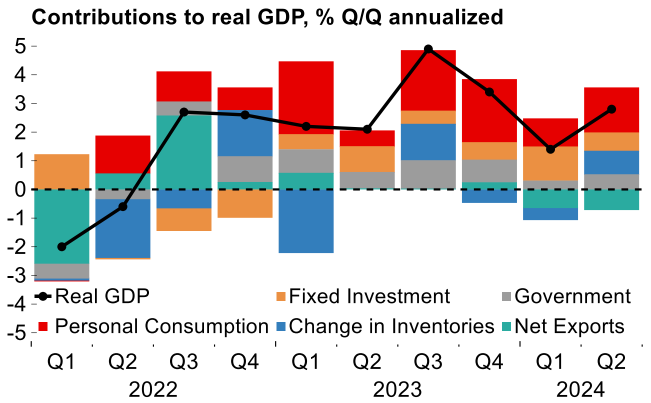
- Growth in real GDP accelerated in Q2 from a recovery in durable goods consumption of motor vehicles and parts, and inventories of wholesale and retail trade industries. Services spending remained strong, highlighting the resiliency of the US consumer, but domestic investment is beginning to show signs of weakening. Growth fell for both residential and nonresidential structures, and equipment investment was buoyed by the aircraft industry.
- PCE inflation has fallen back down to levels experienced in Q4 2023, with core services components now driving disinflation. The probability of re-accelerating services inflation appears low given the broad cooling of the labor market, but upward price pressures are rising for manufactured goods. Geopolitical tensions in the Red Sea have container freight rates rising rapidly and uncertainty around tariff and trade policy after November's presidential election are adding to inflation risks.

Consumer spending is sustaining growth

The economy grew slightly above expectations in Q2 2024, with real GDP expanding at an annual rate of 2.8%, up from 1.4% in Q1 (Chart 1). Growth was poised to accelerate in the second quarter given that much of the slowdown in Q1 came from the automotive sector and volatile inventories.

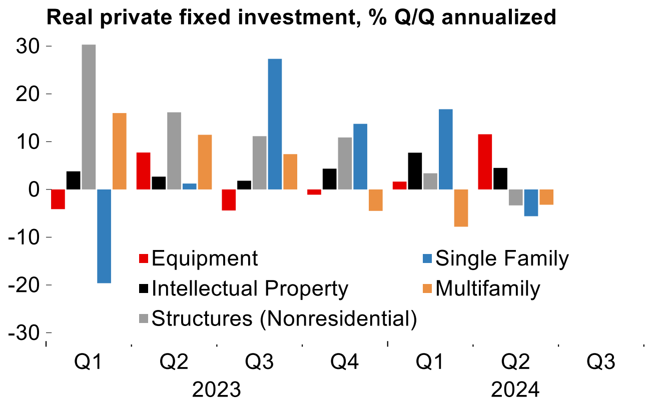
Goods consumption grew by an annualized 2.5% in Q2, with motor vehicles and parts consumption growing by 4.8% (after a dramatic negative 14% growth in Q1). Services consumption slowed, but growth remained strong at 2.2%. Even when excluding housing, utilities, and healthcare, services spending grew by an annualized 1.6%. In aggregate, domestic demand continues to be strong in the US, with final sales to private domestic purchasers expanding by an annualized 2.6%, closely in line with the pre-pandemic average of 3% annualized quarterly growth.

Chart 1: Personal consumption of both goods and services is sustaining economic growth



Source: BEA, MUFG Bank Economic Research Office

Chart 2: Investment in equipment accelerated in Q2, while investment in residential and nonresidential structures is falling



Source: BEA, MUFG Bank Economic Research Office

On the consumer spending front, there is virtually no indication that the economy is slowing down. While yes, household excess savings have largely been depleted, credit card and other consumer loan delinquency rates are rising, and household credit to deposit ratios are starting to fall across most income groups. All of these trends point to an eventual slowdown in consumption, but these downward pressures have yet to materialized in the actual spending data.

Where you see a slowdown is in fixed investments, particularly in structures. In Q2, growth was negative in real nonresidential structures for the first time since Q3 2022 (Chart 2). The Chips and Science Act that was signed into law in August 2022 subsidized construction of domestic manufacturing facilities for semiconductors (i.e., nonresidential structures), and there are no signs that the stimulative effects are wearing off. Real growth in manufacturing structures is up by around 100% since the bill was passed, the vast majority of which is in the semiconductor industry.

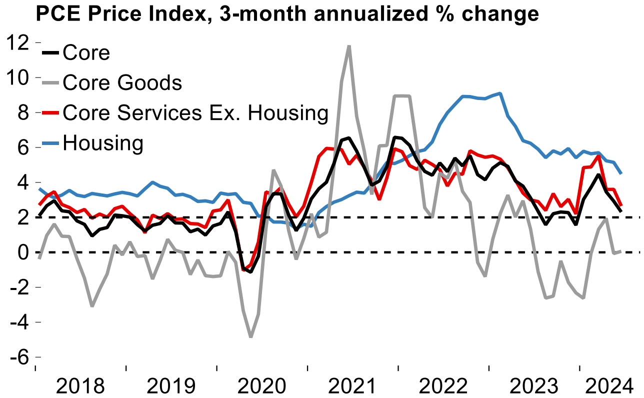
However, there is considerable weakness in other sectors that are not receiving federal support, and notable is the decline in warehousing, healthcare, and office structure investment that occurred in Q2. Additionally, real investment growth in multifamily residential structures continues to be negative and investment in single-family homes has returned to negative growth after hopes of an early Fed rate cut spurred growth in Q1 this year. Investments in equipment have also been broadly weak, with the latest accelerating in Q2 being driven by aircraft equipment and engines and turbines.

Goods inflation risks

As expected from the decline in the CPI, core PCE inflation fell considerably in June and is continuing along a disinflationary trend. Core PCE now stands at 2.3% on a 3-month annualized basis, down from 2.9% in May. As with the CPI components, core PCE services are driving much of the disinflation, with core services excluding housing falling to 2.7% in June, down from 3.6% in May, and housing inflation falling to 4.5% in June, down from 5.2% in May (Chart 3).

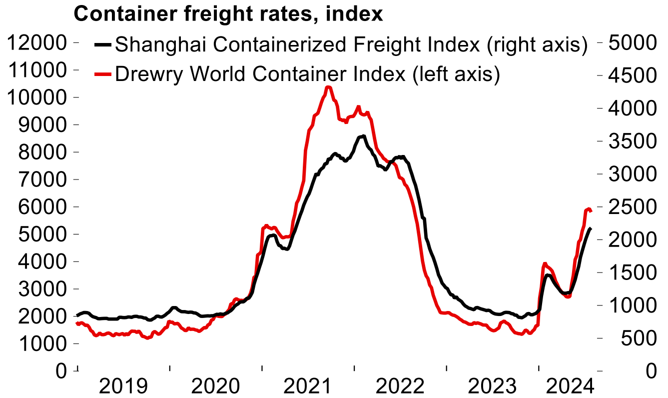
This progress in "super-core" inflation is increasing the odds of a Fed rate cut to occur before Q4 this year. Consistent improvements in labor supply are easing supply-side cost pressures in the services sector, helping to bring wage growth down. And if productivity growth continues, there is an expectation that unit labor costs will fall and there will be less passthrough of wages into prices. Under the current trajectory, the risk of a re-accelerating services prices remains relatively low.

Chart 3: Inflation has fallen back down to growth levels experienced in Q4 2023



Source: BEA, MUFG Bank Economic Research Office

Chart 4: Geopolitical tensions in the Red Sea pose an inflation risk for manufactured goods



Source: Macrobond, MUFG Bank Economic Research Office

The situation is much less certain for goods inflation, where although core goods PCE has fallen back down to near zero percent in June, there are growing pressures that may not have fully materialized yet. Geopolitical tensions in the Red Sea have intensified, and major container shipping companies have altogether avoided the Suez Canal, where 10-15% of global trade passes through. This has added to shipping costs considerably, and container freight rates have risen rapidly (Chart 4).

Though this is representative of a transitory supply-side disruption, it's not clear when it will subside or how much of an impact it will have on prices of imported manufactured goods. Additionally, there is considerable uncertainty around the results of November's presidential election which could see a dramatic shift in trade policy and tariffs levied on imported goods. Upward inflationary pressures are now predominately in consumer goods. This may not impact monetary policy in 2024, but the Fed may become reactive in the first half of 2025.

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