United States Economic Update

National Australia Bank

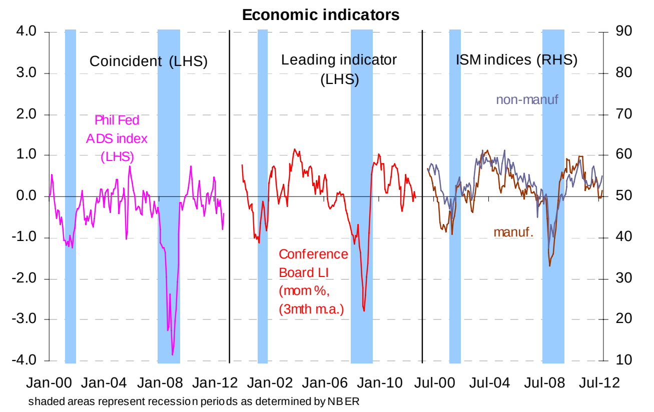
- **While the U.S. economy has been growing at only a modest rate, the unemployment rate dropped sharply in September to its lowest level since January 2009.**
- **A big uncertainty is the direction of business investment. We expect a recovery in business investment from the December quarter, consistent with still reasonable fundamentals but there is a downside risk.**
- **September quarter GDP is tracking slightly higher than in the June quarter, and is expected to strengthen further over the rest of 2012 and into 2013. We are forecasting GDP growth of 2.1% in 2012 and 2.4% in 2013.**

Overview

GDP growth was only 0.3% qoq in the June quarter and partial indictors suggest that is was only slightly higher in the September quarter. This is consistent with the finding of the Federal Reserve's 'Beige book' released this week, which brings together qualitative information received from its business contacts, which summed up activity as 'expanding modestly'.

However, the unemployment rate dropped sharply in September, and while this may partly reflect survey volatility, non-farm employment continues to grow solidly. Broad indicators of the U.S. economy, while not strong, have stabilised and some are starting to move back up. Several of these indicators are presented below. The Aruoba-Diebold-Scotti Business Conditions Index in August even momentarily fell below its recession warning level of 0.8, and while it has since recovered it is still indicating growth is below trend. This is also the implication of the Conference Board's leading indicator which has been flat recently, again consistent with below trend growth. The manufacturing ISM survey which indicated contraction in that sector over June to August moved into positive territory in September, while the non-manufacturing ISM survey also strengthened last month.

Broad economic indicators have stabilised



Source: ISM, Philadelphia Federal Reserve, Conference Board

As noted above, September quarter GDP is expected to be only slightly higher than in the June quarter. We expect annualised quarterly growth of 1.5% (1.3% in the June quarter). Consumption is likely to show modest growth and housing construction continues to grow rapidly. However, the latter is only a small part of the economy and business investment indicators have noticeably weakened and exports are falling. The drought will also be a (small) negative for the quarter.

A big uncertainty is over the direction of business investment, with partial indicators of current investment declining. Surveys suggest that capex intentions are weak but still positive. We expect a recovery in business investment, consistent with the fundamentals of high profits and improving conditions. The risk is that the downturn is more embedded, perhaps driven by concerns over overseas developments and U.S. fiscal policy.

In the housing sector, with the inventory of new homes still very low and sales rising, strong growth is likely for an extended period, and this will be boosted by the Fed's recent QE programme of buying agency MBS. The recovery in house prices should also support household wealth and confidence. Monetary policy is highly accommodative and the Fed has indicated a willingness to do more if growth disappoints. Credit conditions also continue to improve. As a result, the slow recovery will continue although we expect it to strengthen over the rest of 2012 and into 2013.

Nevertheless, growth will be consistent with only a slow reduction in the unemployment rate over time. Activity continues to be constrained by household balance sheet repair (although this may be fading), the weak global environment, contractionary fiscal policy and a generally high level of uncertainty around policy and overseas developments.

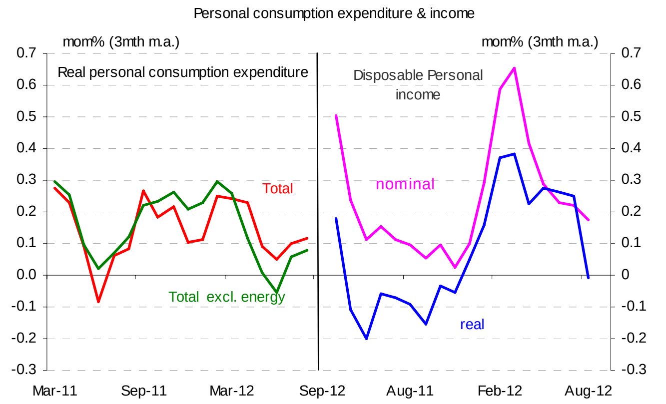
Overall, we expect GDP growth of 2.1% (previously 2.2%) in 2012 and 2.4% in 2013 (previously 2.6%). The downwards revisions mainly reflect the BEA's downwards revision to June quarter growth in its third estimate as well as a lowering of business investment in line with current indicators. The main downside risks remain the possibility that fiscal policy will de-stabilise confidence and/or be significantly contractionary in 2013, and spill-overs if there were a major deterioration in the Euro-zone.

Consumption

Real consumption was subdued in August growing by only 0.1% mom, although this followed strong growth in July (0.4% mom). Overall, the trend in private consumption points to only modest growth, although it is off mid-year lows. The recent run-up in gasoline prices has led to spike in inflation which has compressed real income growth. The lingering effects of this may continue to affect consumption for a few more months. That said, auto sales grew in September by 3.0% mom (similar to the August growth rate), suggesting reasonable underlying momentum.

While nominal household income growth remains modest, recent trends have been favourable to household wealth, with house prices continuing to rise as are equities. Household net wealth (as a percentage of disposable income) remains low by the standard of the last decade and households are likely to keep trying to strengthen their balance sheets, although the pace at which this is occurring may be slowing down (see this month's Spotlight *Household balance sheets* for further discussion).

Despite pressure on incomes, consumption up from recent lows

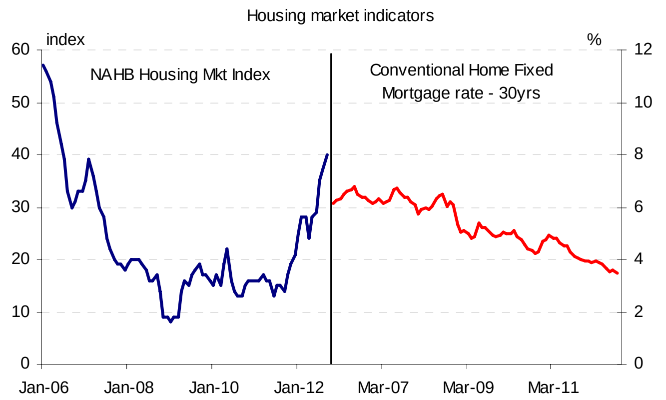


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, NAB

Housing

Housing continues to be the star performer in the US economy – at least in terms of growth rates (the level of activity is still weak by historical standards). While permits declined slightly in August, the trend is still upwards and is translating into actual construction. Private new residential construction expenditure between March and August grew at an annualised rate of 36%. In September, the NAHB Housing Market Index moved to its highest level in over six years. Moreover, the Fed's September stimulus measures were targeted towards the housing sector - the additional asset purchases (QE 3) are entirely made-up of mortgage-backed securities. This will place further downwards pressure on already historically low retail mortgage rates and will provide further impetus to the housing recovery.

Fed adds further impetus to strongly growing housing market

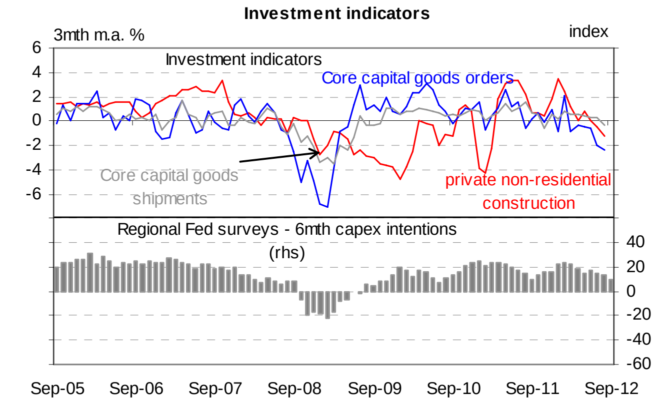


Source: Federal Reserve, National Association of Home Builders

Business investment

Partial indicators of business investment continue to weaken. Core capital goods shipments declined for the second month in a row in August. While core capital goods orders rose 1.1% mom in August, this was disappointing after large falls over the previous two months. Capex intentions from the Fed regional manufacturing surveys also declined again in September, although they remain positive. As a result we have significantly marked down our forecasts for the September quarter.

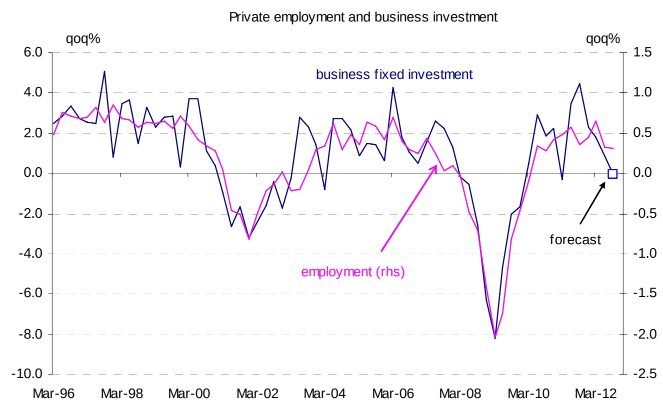
Indicators of business investment continue to weaken



Sources: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves

The big question is where to from here. We continue to see the current weakness as largely being temporary. While business profits have flattened out in recent quarters, they remain at high levels, and credit conditions have generally been improving. Historically, these indicators have been a reasonable guide to the future direction of investment. Moreover, businesses are continuing to add jobs which generally occurs when business investment is also growing. When there was a decline in business investment in the March quarter 2011, there was a subsequent rebound the following quarter (although the 2011 experience was more narrowly based as it reflected movements in structures investment).

Divergence between business investment in labour and capital



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

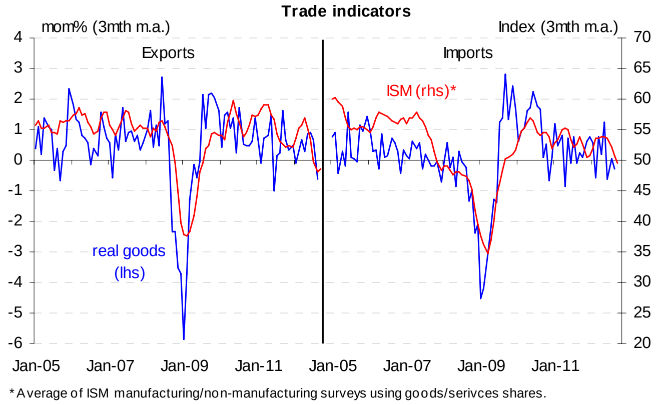
There is a risk however, that the investment downturn is more embedded, perhaps driven by concerns over overseas developments and the U.S. 'fiscal cliff' (there are many anecdotal reports, for example, of defence companies already starting to wind back). In this scenario, the business cutbacks would ultimately be reflected in hiring as well.

In the third estimate of June quarter GDP, inventory accumulation was revised down due to a decline in farm inventories. The BEA has also flagged a further negative impact on farm inventories from the drought in the second half of 2012. Outside of the farm sector, early data for the September quarter show inventories growing rapidly, although this is unlikely to be sustained.

Trade

Export volumes are now starting to match the weakness that has been signalled in the ISM surveys, and was to be expected given the weakness in the world economy and, until recently, an appreciating US dollar. Real exports fell 2.6% mom in August (after a smaller fall in July). Imports also fell, by 0.9% mom, the second decline in three months. This means that after making a positive contribution to GDP growth in the June quarter, net trade is set to detract from growth. While our combined ISM export indicator is showing signs of stabilising it remained in contractionary territory in September, as did the import measure.

Trade volumes falling

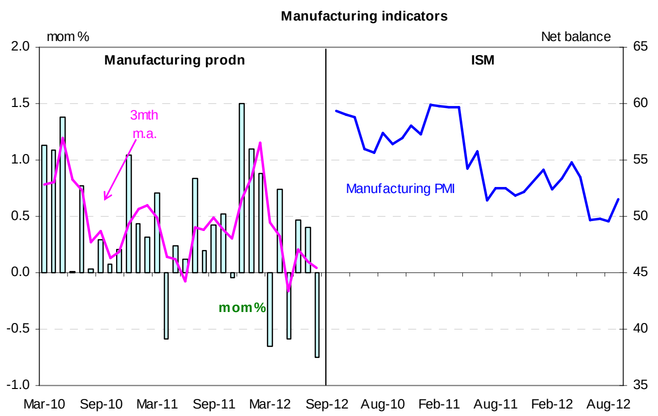


Source: Bureau of Economic Analysis, Institute of Supply Managers

Industrial production

Industrial production declined by 1.2% mom in August, the largest monthly decline in over three years. All three components recorded falls – manufacturing IP was down 0.7%, mining by 1.8% and utilities by 3.6%.

Manufacturing growth flat but ISM suggests bottom has been hit



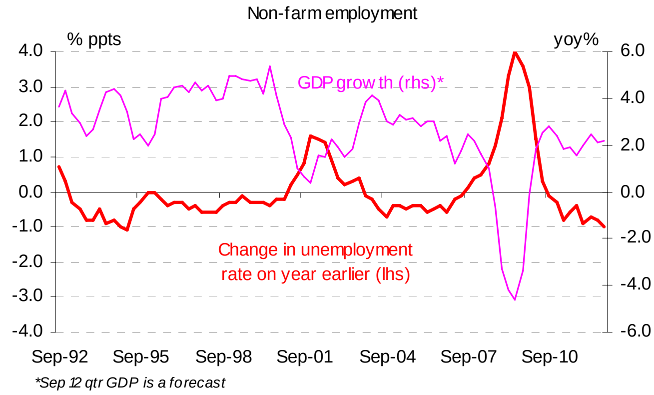
Source: Federal Reserve, Institute of Supply Managers

The decline in manufacturing IP followed increases in the previous two months. Looking through the monthly volatility manufacturing IP has been essentially flat since early 2012. The decline in manufacturing IP was consistent with the contractionary reading for the ISM manufacturing PMI for the same month. However, the ISM moved above 50 in September, with improvements in most categories, suggesting that the worst has passed, although labour market indicators for manufacturing point to only weak growth in September.

Labour market

The unemployment rate declined by 0.3 ppts in September to 7.8%, its lowest level since January 2009. This followed a 0.2 ppts decline in August. Over the last year it has fallen by 1.2 ppts. The household employment survey recorded a 873,000 increase in employment; while this is scarcely believable by itself, it followed a decline of over 300,000 in the previous two months. So sampling induced volatility appears to be going on, and while the unemployment rate itself tends to be relatively stable, some correction in future readings wouldn't be a surprise. The latest initial jobless claims data also produced a large surprise, falling from 369,000 to 339,000; however, the improvement was centred in one state and may reflect seasonal adjustment problems.

Large fall in unemployment surprising given pace of GDP growth



Source: Bureau of Labor Studies, Bureau of Economic Analysis, NAB

The extent of the decline in the unemployment rate over the last year is surprisingly large given the pace of growth in the economy. Normally a much more rapid pace of GDP growth is required to reduce the unemployment rate by over 1 ppt. Almost half of the (projected) 2.2% growth in GDP over the year to September quarter 2012 occurred in the December quarter, and any lagged affect from this will be fading. Part of the explanation lies in the participation rate. This has been trending downwards reflecting demographic and societal factors as well as the absence of any cyclical rebound following the recession.

The other headline measure in the employment report is non-farm employment from the payrolls survey. This increased by a modest 114,000 although there were also upwards revisions to the prior two months of 86,000. Over the last six months non-farm employment has grown by an average of 106,000 a month. This is about all that should be expected given recent U.S. growth. Jobs growth at this level will only bring down the unemployment rate slowly, if at all (depending on the participation rate).

Public demand & fiscal policy

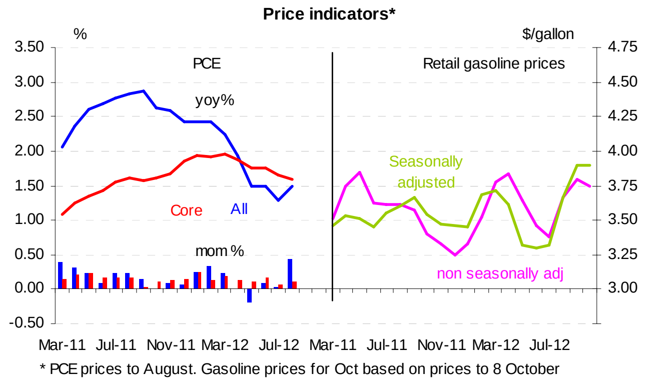
Partial indicators of government demand such as employment and construction suggest that the worst of the state and local government cutbacks are over (unless future Federal fiscal actions could start a new round). Even Federal government employment has increased in the last couple of months, although Federal construction expenditure continues to trend down.

The Federal fiscal stance (which also takes into account income transfers and taxes) remains contractionary. The major uncertainty is the extent of tax increases and spending cuts next year (the 'fiscal cliff'). The Congressional Budget Office has estimated that if the tax increases and spending cuts that make up the fiscal cliff go take effect, the US economy will probably move into recession early in 2013. Progress on addressing the fiscal cliff will have to wait until after the elections in November.

Inflation

Annual personal consumption expenditure (PCE) price growth picked up to 1.5% in August due to recent increases in gasoline prices. Gasoline prices also rose strongly in September, pointing to a further boost in annual inflation in that month. However, more recently world oil prices have stabilised, and with the recent increase in retail gasoline prices partly due to temporary refining issues, the upwards pressure on inflation from energy prices has come to an end for now. However, retail food prices are yet to feel the impact of the drought.

Price pressures subdued despite increases in gasoline in August



Sources: BEA, U.S. Energy Information Agency, NAB Group Economics

Core inflation, which excludes food and energy prices, was unchanged at 1.6% yoy in August. Recent monthly growth rates suggest an even more subdued tone, consistent with subdued wages pressure and (until recently) currency appreciation. Core inflation is expected to track at around current levels for a while, before starting to track back towards 2% from mid-2013.

Monetary Policy

In September the Fed loosened monetary policy by extending its forward guidance on the feds fund rate and through announcing additional asset purchases (QE 3). The Fed also stated that "…a highly accommodative stance of monetary policy will remain appropriate for a considerable amount of time after the economic recovery strengthens". This signals that the Fed will delay rate hikes for longer than would normally be expected. The obvious question is when would the Fed normally tighten policy?

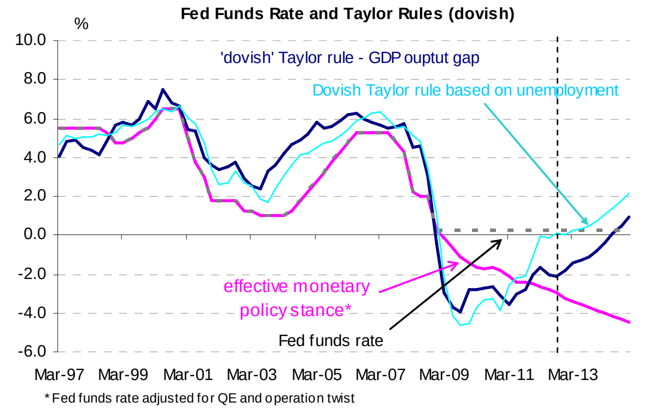
One way to answer this question is to use a Taylor rule, which specifies a path for interest rates given inflation and the gap between output and its potential (the output gap). The problem with this is that there are numerous Taylor rules. Under the original version the Fed would have already increased the Fed funds rate – i.e. they don't have to promise to leave loose policy in place for longer than normal as they are already doing so!

However, many Fed members have indicated a preference for more dovish versions of the Taylor rule; two of which are reproduced in the chart below.[1] One possible rationale for doing so is that the mechanisms by which monetary policy affect the economy have been impaired and so more stimulus is required to get the same impact. Under these dovish rules, if the economy evolves as the Fed expects then the fed fund rate should start to rise by mid 2014 at the latest. That is, if the fed funds rate does not rise until mid-2015 in line with current forward guidance, then the tightening will have been delayed by *at least* one-year relative to what would normally happen. More strikingly, even these 'dovish' rules imply that policy should be tightening now – the negative interest rate generated by these rules is getting smaller, while at the same time the Fed has been loosening the effective monetary policy stance[2].

[1] Dovish' output gap based Taylor rule (1.5+1.5*inflation +1.0*output gap). Unemployment gap based rule = 2.1+1.3* inflation+2*unemp gap). Calculations use mid point of FOMC central tendancy fcsts and CBO estimates of potential GDP and NAIRU.

[2] Based on estimates in The San Francisco Fed Economic Letter (2011-31) *Unconventional Monetary Policy: Lessons from the Past Three Years*. Assumes same impact from each QE round which might overstate extent of loosening as the later rounds may have a smaller impact. However, no allowance is made for the Fed's forward rate guidance and, even if overstated, the direction of policy would not change.

Fed loosening policy as monetary policy rules say tighten



Sources: Federal Reserve, NAB Group Economics

The risk from this strategy is that in future inflation may come under pressure. The Fed wouldn't mind a small pick-up in inflation expectations as long as they remain within normal bounds, as this would mean a reduction in real interest rates. However, they will not want to see above normal expectations as this would risk a higher than desired level of inflation being embedded into the economy which would be costly to undo. If inflation expectations start to move above their normal level there will be a lot of pressure for the Fed to tighten.

The Fed is undertaking a potentially difficult balancing act – it wants consumers and businesses to expect that it will allow a strong recovery by delaying tightening, but the point of rate hikes at such time is to keep inflation and inflation expectations under control, which the Fed also wants. This is not necessarily an impossible exercise – it depends on how well anchored medium-to-long term inflation expectations are; if the public remain confident that the Fed will bring inflation under control once the recovery is well-established then this minimises the risk of any short-term price pressures becoming entrenched.

If inflation expectations start to show signs of moving too high for comfort the Fed will be in a bind. It may have to choose between losing credibility either in respect of inflation or the value of its policy 'promises'.

Given this, it was not surprising to see in the FOMC's September minutes that it is considering specifying the exit conditions from current policy in terms of numerical targets (eg. for inflation and unemployment). The Chicago Fed's president has suggested a rule whereby the Fed promises not to tighten policy unless unemployment falls below 7% or inflation rises above 3%. A rule like this, by showing in advance how the Fed will balance inflation and growth concerns, would reduce the risk to the Fed's credibility in the event that it was faced with an inflation/growth trade-off. By addressing this issue through a pre-commitment of this nature, it would give its current policy tools more credibility.

The risk of such a rule is that it causes public confusion about what the Fed is aiming for – is it 2% inflation over time or something higher? Moreover, in setting monetary policy, the Fed considers many factors and coming up with a robust rule based on just statistics (which are subject to statistical volatility) may by problematic.

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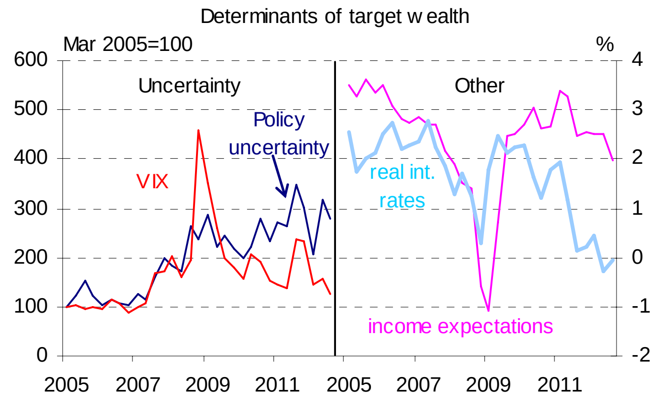
Do you have any comments on this note or suggestions on how it could be made more useful for you? Are there any subjects of particular interest to you? If so, please send me an email: antony.kelly@nab.com.au.

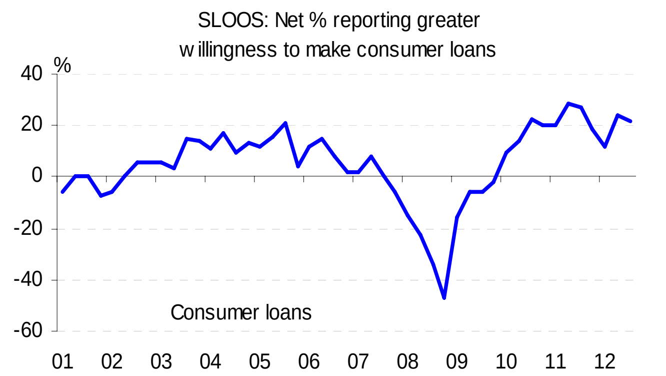
Spotlight: H'hold balance sheets

- A regular theme in these monthly US economic updates has been that households are still looking to repair their balance sheets and that this process will continue to be a drag on growth. More recently we have noted that this headwind may have weakened. In this month's spotlight we look at this topic in a bit more depth, drawing on research by Slacalek and Sommer[3]. In their work, the household savings rate is determined by a range of factors, in particular, credit conditions and the gap between 'target wealth' and actual wealth. Where target wealth is higher than the actual level, households will seek to increase savings.
- Target wealth was found to be a function of uncertainty (the greater the uncertainty the higher is the target), expected real interest rates (higher rates increase target wealth), and (less significantly) expected income growth (higher expectations lower target wealth). Movements in these variables over recent years are shown in the top chart[4]. It is clear that policy uncertainty remains elevated and expected income growth, while well off its recession lows, is still weak. Only declining real interest rates are exerting consistent downwards pressure on target wealth. At the same time, progress in rebuilding actual wealth has been painfully slow. Nevertheless, recent increases in equity and house prices suggest that actual wealth is still tracking up, helping to reduce the gap to target wealth.
- Overall, this suggests that target wealth remains elevated, and above actual wealth, consistent with our view that households will continue to strengthen their balance sheets. However, as Slacalek/Sommer note, there is considerable uncertainty about any estimate of target wealth (which is not directly observable). This is highlighted by the difference in various uncertainty measures – the Bloom et al policy uncertainty measure remains exceptionally high while the VIX measure is well down from its 2008/2009 highs.
- Credit conditions are also an important factor determining savings. Unsurprisingly, with easier access to credit people to spend more and save less. To gauge credit conditions, Slacalek/Sommer used the Fed's Senior Loan Officer Survey (SLOOS) series on willingness to make consumer instalment loans (middle chart). This measure indicates consumer credit conditions are improving (as do other SLOOS measures relating to credit card, auto and other consumer loan lending standards).
- Overall, this suggests that while households will continue to strengthen their balance sheets, the pace at which this occurs might slow down. This is consistent with what we can see in the data - while household gearing is still declining (see left hand panel, bottom chart), the growth rate of household debt has been tracking up. Consumer credit has been growing for a while and total debt (which includes housing) also turned positive in the June quarter (right hand panel). While the Fed's monetary policy stimulus – by reducing real interest rates – will continue to encourage this recent trend, the work of Slacalek/Sommer suggests that a moderation in the elevated levels of uncertainty may be more important. The hope is that key US policy issues (particularly fiscal) will start to be addressed after the November elections and that a stabilisation of the Euro area's debt crisis and, next year, a recovery in its economy, will improve confidence.

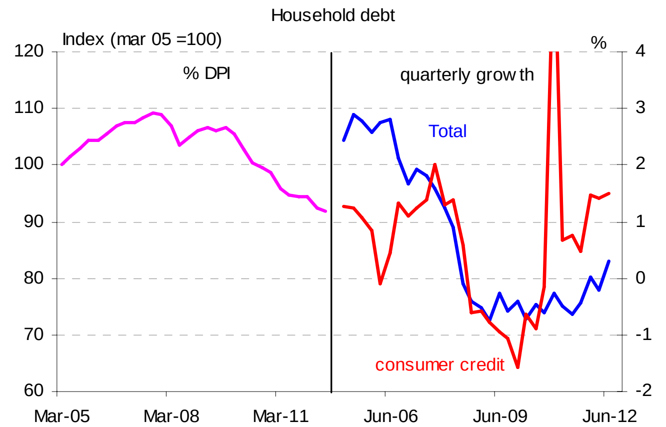
Uncertainty key factors likely keeping target wealth high



Credit conditions improving



Debt now increasing – pace of balance sheet repair slowing down



Sources: www.policyuncertainty.com, Thomson Reuters (Chicago Board Options Exchange), Federal Reserve, Philadelphia Federal Reserve Survey of Professional Forecasters

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3 Slacalek J., Sommer M., What Drives Household Saving? Examining the Role of Target Wealth, January 2012

4 Slacalek and Sommer used an uncertainty measure derived from the work of Davis, Bloom and Baker in measuring economic policy uncertainty; income expectations were based on one year ahead expectations of GDP growth from the Philadelphia Fed's Survey of Professional Forecaster's (SPF), and real interest rates estimated as ten year treasury yields less SPF one-year ahead inflation expectations.

US Economic & Financial Forecasts

	Year Average Chng %			Quarterly Chng %							
				2012				2013			
	2011	2012	2013	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components											
Household Consumption	2.5	1.9	2.4	0.6	0.4	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.7**
Private fixed investment	6.6	8.5	7.5	2.4	1.1	**0.6**	**1.7**	**1.9**	**2.3**	**2.4**	**2.4**
Government Spending	-3.1	-1.8	-0.6	-0.8	-0.2	**-0.1**	**-0.2**	**-0.2**	**-0.2**	**-0.2**	**-0.2**
Inventories*	-0.2	0.1	0.1	-0.1	-0.1	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	-0.1	-0.1	0.0	0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.1**	**2.4**	**0.5**	**0.3**	**0.4**	**0.5**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)											
PCE deflator-headline		(yoy%)									
Headline	2.5	1.8	2.1	0.6	0.2	**0.4**	**0.6**	**0.5**	**0.6**	**0.5**	**0.5**
Core	1.7	1.7	2.0	0.6	0.4	**0.3**	**0.4**	**0.51**	**0.51**	**0.48**	**0.51**
Unemployment Rate (%)	8.7	7.9	7.6	8.3	8.2	8.1	**7.9**	**7.9**	**7.8**	**7.7**	**7.6**
US Key Interest Rates (end of period)											
Fed Funds Rate	0.25	0.25	0.3	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
10-year Bond Rate	1.98	1.80	2.25	2.17	1.62	1.72	**1.80**	**2.00**	**2.10**	**2.20**	**2.25**

Source: NAB Group Economics

***Contribution to real GDP**

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