United States Economic Update

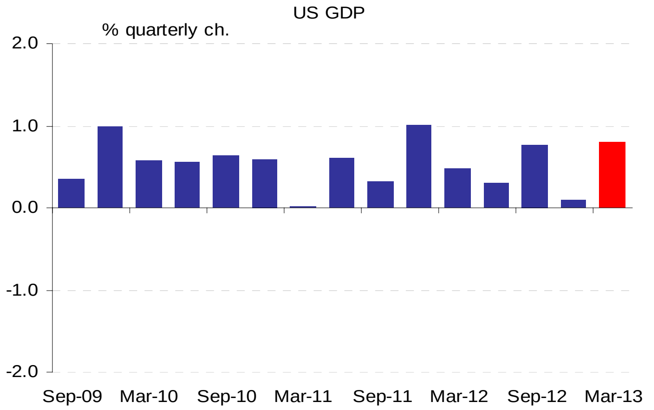
National Australia Bank

- **Partial data for the March quarter are pointing to a noticeable pick-up in GDP growth following only weak growth in the December quarter.**
- **We are expecting GDP growth of 2.4% (revised from 2.2%) in 2013 and 2.9% in 2014. While we expect growth to slow modestly in the June quarter, it will still be at a reasonable (around trend) level in the quarter and slightly stronger over the rest of the year. Federal fiscal policy will be the main drag on activity.**
- **Monetary policy easing in the form of Fed asset purchases or QE to continue through to end 2013. Before the QE program ends completely it is likely to be reduced in size (so called 'tapering') although weak March employment data has delayed the time this intermediate step might occur.**

Economic Overview

Economic indicators available for the March quarter are pointing to a noticeable pick-up in GDP growth following only weak growth in the December quarter (recently revised up to 0.4% qoq annualised rate). We are currently expecting March quarter GDP growth of 0.8% qoq (3.3% annualised) reflecting stronger consumption growth and inventory accumulation, a smaller detraction from public demand, as well as continuing growth in business and housing investment.

GDP growth expected to rebound strongly in March quarter



Source: Bureau of Economic Analysis, NAB Group Economics

The strengthening in consumer spending in January and February occurred despite increases in taxes in January and a run-up in petrol prices in February. As a result there has been a large fall in the savings rate. Improvement in household wealth is one-factor supporting consumption growth. Business investment indicators are generally positive and point to investment having risen again in the quarter (albeit at a more subdued rate), while the rapid growth in housing investment continued in the March quarter. Inventory data show a more rapid rate of inventory accumulation than in the previous quarter suggesting that it will make a positive contribution to growth. Notwithstanding the start of the sequester in March, the decline in public demand in the March quarter is expected to be smaller, as some rebound from the exceptionally large fall in defence spending in the December quarter is likely.

As with the rest of the economy, the labour market continues to recover slowly, notwithstanding a weak March employment report. The unemployment rate fell again, this time by 0.1 percentage points to 7.6% in March although this reflected a fall in the participation rate. While non-farm employment growth in the month was the weakest since June last year, the (upwardly revised) growth in February was the strongest in around a year. Looking through these monthly swings, employment is growing moderately which is leading to a slow decline in the unemployment rate (assisted by a declining participation rate).

We expect GDP growth will slow down modestly in the June quarter. This prospect is already being signalled by a weakening in a variety of indicators in the March month – for example in the ISM surveys (although they are still at a level consistent with around trend growth) and employment growth. Households, for whom confidence measures have been volatile recently, are likely to rebuild, to some extent, their savings rate following the recent dip. The contribution to growth from inventory accumulation will also be lower and the sequester budget cuts will begin to bite. This will drive a slower (but still reasonable) rate of GDP growth in the quarter.

Nevertheless, the continued growth in household wealth and employment, as well as low interest rates mean that consumption will continue to grow and strengthen into the second half of the year. Corporate profits continued to rise at the end of 2012 and, together with banks continuing to ease standards for business loans, this will underpin growth in business investment. With sales trending up, low levels of inventories and low mortgage interest rates, the rapid growth in housing construction is also expected to continue. The world economy is likely to improve over 2013 and into 2014 supporting exports, notwithstanding the recent appreciation in the US dollar.

Moreover, the Fed is likely to continue easing monetary policy over the rest of 2013 through its asset purchase (QE) program. There has been discussion recently of a 'tapering' of the program (i.e. reducing the size of the monthly asset purchases). While this is likely to be an intermediate step before QE comes to an end, any immediate prospect of this has been put-off by the weak March employment report.

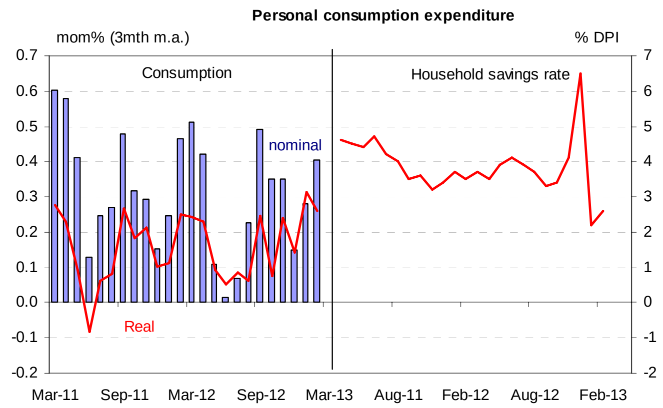
Federal fiscal policy, however, will be a drag on growth in 2013, although to about the same extent it was in 2012. On a more positive note, with a Federal Government shutdown avoided at the end of March (and for once in a fairly orderly manner), this leaves the Federal debt limit as the last major fiscal risk for the year (it will need to be increased again around August). Moreover, the drag from state and local government demand has largely come to an end.

As a result, over 2013 we expect the recovery to continue, with the pace of growth over the year stronger than in 2012. We expect GDP growth of 2.4% (revised upwards from 2.2%) in 2013 and 2.9% in 2014. The upwards revision to the 2013 forecast reflects an improved base due to the December quarter revisions, as well as a higher estimate to March quarter growth consistent with the strength in partial indicators.

Consumption

One of the downside risks to the outlook that we have highlighted in recent months has been the possibility of a greater than expected impact on consumer demand of the tax increases that kicked in at the start of 2013. Our expectation was that there would be some impact but that it would be relatively muted as households would ‘smooth’ the impact out over time (by allowing the savings rate to decline). The February personal consumption data showed real personal consumption rising by 0.3% mom in January (revised up from 0.1% mom) and February. Far from a slowdown in consumption this represents an acceleration of real spending from its 2012 pace. As a result the savings rate has declined noticeably, almost taking it back to its pre-recession level. The savings rate has been distorted by changes to the timing of income which were brought forward into 2012 but even allowing for this it is clear it has fallen.

Despite tax increases consumption strengthened in early 2013



Source: Bureau of Economic Analysis, NAB Group Economics

Factors that might explain the strength of consumer spending are rising household wealth with both house prices and equity prices trending up, as well as the decline in petrol prices over late 2012/January 2013. However, consumer confidence measures have been quite volatile recently suggesting relatively high uncertainty and petrol prices rose strongly over February (although this was partially reversed in March). Given this, we don’t expect the current pace of consumption growth to be maintained and there is likely to be a correction in coming months data and an associated rebuilding of the savings rate. The first (modest) sign of this is in new light vehicles sales which declined 0.7% mom in March (but were still 8% higher than a year ago).

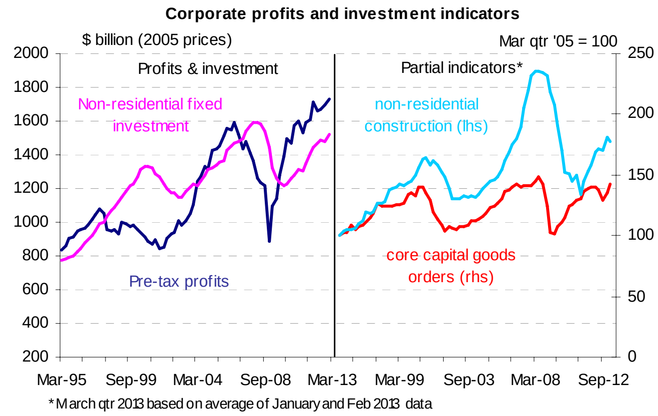
Business investment

Partial indicators generally suggest that the recovery in business investment that occurred in the December quarter continued into the start of 2013. We expect this to continue over the rest of the year.

While core capital goods orders (which exclude defence and aircraft) declined by 3.2% mom this was likely a correction to the exceptional growth in the previous month (up 6.7%). As a result, orders for the first two months of the March quarter are tracking 5.5% higher than the previous quarter; actual shipments are more muted (1% higher growth on previous quarter so far) but are also trending up. Similarly, while the improvement in Fed regional survey measures of future capital investment came to an end in March they are still tracking higher than they did over the second half of 2012. The only negative is some recent weakness in non-residential construction.

The initial estimate of corporate profits for the December quarter shows business profits continuing to rise. Historical experience suggests that this will underpin further growth in business investment in coming quarters, as will continued easing in lending standards by banks.

Investment partial indicators and fundamentals generally positive



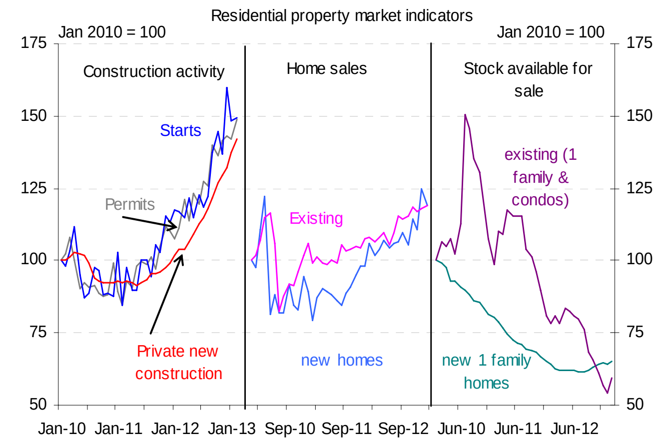
Source: Bureau of Economic Analysis, Census Bureau, NAB Group Economics

A factor behind the weak December quarter GDP growth was a slowdown in the rate of inventory accumulation (which detracted 0.3 percentage points from the quarterly growth rate). The limited data available for inventories for the March quarter suggests that non-farm inventory accumulation picked up in the quarter. Moreover, the decline in farm inventories that occurred in the second half of 2012 should at least moderate (if not turn positive).

Housing

In terms of growth rates, housing construction’s status as the stand out sector in the U.S. economy continued into early 2013, although the level of activity is still weak by historical standards. After a small decline in January, building permits (a leading indicator of activity) rose by 4.6% mom in February. New residential construction expenditure grew by 3.3% mom in February – the seventh consecutive month of above 2% growth. With sales trending up (reflecting growth in household formation), low inventories and mortgage interest rates, and the level of construction still well below normal levels, the growth in the sector is likely to continue for some time yet.

Recovery in housing sector continuing

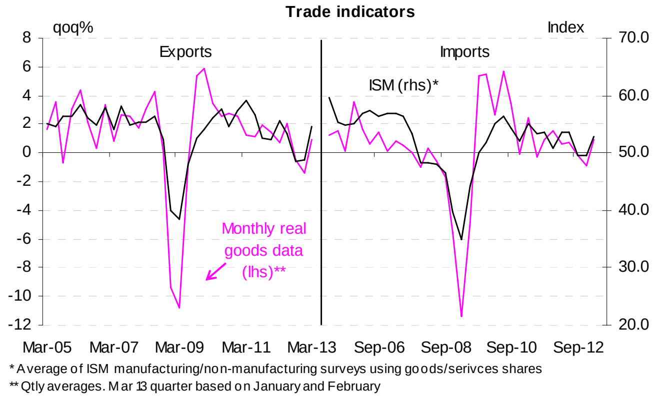


Sources: Census Bureau, National Association of Realtors

Trade

After both exports and imports declined in the December quarter, trade appears to have started growing again in the March quarter. The average level of both real goods imports and exports over January and February was higher than the December quarter level (both by 0.9%) and the trade measures in the ISM surveys are also moving upwards. Pressure on exports might come from the recent strengthening in the dollar. However, the world economy is expected to strengthen over the course of the year which should counterbalance any drag from a higher US dollar.

Signs that trade is growing again

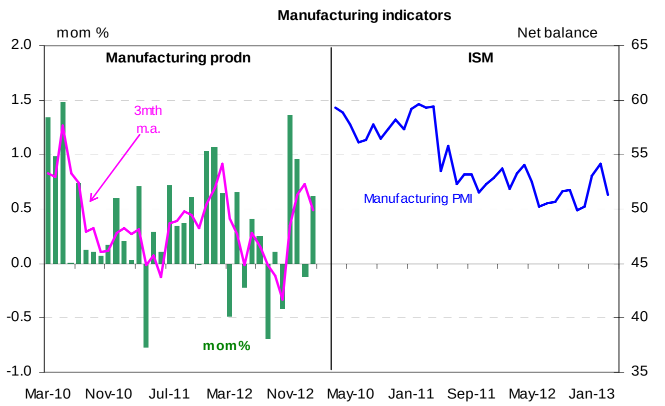


Sources: ISM, Census Bureau

Industrial production

Industrial production grew by 0.8% in February 2013, with growth in all three main categories (mining, utilities and manufacturing). Growth in manufacturing IP was 0.6% mom in February, following a small decline in the previous month. Always somewhat volatile, the manufacturing production data have more recently been distorted by Hurricane Sandy which contributed towards a decline in October but subsequently stronger growth as lost production was made up. This is also reflected in the Manufacturing ISM which strengthened in the March quarter. However, the ISM softened in the March month and the labour market data suggest a decline in manufacturing IP in the same month, suggesting that the growth immediate outlook for manufacturing is only modest.

Manufacturing sector growing again



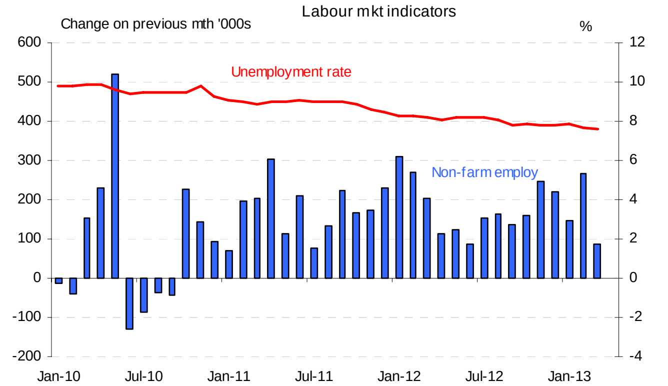
Source: Federal Reserve

Labour market

The employment report for March was decidedly mixed. The negatives were the slowest non-farm employment growth (88,000) since June, a decline in the separate household survey measure of employment (which has been weak since end 2012), another decline in the participation rate taking it to its lowest level since 1979 (suggesting problems on the supply side of the economy) and no growth in hourly earnings. This followed a spike in the most recent initial jobless claims data.

The positives were a decline in the unemployment rate to 7.6%, upward revisions to the non-farm employment estimate for the previous two months, and an increase in average weekly hours worked. Moreover, initial jobless claims on average in March declined and they were at their lowest level in over five years (with the spike at the end of the month probably reflecting seasonal adjustment problems associated with Easter).

Mixed labour market signals in March



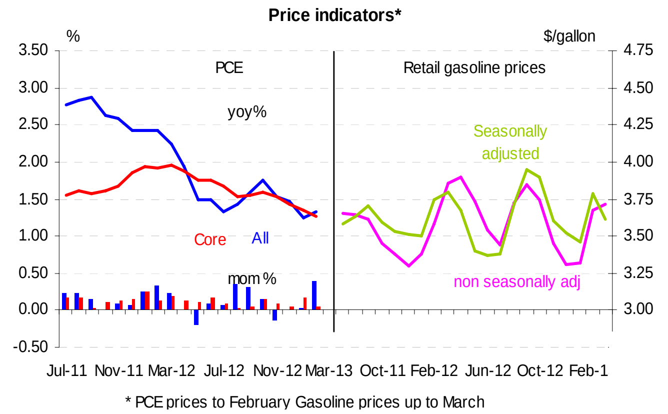
Source: Bureau of Labor Statistics

Overall, the March labour market data was disappointing. However, not too much should be read into a single report as the data are based on samples and there is a degree of volatility. Non-farm employment growth in February was the strongest seen since February 2012. In the March quarter the average monthly non-farm employment increase was 168,000, equivalent to an annualised growth rate of 1.5%. Overall, the slow recovery in the U.S. labour market appears to be continuing.

Inflation

There was a spike in headline inflation in February, with the personal consumption expenditure price index increasing by 0.4% mom. This was largely driven by energy prices, which rose 8.5% mom. In contrast, core inflation (ex food and energy) only increased by a very modest 0.06% mom. Moreover, with retail gasoline prices (seasonally adjusted) declining in March and into early April the spike will be short lived. As a result inflation pressures remain subdued, with annual consumer prices only growing by 1.3% over the year to February (both on a headline and core basis) well below the Fed's 2% longer-term goal.

Inflation remains subdued



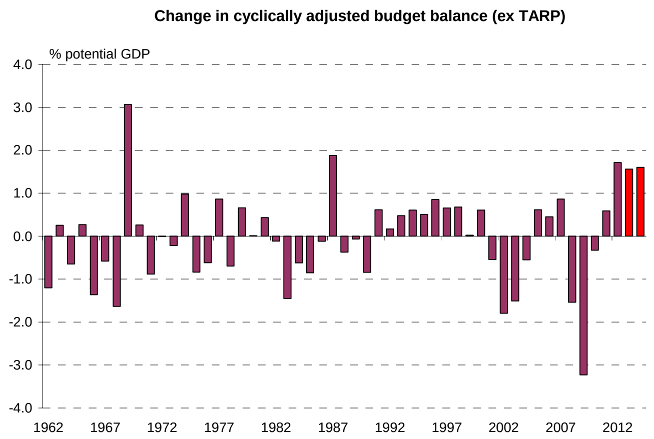
Sources: BEA, U.S. Energy Information Agency, NAB Group Economics

Fiscal policy

The Federal government automatic budget cuts under the 'sequester' came into effect in March adding to the fiscal restraint imposed by the tax rises at the start of the year. On a more positive note, a Government shutdown at the end of March was avoided as agreement was reached, with relatively little fuss, on a continuing resolution to fund the government. That leaves the Federal debt limit as the last major fiscal risk for the year (it will need to be increased again around August).

One way to assess the stance of fiscal policy is to look at the 'cyclically-adjusted' budget position. This strips out the impact of changes in economic conditions on the budget; as a result any changes in this measure should represent policy change (as well as other factors such as changes in take-up rates of government programs for reasons other than changes in economic conditions). The Congressional Budget Office recently updated its estimate of the cyclically adjusted budget balance (what it calls the deficit/surplus without automatic stabilizers). It suggests the fiscal stance (measured as the change in the budget balance from the previous year as a percentage of GDP) in fiscal 2013 will be similar to that of 2012. On current budget settings this will also be the case in 2014. Therefore, despite the focus on the tax rises and the sequester the headwind from Federal fiscal policy has not got any stronger. At the same time, the latest partial data for state and local employment and construction suggest that the contraction from this sector is largely over (although it is possible there will be spill-overs from the sequester).

Federal fiscal headwind in fiscal 2013 similar to that in 2012



Source: Congressional Budget Office, NAB Group Economics

Monetary Policy

In our last two US Economic Updates we have had a close look at U.S. monetary policy. The main conclusions have been:

- Extremely loose monetary policy likely to continue for an extended period.
- Expect QE3 monthly asset purchases will finish at end of 2013 (an end to continued loosening of policy).
- Fed funds rate likely on hold until late 2015/early 2016.
- When the Fed funds rate does start to rise we expect that it will move towards a rate of 4% in the long-term

The stronger than expected performance of the economy in the first part of 2013 means that there is some risk that some monetary policy actions might be brought forward somewhat. However, at this stage we are not changing our central forecasts, particularly given the continued subdued inflation readings and the weak March employment report.

Our view is broadly in-line with views stated by some recent Fed speakers. Williams (San Francisco Fed) – considered to be a 'dove' - thinks asset purchases will remain in place well into the second half of 2013 while Lockhart (Atlanta Fed) – considered neutral to hawkish – thinks they will remain in place until late this year/early next year.

What has become clearer is that before the program ends it will probably run at a reduced size for a period of time (so called 'tapering'). Williams indicated that if his expectations for the economy are met this could be as soon as the US summer. This was before the weak March employment report which may delay any scaling down of asset purchases (unless there is a sharp correction in April). Some Fed speakers (Evans, Pianalto) have suggested monthly employment gains of 200,000 for about six months or as a benchmark for assessing whether there has been substantial improvement in the labour market. For the six months to February, non-farm employment growth was tracking just below this, but the sub 100,000 jobs growth in March has thrown a spanner in the works, at least temporarily.

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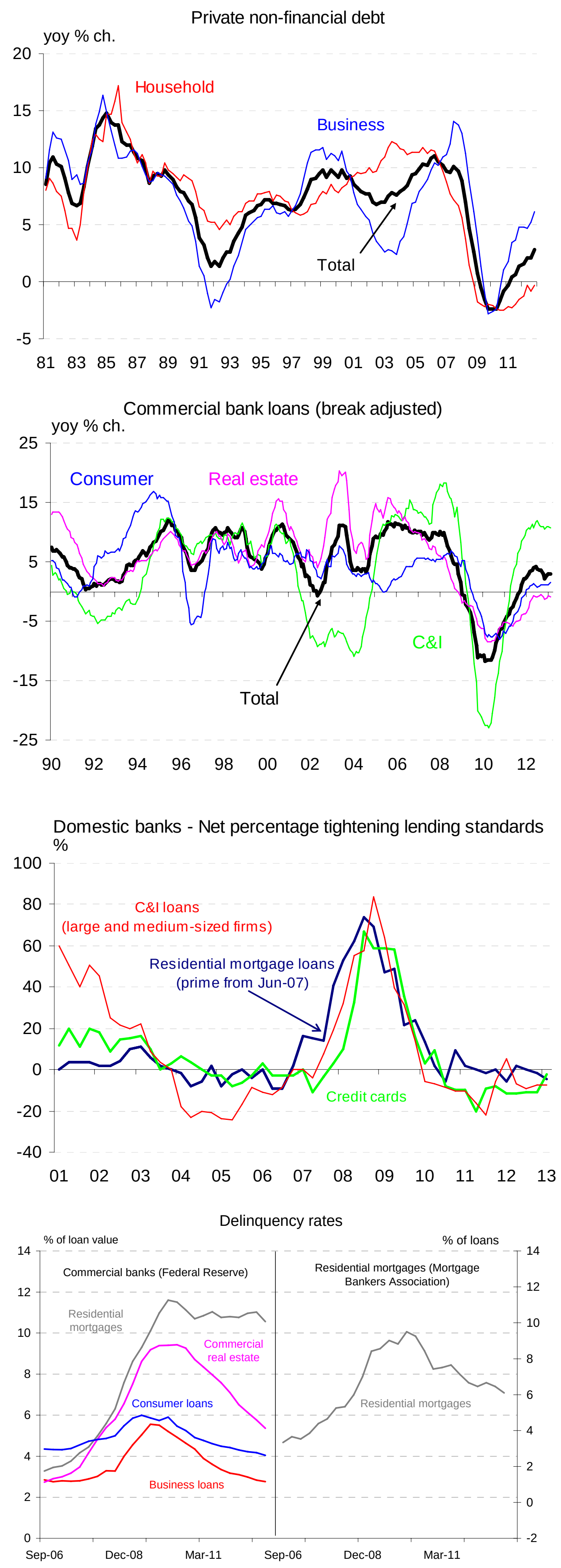
Spotlight: Credit conditions

- Credit conditions continue to improve in the United States, which will support continuing US economic growth. The annual growth rate for system wide credit growth is still modest but rising. Business credit has been the main driver of credit growth, but consumer loans are also rising and real estate debt is close to stabilising. Lending standards continue to be eased but are still relatively tight by historical standards (particularly for real estate) while loan quality has improved. Looking forward only moderate credit growth is expected.
- The broadest measure of credit to the non-financial sector comes from the Federal Reserve's Flow-of-Funds publication as it covers all sectors of the economy and all types of financial institutions. Total private non-financial sector debt outstanding rose by 2.8% over the year to the December quarter 2012, the fastest rate of increase since the September quarter 2008. This growth has been driven by business credit (up 6.1% over the same period), particularly to the corporate sector. The decline in household credit has largely come to an end with mortgage debt still declining (but at a slower rate) but offset by by moderate growth in consumer credit (credit cards, auto & student loans etc).
- More timely data are available for commercial banks (available to February) and the story is broadly similar – the strongest category are commercial and industrial loans, while consumer lending is growing and real estate (residential and commercial) debt continues to fall but at a much slower rate suggesting that the bottom will soon be reached. However, at least for commercial banks, the pace of growth in business and consumer loans has levelled off.
- Lending standards continue to be eased, according to the Federal Reserve's Senior Loan Officer Opinion Survey. However, given the significant tightening in standards between 2007 and 2009 lending standards are still historically tight for real estate loans, but less so for consumer and, in particular, commercial and industrial loans. The SLOOS also suggests that the terms of commercial and industrial loans are being eased (in the last survey over 50% of respondents reported decreasing the spread over the cost of funds). For foreign bank branches/agencies in the U.S. there was actually a tightening in standards from late 2011 to mid 2012 reflecting a deterioration in Euro-zone financal conditions; however, the last two surveys suggest that this process has stopped.
- A factor likely supporting the continued easing in lending standards is the steady improvement in loan quality over the last two to three years. In particular, business and consumer loan delinquency rates are back to pre-recession levels. The improvement in real estate – particularly residential real estate – has been slower.
- While low interest rates will support credit growth, as will the recovery in the US housing market, the outlook for credit growth looks modest. This reflects the still modest pace of recovery, households likely desire to further repair their balance sheets (because of the large loss in wealth caused by the recession), and relatively tight lending standards by historical standards.

Credit conditions in the U.S. slowly improving



Sources: Federal Reserve, Mortgage Bankers Association

US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %									
					2012		2013				2014			
	2011	2012	2013	2014	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household Consumption	2.5	1.9	2.2	2.6	0.4	0.5	**0.8**	**0.5**	**0.6**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**
Private fixed investment	6.6	8.7	7.7	9.0	0.2	3.3	**1.1**	**2.4**	**2.4**	**2.3**	**2.2**	**2.1**	**2.0**	**1.9**
Government Spending	-3.1	-1.7	-1.8	-0.8	1.0	-1.8	**-0.1**	**-0.7**	**-0.4**	**-0.3**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Inventories*	-0.2	0.1	0.1	0.0	0.1	-0.3	**0.2**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	0.1	0.1	-0.1	0.1	0.1	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.2**	**2.4**	**2.9**	**0.8**	**0.1**	**0.8**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline		(yoy%)												
Headline	2.5	1.6	1.2	1.9	0.4	0.4	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.7	1.5	1.2	1.9	0.3	0.3	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment Rate (%)	8.7	7.8	7.4	7.0	8.0	7.8	7.7	**7.6**	**7.5**	**7.4**	**7.3**	**7.2**	**7.0**	**7.0**
US Key Interest Rates (end of period)														
Fed Funds Rate	0.25	0.25	0.25	0.3	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
10-year Bond Rate	1.98	1.72	2.50	3.25	1.72	1.72	1.96	**2.50**	**2.50**	**2.50**	**2.50**	**2.75**	**3.00**	**3.25**

Source: NAB Group Economics

***Contribution to real GDP**

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