14 June 2013

United States Economic Update

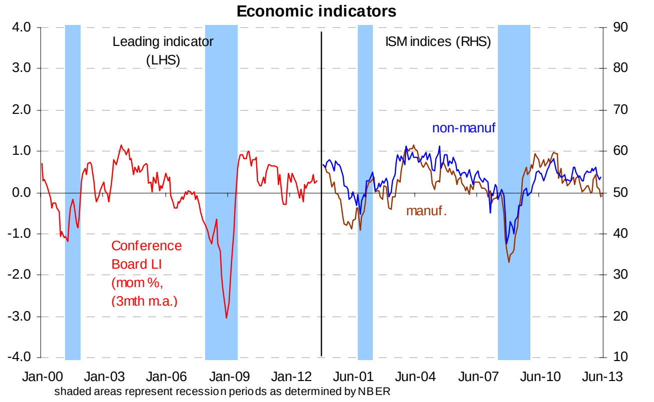
National Australia Bank

- **GDP growth looks likely to slow a little in the June quarter. Trend is still one of modest growth.**
- **Continued easy monetary policy – even if the size of asset purchases under QE3 are reduced (so called 'tapering') – improving credit conditions and the housing recovery continue to support growth. As the impact of the tax increases and the automatic budget cuts fade we expect GDP growth will strengthen in the second half of the year.**
- **We are forecasting GDP growth of 2.1% in 2013 and 2.9% in 2014.**

Early indicators suggest that GDP growth will slow a little in the June quarter from its March quarter level. However, as the impact of tax increases and the automatic budget cuts fades, growth is expected to strengthen later in the year.

Not surprisingly, consumption growth which accelerated in the March quarter (partly due a rebound from Hurricane Sandy and a weather related boost in power consumption) appears to have moderated. Nevertheless, May's solid retail sales report suggests consumption is holding up reasonably well despite the tax increases as the start of the year. Nor are inventories likely to provide the same boost to GDP growth in as in the March quarter. However, with non-residential construction recording its first growth in four months in April and core capital goods orders still growing, we expect business investment to strengthen somewhat. Moreover, housing activity continues to grow rapidly. While the April trade figures suggested net exports might contribute to growth this quarter, the ISM export measures are more down beat and we continue to expect another small detraction from growth from net exports.

Activity indicators point to subdued growth in June quarter



Sources: ISM, Conference Board

Other measures of activity point to a slowdown in growth in the quarter. In particular, the ISM indicators have softened in recent months, and the manufacturing ISM dipped below 50 in May suggesting a small contraction in the sector. However, the non-manufacturing ISM has been doing better. Indeed our weighted composite of the manufacturing and non-manufacturing ISM actually picked up a little in May, although it is still down on levels seen earlier in the year. The Conference Board's leading indicator is also consistent with modest growth in the quarter.

Overall, the GDP results suggest an economy growing at a modest pace; GDP has been volatile recently but has averaged 0.5% qoq over the last three quarters.

Beyond the current quarter, the impact of the tax cuts at the start of the year will begin to fade, and consumption will also be supported by the continued growth in household wealth and employment, as well as low interest rates (notwithstanding some recent increases) from the Fed's ultra-loose monetary policy.

The continued easing in lending standards by banks will also aid consumption activity as well as business investment. Business investment will also be supported by high corporate profits, notwithstanding a small decline at the start of 2013.

The rapid growth in housing construction is also expected to continue. New home sales resumed their upwards trend in the last couple of months, and with the inventory of new-homes (and existing homes on the market) low this will translate into additional construction.

Subdued world economic conditions are likely to continue to be a constraint on the export sector, as is the rising USD. However, we are expecting an improvement in the global economy late in the year which will take global growth almost back to trend in 2014.

Federal fiscal policy, however, will be a drag on growth for some time to come. A risk to our forecast is that the debt limit on the Federal Government is not increased in a timely or orderly manner. However, the time when this needs to be addressed has been pushed back to October/November due to some improvement in the budget outlook.

In terms of monetary policy, the focus has switched to when the size of the Fed's asset purchase (QE) program may be reduced in size (so-called 'tapering'). Tapering is being seen as increasingly likely and markets have reacted by raising interest rates. The rise in rates probably also reflects a broader re-assessment of the future of monetary policy. That said the Fed is still committed to a very easy monetary policy over the foreseeable future.

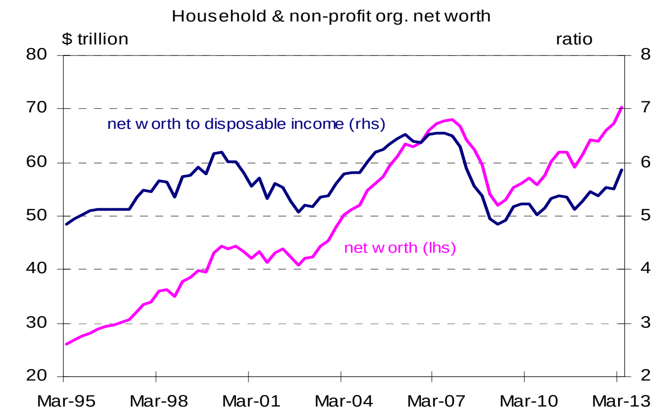
In summary, we expect that the drawn-out recovery seen to-date will continue. While GDP growth will likely moderate in the current quarter it should strengthen in the second half of the year. As a result GDP growth is forecast to be 2.1% in 2013 and 2.9% in 2014.

Consumption

Growth in household consumption has moderated in recent months, and grew by only 0.1% mom in April. However, (nominal) retail sales grew by 0.6% mom in May consistent with consumption growth holding up reasonably well. For the quarter as whole, consumption is likely to moderate from the strong growth recorded in the March quarter. This reflects the lagged impact of the tax hikes at the start of the year and the fact that March quarter growth was boosted by a weather related increase in energy consumption.

While income growth remains modest, consumption has been supported by rising household wealth as well as declines in energy prices (although the latter has run its course for now – see the discussion on inflation). Net household wealth rose 4.5% qoq in the March quarter, taking it above its pre-recession peak. While relative to disposable income household wealth is still well short of the pre-recession peaks, by historical standards it does not look too bad. With equity prices rising further in the June quarter (despite the recent correction) and house prices clearly trending up, the improvement in wealth looks set to continue. Importantly, consumer confidence has rebounded and was at post-recession highs in May in both the University of Michigan/ Thomson Reuters and Conference Board measures.

Rising wealth a support to consumption



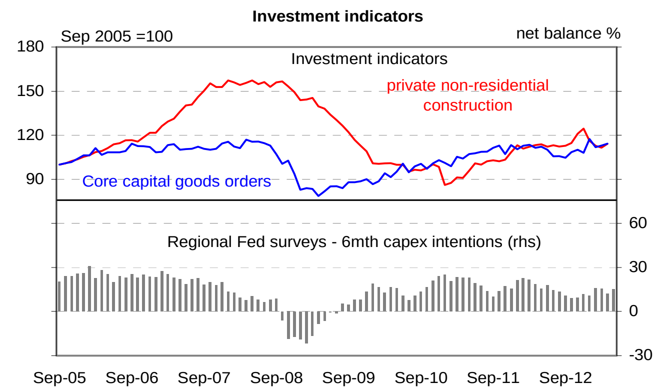
Source: Federal Reserve

Business investment

Indicators generally suggest that business investment is growing at a modest pace. The outlook is also generally positive as, notwithstanding a small decline in the March quarter, profits remain high and credit conditions are favourable.

While core capital goods shipments declined in April, orders rose for the second consecutive month, suggesting that the upward trend evident since the end of 2012 is continuing. A recent area of weakness has been in non-residential construction and here there are signs of stabilisation (if not improvement). April non-residential construction data rose by 2.2% mom, the first increase since December last year. Similarly, the average of Fed regional survey measures of future capital investment ticked up in May, and while still not indicating particularly strong intentions, they are well off the lows of late 2012 despite the fears that tax rises at the start of the year and the onset of the 'sequester' budget cuts (starting March) might derail confidence.

Investment partial indicators suggest modest positive trend



Source: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves, NAB.

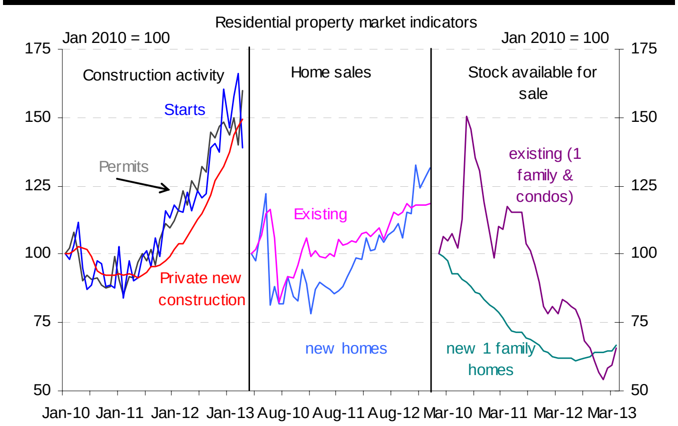
Corporate profits declined in the March quarter reflecting a small fall domestically and a larger fall in profits from overseas operations. The broad trend is one of still rising corporate profits, but at a declining pace. With profits high by historical standards, this should continue to support business investment. In addition, credit conditions are increasingly supportive, with the most recent survey of loan officers indicating business lending standards and loan terms continue to be eased.

The second estimate of March quarter GDP revised down the estimated pace of inventory accumulation (entirely due to lower non-farm inventory). This lowers the risk of an inventory correction in the current quarter.

Housing

Indicators of housing construction can be very volatile and this certainly been the case recently. New housing starts declined 16% mom in April mainly due to a large fall in multi-family starts. The latter regularly shifts 30-40% (up or down) in a single month). In contrast, there was a 14% mom increase in building permits, a leading indicator of activity (again this was mainly, but not solely, due to multi-family activity). Moreover, with new home sales resuming their upwards trend in the last couple of months, and inventories low, the housing recovery remains on track.

Housing indicators volatile but recovery continuing



Sources: Census Bureau, National Association of Realtors

A change in the market that has occurred is an increase in mortgage interest rates. The Fed's measure of a conventional 30yr fixed mortgage has gone from around 3.3-3.4% in

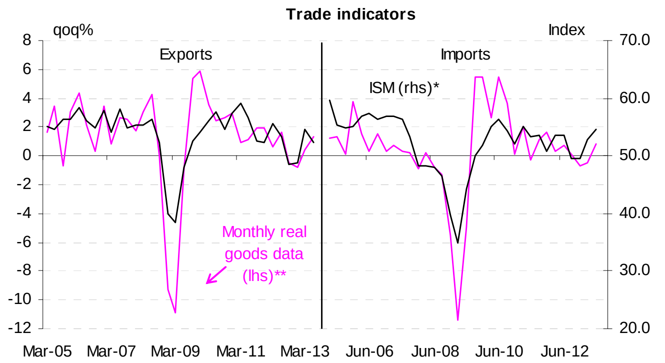
December 2012 to 3.9% in early June (reacting to broader bond market moves). However, even this is still low by historical standards and with house price growth gathering pace (to be 7-10% higher than a year ago depending on the measure used), the increase is unlikely to fundamentally change the market dynamics.

Trade

Both real goods exports and imports rose strongly in April – by 2.0% and 3.3% mom respectively – following several months of weak trade data. This has broadly matched the trend (three month average) movement in ISM. The real trade balance in April was an improvement on the March quarter, pointing to a possible contribution to GDP growth from net exports.

However, the May ISM results cautions against reading to much into the April result. In particular, export orders weakened noticeably. This may reflect the continued weakness in the global economy and the impact of recent increases in the USD (although the latter factor should not be overstated as in May the trade-weighted exchange rate was back to around year ago levels). While the non-manufacturing imports index had a large fall, import trade is dominated by goods and the manufacturing ISM index remains solidly in positive territory, consistent with underlying modest growth in the US economy.

Rebound in trade…but ISM suggests export weakness ahead



*Average of ISM manufacturing/non-manufacturing surveys using goods/serivces shares: June qtr based on April and May. ** Qtly averages. June 13 quarter based on April data

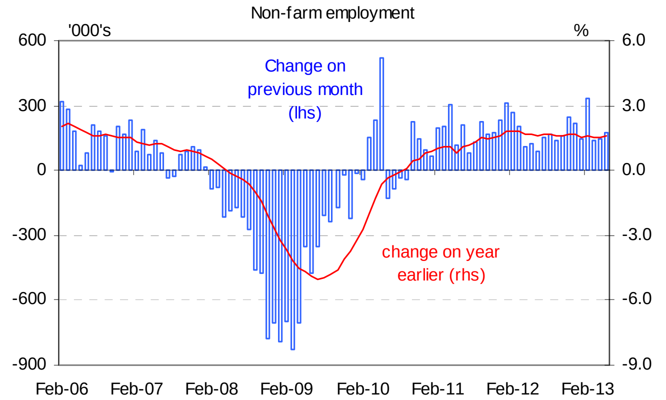
Sources: ISM, Census Bureau

Labour market

Despite the rise in the unemployment rate in May to 7.6% (from 7.5%), the latest employment report was greeted with some relief. This was partly due to low expectations but also reflects the details of the report, as well as the fact that the unemployment rate is still down over the course of the year. Non-farm employment grew by 175,000, an improvement on the previous two months (but still below the average over the last six months). The separate (and more volatile) household survey measure of employment rose 319,000. The rise in the unemployment rate was therefore due to an increase in the participation rate (although it is still low and below its level at the start of the year).

Through all the month-to-month volatility, non-farm employment growth has been remarkably steady for a while (since September 2011 it has only moved once outside the 1.5 to 1.8% range once). The pace of job gains has been strong relative to GDP growth; implicitly this reflects low productivity growth. While this can happen for a period of time, at some point either GDP growth will need to strengthen or employment growth slow down.

Steady employment growth continues



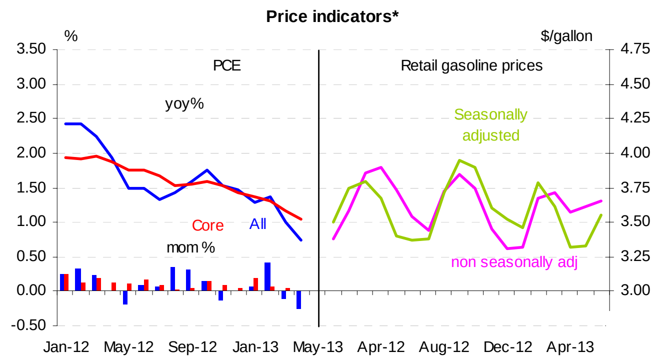
Source: Bureau of Labor Statistics

Inflation

Inflation has gone into reverse in recent months, with the headline personal consumption expenditure (PCE) price index declining in both March and April. This was in large part driven by falling energy prices (down 11.5% over the two months to April) but also reflects generally subdued 'core' (ex food and energy) prices. For example, durables goods prices have fallen in each of the last three months and health care tumbled in April (its annual growth rate in April was the lowest since the early 1960s). As a result core prices only rose by 0.01% mom. Explanations for this include pass through of falling commodity prices into core PCE prices, the appreciation of the USD dollar since January (up 1.9% on a trade-weighted basis to May), the still large amounts of slack in the economy and weakness in the global economy constraining goods inflation.

Retail gasoline prices stopped falling in May (seasonally adjusted basis) and are up at the start of June. Even though the dollar is continuing to trend up, this suggests that the slowdown in the headline inflation rate may have come to an end for now. However, it will likely be well below the Fed's 2% objective for a while to come.

Inflation subdued



* PCE prices to April; Gasoline prices for June are an average of 3 & 10 June prices

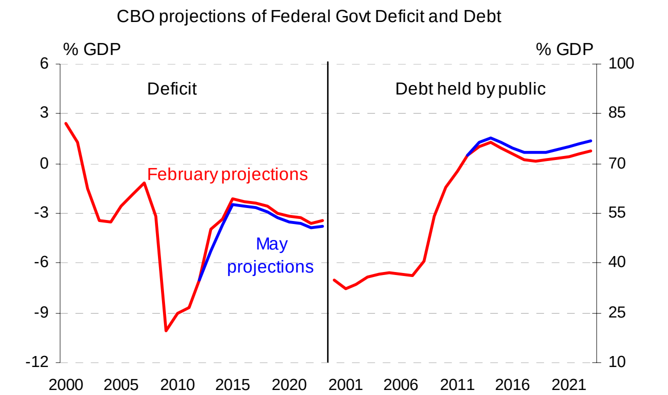
Sources: BEA, U.S. Energy Information Agency, NAB

Fiscal policy

With so-called sequestration – code for automatic budget cuts – kicking in at the start of March, fiscal policy has receded from the limelight.

One development has been a small improvement in the fiscal outlook. The Congressional Budget Office updated its budget projections in mid-May, and this included a downward revision in the projected deficit, as well as debt held by the public. The changes were entirely due to 'technical' reasons – factors unrelated to a changed view of the economy or policy changes. As such, they do not imply any additional fiscal tightening. One consequence of the changed projections is that the anticipated date for the Federal Government debt limit to bite has been moved back to October/November.

Despite improvement long-term budget problems remain



Source: Congressional Budget Office

The revised CBO estimates do not change the broad outlook for the fiscal position. However, with the deficit already projected to moderate in coming years, the revisions may have the impact of reducing the urgency to address the longer-term fiscal issues facing the U.S. However, the debt to GDP ratio is expected to remain at high levels by historical standards and then start to worsen again at the end of this decade. So while currently on the backburner, the fiscal policy debate will not go away for long.

Monetary Policy

Discussion of the U.S. economy in recent times has focussed on the prospect of the Federal Reserve 'tapering'. 'Tapering' in this context refers to reducing the size of its asset purchases (QE3) which are currently running at $85b a month.

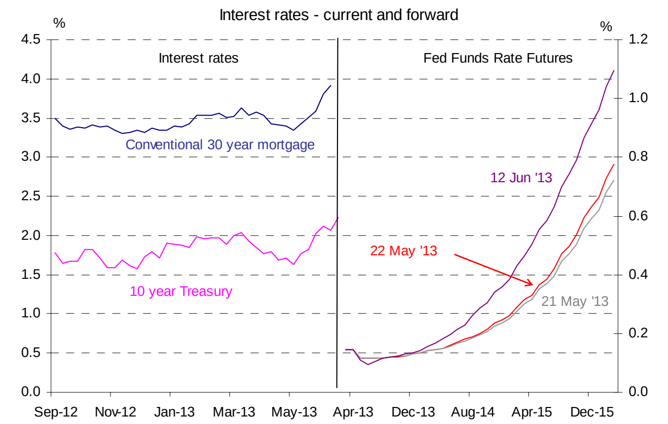
While discussion of tapering has been going on for a while, it gained further momentum following the Federal Reserve Chairman's answering of questions after his testimony to the Joint Economic Committee of the U.S. Congress on 22 May. In particular, he stated "If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings...take a step down in our pace of purchases."

Our view for a while has been that the QE program will finish at the end of this year with some tapering of the program beforehand. This has been based on our reading of Fed meeting minutes combined with our forecasts of the economy.

As expectations of 'tapering' starting in 2013 have increased, so have interest rates. For example, 10 year Treasuries have risen around half a percentage point since end 2012, as have mortgage interest rates. The movement in interest rates appears to reflect not just changed expectations of the amount of asset purchases, but also a change in view of the entire stance of monetary policy. The Fed Funds rate forward curve has shifted up since the Chairman's 22 May remarks.

However, the Fed's thresholds (relating to unemployment and inflation) for when consideration will be given to raising the Fed Funds rate have not changed and the Fed Funds rate will remain exceptionally low for a long time yet (we expect until late 2015).

Interest rates rising as monetary policy expectations change



Source: Thomson Reuters Datastream, Federal Reserve, Bloomberg

While a reduction in the size of asset purchases is looking increasingly likely it is not expected to occur at next weeks FOMC meeting. Moreover, it could still be delayed by a run of poor economic data, particularly given that the subdued inflation readings would appear to give the Fed room to keep policy easier for longer. Regarding the latter point, however, the Fed places a lot of weight on inflation expectations, and these remain within their historical bounds, notwithstanding some recent falls in bond market measures.

Moreover, once having started to 'taper' it is not automatically given that the next step will be a further reduction. Again this will depend on how the economy is perceived to be travelling (unless concerns about the perceived negatives of QE voiced by some Fed members gather steam). As the Chairman said in his testimony: "…it [the FOMC] is prepared to increase or reduce the pace of its asset purchases to ensure that the stance of monetary policy remains appropriate as the outlook for the labor market or inflation changes."

When tapering does begin, another issue is by how much the QE program is adjusted. If by only a small amount (e.g. $20b) then this would mean that between the start of tapering and the end of QE there is likely to be a stretch of time even if the recovery continues to strengthen. With the Chairman using words like 'recalibration' which might suggest small changes, the risk is greater that the QE program will run for longer than we expect rather than that it will end sooner.

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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	2.3	2.6	0.4	0.5	0.8	**0.5**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	6.6	8.7	7.3	8.9	0.2	3.3	1.0	**2.0**	**2.3**	**2.2**	**2.2**	**2.1**	**2.0**	**2.0**
Government Spending	-3.1	-1.7	-2.8	-0.7	1.0	-1.8	-1.3	**-0.6**	**-0.4**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Inventories*	-0.2	0.1	0.0	0.1	0.1	-0.3	0.2	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	0.1	0.0	-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**	**2.1**	**2.9**	**0.8**	**0.1**	**0.6**	**0.5**	**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	1.0	1.8	0.4	0.4	0.2	**0.1**	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Core	1.7	1.5	1.2	1.9	0.3	0.3	0.3	**0.2**	**0.3**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment Rate (%)	8.7	7.8	7.4	6.9	8.0	7.8	7.7	**7.6**	**7.5**	**7.4**	**7.2**	**7.1**	**7.0**	**6.9**
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	**2.10**	**2.25**	**2.50**	**2.70**	**2.75**	**3.00**	**3.25**

Source: NAB Group Economics

***Contribution to real GDP**

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