US Economic Update – US GDP, 2013 Q2

National Australia Bank

- **US GDP rose by 1.7% (annualized rate) in the June quarter, an improvement on the March quarter, but still only a modest rate of growth.**
- **The stronger growth largely reflected a pick-up in business investment and a much smaller detraction from growth from public demand.**
- **We expect GDP will grow by 1.5% in 2013 (previously 1.8%) and 2.7% (unchanged) in 2014. The downwards revision in 2013 largely reflects downwards revisions to historical data.**

US GDP in the June quarter grew by 0.4% qoq or at an annualised rate of 1.7%. While only a modest rate of growth, the result was above expectations and represents an acceleration of growth from the March quarter. However, growth in the previous four quarters was revised down. As a result year average growth in 2013 is likely to be lower than previously expected.

The stronger growth largely reflected a pick-up in business investment and a much smaller detraction from growth from public demand. Housing investment again grew strongly and consumption growth was weaker than in the previous quarter but still showed modest growth. Inventories again contributed to growth (by a smaller amount than in the previous quarter) but there was a sizeable detraction from net exports due to a jump in import growth.

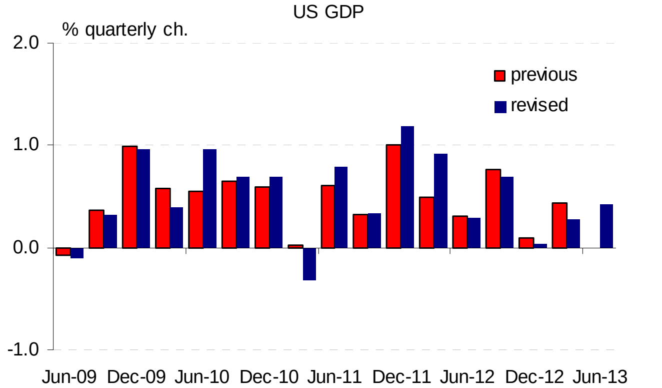
Private consumption growth slowed down to a modest 0.4% qoq. This represents a return to the growth rates seen in the second half of 2012. Services growth was particularly weak, increasing by only 0.2% qoq. The 'housing and utilities' category declined after a strong rise the previous quarter, which probably reflects weather induced changes in energy consumption. Goods consumption was stronger, led by durables, up 1.6% qoq, with non-durables rising 0.5% qoq.

The modest growth in consumption needs to be considered in the light of the tax increases at the start of 2013. While households are likely to adjust to this over-time the impact should start to fade in the second half of the year. Moreover, consumer confidence recently has improved (and is around post-recession highs). A downside risk comes from the increase in gasoline prices (in seasonally adjusted terms) in June and maintained in July.

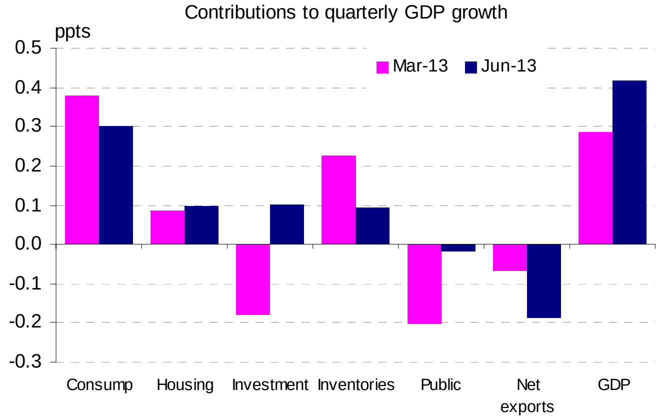
Business fixed investment grew by 1.1% qoq, rebounding from a 1.2% decline in the previous quarter. The turn around was largely due to a strong rise in non-residential structures investment, which increased by 1.7% qoq, following a large decline (-7.2% qoq) the previous quarter. The volatility largely reflects changes in 'power and communication' investment, but mining investment also grew strongly in the June quarter. Equipment investment also strengthened (from 0.4% to 1.0% qoq) and the new intellectual property products category (which includes software and research and development) rose 1.0% qoq, similar to the previous quarter.

The pace of business inventory accumulation also picked up in the June quarter, leading to another positive contribution to GDP growth. Farm inventories again increased consistent with the overall easing in drought conditions in the United States. The

GDP growth still modest but strengthened in June quarter…



…due to investment and smaller public demand headwind



Q2 2013 GDP Details

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.4	0.3	1.8
Fixed investment	1.5	0.2	4.7
Structures	1.7	0.04	-0.3
Equipment	1.0	0.1	2.6
Intellectual property	1.0	0.04	4.0
Residential	3.2	0.1	14.9
Ch. in inventories		0.1	
Public Demand	-0.1	-0.02	-2.0
GNE	0.6	0.6	1.5
Net exports		-0.2	
Exports	1.3	0.2	1.4
Imports	2.3	-0.4	1.8
GDP	0.4	0.4	1.4

Source: US Bureau of Economic Analysis level of inventories to sales does not appear to be out of line with the historical trend, so while the pace of inventory accumulation is unlikely to pick-up any further next quarter, it is not obvious either that there will be a large slow down.

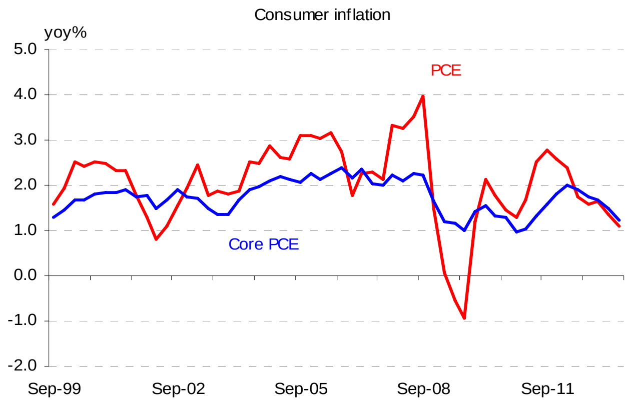
Housing continues to be the stand-out sector, growing by 3.2% qoq to be almost 15% higher than a year ago. Notwithstanding the strong growth, it is still off a low base, and the level of activity still remains very low by historical standards.

Both export and import growth picked up after being weak in recent quarters. Exports grew by 1.3% qoq after a small decline the previous quarter. Imports recovered even more strongly, rising 2.3% qoq after falling over the two previous quarters. As a result, net exports made their largest detraction from growth since the December quarter 2011. A degree of caution is warranted in interpreting advance GDP trade estimates as they are based on only two months data, but the broad trend of strengthening trade flows in 2013 is consistent with the trade indicators from the ISM surveys.

Public demand again fell in the June quarter, but by a much smaller amount than at the start of the year. This reflected a small increase in state and local government demand (+0.1% qoq), and a much smaller decline in Federal government spending. In particular, while non-defence spending fell by a similar degree to that in the March quarter, defence spending only declined by 0.1% qoq, after falling almost 9% over the two previous quarters. Defence spending has not only been affected by the ‘sequester’ budget cuts, but also by the winding down of overseas military operations. The June quarter results suggests that the latter factor might be receding, although the sequester is yet to fully play out.

Inflation remains quite soft. The personal consumption expenditure (PCE) price index was essentially unchanged in the quarter, and excluding energy and food prices (the ‘core’ PCE) it was only up a weak 0.2% qoq, the lowest quarterly growth since end 2010. As a result annual PCE inflation was only 1.1% (1.2% for the core measure), well below the Fed’s 2% long-term goal.

Subdued inflation



Source: US Bureau of Economic Analysis

Historical revisions and changes to GDP

As part of releasing the June quarter GDP accounts the BEA made some important methodological revisions as well as updating past estimates for newly available data. The changes cover the period 1929 to 2013. The methodology changes include expanded capitalization of intellectual property products (expenditures for R&D and for entertainment, literary, and artistic originals are now classed as fixed investment) and expanding the change in ownership transfer costs that are recognised as fixed investment.

The changes to the accounts have increased the level of nominal GDP by over 3%. It also suggests that the most recent recession was slightly less severe than previously thought and the recovery slightly stronger. 2012 growth is now 2.8% in year average terms, up from 2.2%, due to upward revisions to December quarter 2011 and March quarter 2012 growth.

Assessment

The June quarter accounts do not change our view of the direction of the economy. While growth in the quarter was stronger than expected and growth has accelerated over the last two quarters, this is balanced out by downward revisions to growth in previous quarters. Moreover, the stronger than expected growth was in-part due to inventories, essentially bringing forward growth from later in the year.

In the second half of 2013 we expect that the impact of the tax increases will begin to fade. Consumption will also be supported by the continued growth in household wealth and employment and the gradual easing in lending standards by banks. This latter factor will also aid business investment, which is being underpinned by high corporate profits. The rapid growth in housing construction is also expected to continue, due to low inventory and continued employment growth which will support household formation.

In contrast, subdued economic conditions in the US’ major trading partners, together with the rise in the USD will constrain the export sector. However, world growth is expected to strengthen heading in 2014. Federal fiscal policy will also be a drag on growth for some time to come, although the extent of the drag may moderate towards the end of the year. Moreover, Federal spending reductions will likely be partially offset by improving conditions at the state/local government level. Interest rates remain low by historical standards, but the uncertain impact of their recent rise represents a downward risk to the outlook.

As a result, we expect that the drawn-out recovery will continue, but with the pace of growth strengthening further over the rest of this year. We are forecasting GDP growth of 1.5% in 2012, revised downwards from 1.8%, mainly due to the revisions to historical data. Our forecast for 2013 of 2.7% is unchanged.

The release of the June quarter GDP result coincided with the Federal Reserve’s July meeting. The meeting statement did not provide any further illumination on the likely timing of QE tapering, but changes in the statement have been generally interpreted as ‘dovish’. In particular, the description of growth was changed from ‘moderate’ to ‘modest’ and statements regarding the risk of low inflation and the rise in mortgage rates were included.

In his post June meeting press conference the Fed Chairman raised the prospect of QE tapering (a reduction in the size of the Fed’s asset purchases) starting later this year in the context of continuing job gains, economic growth that picks-up over the next few quarters and inflation moving back towards 2%. Indicators suggest that jobs growth remains solid. The June GDP result, combined with revisions to previous quarters, suggests an upwards trend to GDP growth this year (albeit off a lower base). So two out of three conditions seem to be on-track. While, inflation was weaker in the June quarter, the CPI core measure of inflation strengthened in May and June, but we won’t be sure that this has carried over into the monthly PCE indicator (the Fed’s preferred measure) until the data are released later this week. The Fed will also want to see these trends reflected in partial data released before the September meeting.

These considerations reinforce our view that while the September meeting is the likely date for a start to tapering to be announced, there is a not insignificant risk that it will be pushed out to later in the year.

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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	2.2	2.0	2.4	0.4	0.4	0.6	0.4	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Private fixed investment	6.2	8.3	5.2	8.6	0.7	2.8	-0.4	1.5	**2.1**	**2.2**	**2.1**	**2.1**	**2.0**	**2.0**
Government Spending	-3.2	-1.0	-2.2	-0.6	0.9	-1.7	-1.1	-0.1	**-0.3**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Inventories*	-0.2	0.2	0.0	0.0	0.1	-0.4	0.2	0.1	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	0.1	-0.1	-0.2	0.0	0.2	-0.1	-0.2	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.8**	**1.5**	**2.7**	**0.7**	**0.0**	**0.3**	**0.4**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline		(yoy%)												
Headline	2.6	1.7	1.0	1.7	0.4	0.4	0.3	0.0	**0.4**	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**
Core	1.8	1.7	1.1	1.9	0.4	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**	**7.3**	**7.2**	**7.1**	**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	3.00	2.75	1.72	1.72	1.96	2.30	**2.75**	**3.00**	**2.75**	**2.50**	**2.50**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

** History are quarterly averages, projections are end quarter

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