United States Economic Update

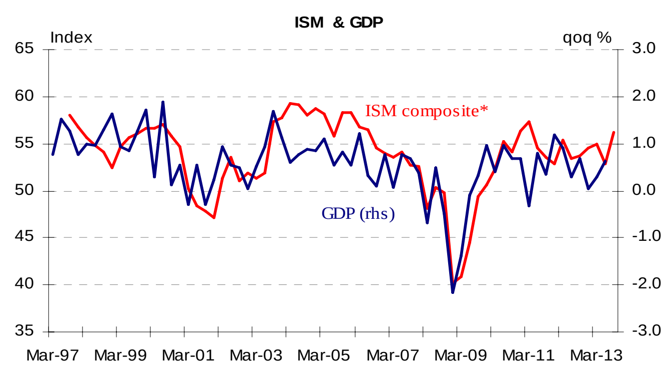
National Australia Bank

- **September quarter GDP growth expected to be 2.0% qoq (annualised rate). Business surveys more positive on strength of the economy.**
- **Partial U.S. Government shutdown will not have a major direct impact on the economy. Main risk is a major fall in confidence if the shutdown drags on and/or the likelihood of increasing the debt limit in time becomes more uncertain.**
- **We are forecasting GDP growth in 2013 of 1.6% and 2.7% in 2014.**
- **Tapering of QE3 now expected to be announced following the December FOMC meeting, but risks weighted to a later start date.**

The U.S. economy continues its drawn out recovery with indicators suggesting GDP growth in the September quarter was only moderate. We are currently projecting growth was 2.0% (annualized rate) in the quarter, although the delayed release of several indicators due to the partial U.S. government shutdown makes tracking GDP even more difficult than normal. Consumption growth in the quarter has been modest, as have capital goods shipments/orders, and housing construction has slowed, although home sales are growing rapidly, and government demand continues to be a drag. This level of growth would be slower than the June quarter, but excluding the stock cycle, it would mean a broadly unchanged underlying pace of growth.

Business surveys have been more positive. While the non-manufacturing ISM dipped in September, it remained above its June quarter average, and our combined ISM measure in September month is still at a level, if sustained, consistent with a modest strengthening in the economy's growth rate.

Business surveys remain positive

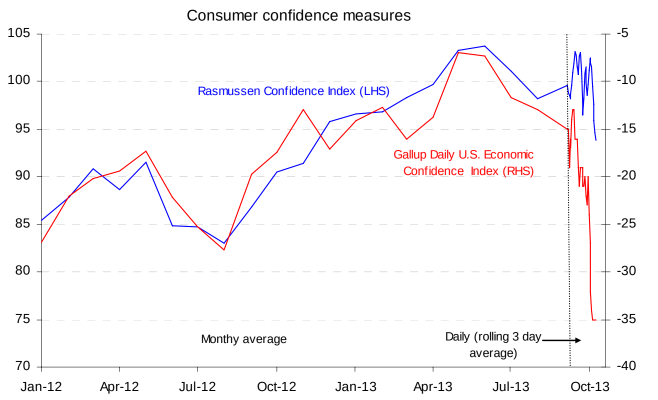


* weighted average of manufacturing and non-manufacturing ISM surveys (based on GDP shares).

Sources: ISM, NAB.

The major concern about the outlook is political events in Washington. This is currently highlighted by the partial US government shutdown. However, the focus is increasingly turning to the looming requirement to increase the Federal government's debt limit. Failure to do so would have extremely serious consequences so while it is considered an unlikely event it will still get a lot of attention. The shutdown by itself will only have a relatively small impact on measured GDP growth, but the greater concern is that these issues lead to a large fall in consumer and business confidence, with flow-on affects on the economy, as occurred around the 2011 debt limit debate. So far the evidence is unclear; while consumer confidence appears to have declined, the Rasmussen measures hasn't moved by as much as it did during the 2011 debt limit scare while the Gallup measure has. The VIX measure of financial market volatility has moved up, but is not yet at a particularly high level (in 2011 it jumped after the debt limit was increased, around the time of Standard and Poor's downgrade of the United States' credit rating).

Mixed signals on affect of shutdown on confidence



Sources: Rasmussen, Gallup

At this stage we are factoring in a relatively small impact from the shutdown, but a repeat of the 2011 debt limit scare is a clear possibility and represents a negative risk to the outlook.

If this does not eventuate, with household wealth continuing to trend up and employment growing, and banks gradually easing lending standards, we expect some strengthening in consumption growth. Indicators of capital expenditure intentions are also at their highest levels for a while, and with profits high and growing, and banks lending standards for business loans easing, business investment is also expected to strengthen. With mortgage rates still low by historical standards, as is the level of home construction, we are still projecting continued strong growth in the sector, despite a recent slowdown.

However, fiscal policy will also be a drag on growth for some time to come, although the extent of the drag is likely to moderate. In terms of monetary policy, we expect tapering of the QE program will probably be announced after the Fed's December FOMC meeting, although the risks are far more weighted to a later start date rather than an earlier one.

Overall, we expect that the drawn-out recovery will continue but with the pace of growth strengthening into 2014. We are forecasting GDP growth of 1.6% in 2013 and 2.7% in 2014.

U.S. Government shutdown

A partial shutdown of the Federal U.S. government started on 1 October with the failure to Congress to agree on a bill to fund the government. The shutdown is partial as not all government functions require an annual funding bill (e.g. social security payments are unaffected). Further, some agencies have independent sources of income (e.g. the postal service) and remain open. Moreover, even for those areas that require a funding bill, essential employees keep working. Essential workers cover such areas as the military and those operating programs with permanent or multi-year funding (e.g. staff administering benefits payments). No one has a precise count, but initial estimates were that around 800,000 federal workers were sent home.

There have been many estimates of the impact of the shutdown on GDP, but the direct impact of lost output by 800,000 federal employees should be bit above a 0.1 percentage point on the annualised quarterly growth rate per week of the shutdown. However, last weekend it was announced that most of the around 350,000 civilian defence staff sent home in the first week would return to work (which would reduce the direct impact of the shutdown to a bit under 0.1 ppts a week).

Of course there may also be indirect affects – e.g. inability to obtain government related paperwork need for loan applications may affect housing and firms that deal with the Federal government may also lay-off workers as new contracts are stalled. Spending by Federal workers may also be affected; however, the unanimous passage of a bill by the House (which is expected to gain Senate approval) to the effect that even workers sent home will receive back-pay should limit this risk.

The total impact of the shutdown will likely increase more than proportionately the longer it goes on as confidence deteriorates further and businesses and households may become more cautious. At this stage, as noted previously, there are mixed signals as to whether there has been a major deterioration in consumer confidence.

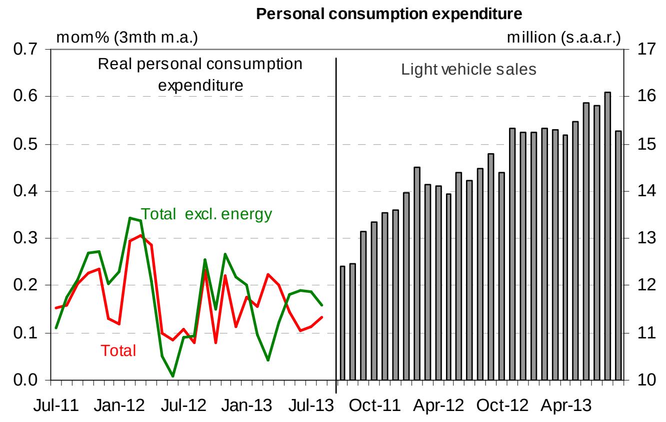
More important than the shutdown, in terms of its potential impact on the economy if things go wrong, is the impending need to increase the U.S. debt limit. Without an increase in the debt limit the U.S. would have to immediately make large spending cuts and at some point, if the government is unable to (or does not want to) prioritize its payments, start to default on its debt obligations. Of course, prioritizing bond holders would mean other promised payments (including contractual obligations) are not met and could also have severe consequences on confidence and perceptions of the creditworthiness of the U.S. government. The Congressional Budget Office estimates that the Treasury will exhaust all of its borrowing authority, as well as its cash balance, between October 22 and 31 October.

We think it extremely unlikely that the debt limit will not be increased in time, but as 2011 showed, if it is left to the last minute then there can be a negative impact on the economy. A small increase in the debt limit to allow time for discussions is a possibility; this would remove immediate worries but would mean the issue festers for longer.

Consumption

Private consumption growth in the September quarter appears to have been modest, and a little slower than the previous quarter. As we noted last month, this is largely due to lower power usage likely reflecting unseasonable weather. Notwithstanding a dip in sales in September, for the quarter as a whole car sales rose by 1.3% qoq, similar to the June quarter (reports suggest that the timing of the Labor Day holiday drew sales into August). Even allowing for these temporary factors, the data have been a little disappointing as the expected strengthening in consumption, as the impact of start of year tax increases fades, has been weaker than expected. This may be explained by the impact on household budgets of the run up in petrol prices in June, although these have now started to unwind.

Recent pace of consumption growth only modest



Sources: Bureau of Economic Analysis, Autodata, NAB

Still modest income growth will continue to constrain household hold consumption, although the upwards trend in household wealth continues to be a positive factor, as are easing lending standards.

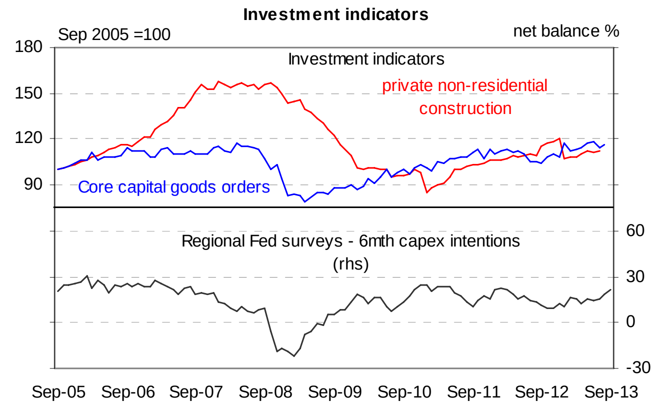
Business investment

Barring a loss of confidence caused by events in Washington, longer-term indicators generally point to continued growth in business fixed investment. Indeed our simple average of the various Fed regional surveys capital expenditure intention measures is at its highest level in around 1½ years. After falling in July, core (excluding defence and aircraft) capital goods orders resumed their upwards path in August. As we reported last month, private non-residential construction rose in July, continuing the general, albeit modest, recovery since a dip at the start of the year; August data are not yet available due to the Government shutdown.

These measures of actual or intended business investment, simply confirm what we would expect to see, given the underlying support for business investment from easing lending standards and high, and growing, corporate profits. The improvement in other advanced economies and better recent data on the Chinese economy, are also likely to have improved the investment environment.

However, while in recent updates we have noted that policy uncertainty was almost back at pre-recession levels, the Baker, Bloom and Davis measure of this jumped up in September presumably reflecting renewed uncertainty about the direction of U.S. monetary policy. The U.S. partial government shutdown and increasing attention on the debt limit could further undermine confidence. At this stage we are assuming that there will be no major, sustained, impact on confidence, but if it were to occur it would represent a clear downside risk to the business investment outlook.

Capex intentions continuing to rise

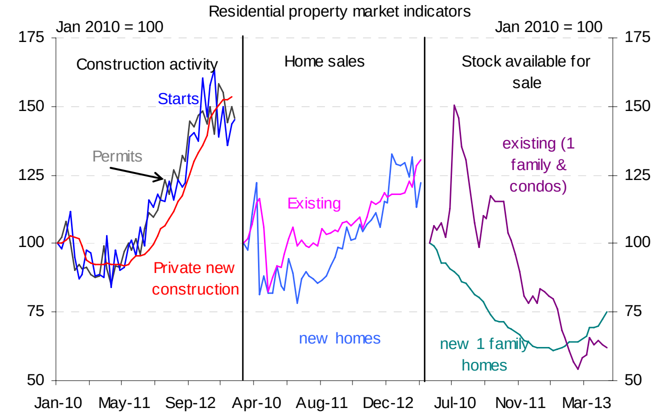


Source: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves, NAB.

Housing

As we have noted in recent months, there continue to be mixed signals on the strength on housing construction. The clear message, however, is that the growth rate of construction activity slowed down in recent months (see chart). That said, the National Association of Home Builders Housing Market Index has risen significantly since April suggesting that the slowdown may be temporary, perhaps in part a correction to very strong data earlier in the year. Another likely explanation is the rise in mortgage interest rates since May (notwithstanding some recent moderation).

Housing construction growth has slowed down recently



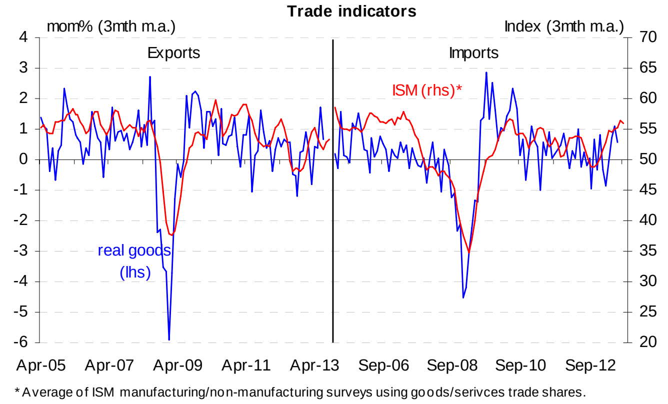
Sources: Census Bureau, NAB

Nevertheless, we still expect the housing sector to show rapid growth over the next few years as the level of construction activity remains low by historical standards, as is available inventory, and while interest rates have moved higher, they are not high by historical standards. In terms of the short-term impact of the slowdown on GDP growth, it will be cushioned by the recent strength in existing home sales, as ownership transfer costs are capitalised and included as part of residential investment.

Trade

One consequence of the partial U.S. government shutdown is that the release of August trade data has been delayed. Nevertheless, the data available though to July suggest trade flows – both exports and imports – strengthened over 2013. The ISM surveys suggest this is continuing, particularly for imports. Strength in imports can be an indicator that U.S. demand is strong (the other possibility, at least for a short period of time, is that it reflects an inventory build-up).

Trade has picked up over 2013



Sources: ISM, Census Bureau

Over the last few years net exports, on average, have made a small positive contribution to growth. We don't expect to see this over the forecast horizon given our forecast for stronger domestic demand combined with appreciation in the currency. However, the upturn underway in other advanced economies, as well as the recent improvement in the Chinese economy, will provide support to net export performance.

Labour market

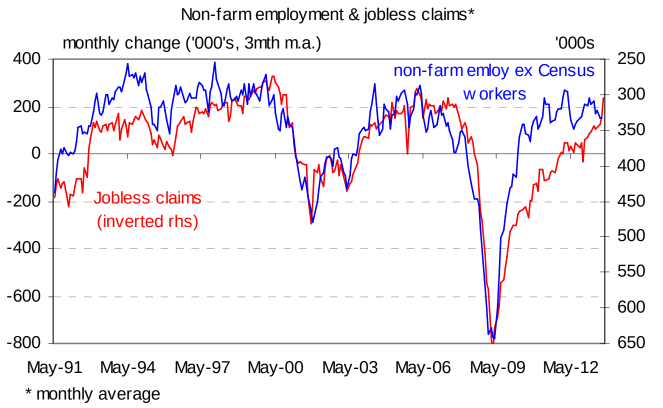
Another casualty of the partial Government shutdown is the monthly employment report, with the September report not yet available. However, other indicators suggest that the labour market continued to recover through September.

As we noted in last month's update, the unemployment rate fell for the second consecutive month in August, and is now 7.3%. However, this largely reflected a fall in the participation rate, and the report also suggested that the rate of non-farm employment growth had slowed recently.

However, other data suggest that there has been no slowdown in the pace of the labour market recovery. The September quarter average of both the ISM manufacturing and non-manufacturing surveys was higher than the June quarter average. Broadly, these surveys do not point to any fundamental change in the pace of job creation.

Another measure of the labour market is initial jobless claims. While these data only show one-side of the equation (people losing their job, whereas net employment growth is also influenced by the rate at which businesses are taking on new employees) they do tend to broadly move in line with the employment data. In September there was a noticeable decline in jobless claims. In part this was due to processing difficulties in some states, but even the last two weekly readings (which should have been largely unaffected by these problems) were well down on August levels.

Jobless claims suggest further improvement in labor market



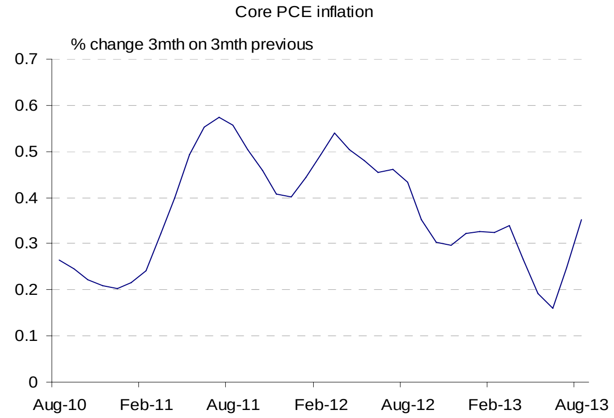
Source: Bureau of Labor Statistics, Department of Labor, NAB.

Inflation

Annual inflation remained subdued in August. The personal consumption expenditure price index - both headline and core (ex food and energy) - grew by 1.2% higher over the last year.

While headline inflation may move a bit lower next month – as the strong increase in prices in September last year drop out of the calculation – the trend decline in core PCE price growth since early 2012 appears to have ended. However, the most recent monthly growth rates are still tracking below the Fed's 2% objective. The desire to see further confirmation that the downwards trend in inflation has ended, and perhaps to see further upward movement, was a consideration in the Fed's decision to not start QE 'tapering' in September.

Downward trend in core inflation appears to be over



Source: Bureau of Economic Analysis, NAB

Monetary Policy

The Fed in its 17-18 September meeting left the rate of asset purchases under its QE program unchanged. This surprised markets who had generally been expecting a start to 'tapering' (i.e. a reduction in the size of Fed asset purchases in 'measured steps'). This was also our expectation although we had cautioned that the risk of tapering being delayed was reasonably high.

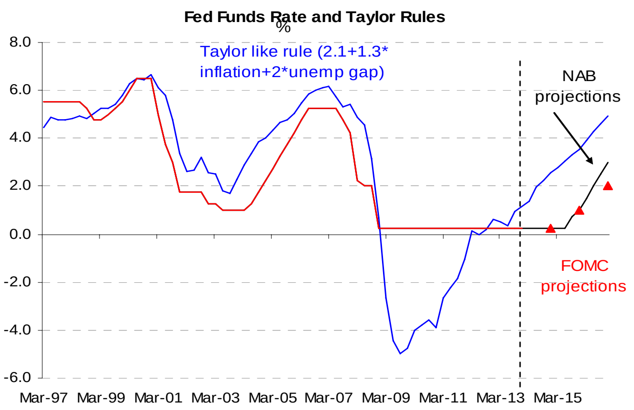
In his press conference following the September meeting, the Fed Chairman noted that "…the broad contours of the medium-term economic outlook … were close tho the views it held in June." However, the Chairman indicated that Fed members wanted to see more data confirming this outlook. Specifically, they want to see growth strengthening, continuing labour market gains, and inflation moving back towards the Fed's 2% objective. The Fed was also concerned about the impact of the recent rise in interest rates, restrictive fiscal policies and 'upcoming fiscal debates' (read shutdown and debt limit). In summary, they think things are broadly on track but they want to see data that confirm this is the case and to get past the current budget/debt battles.

This suggests that the most likely start date to tapering is the December meeting. The September meeting minutes noted that a majority of Fed members thought tapering would start this year (and the program fully end by mid-2014) if their economic projections turn out to be correct. The risks around this timing are heavily weighted towards a delay until early 2014 rather than earlier (i.e. the October meeting). As noted previously, indicators suggest the labour market continues to improve and that inflation has turned the corner. However, given normal data volatility, whether an uptrend in growth will be clear by the December meeting is even more uncertain. Another risk is the shutdown/debt limit saga; if this triggers a general loss of confidence similar to that in 2011 then the Fed will likely leave QE unchanged at it waits to see the impact.

The Fed Chairman in his press conference also emphasised that even when the 6.5% unemployment rate threshold is reached that the Fed Funds rate will not rise automatically. Moreover, he indicated that when it does start to rise most Fed members expect that this will occur only very slowly. Consistent with this the median of Fed members' projections for the fed funds rate at end 2016 is only 2%.

That would be an extraordinarily low Fed Funds rate in a situation of (if their and our forecasts pan out) near full employment, three years of above trend growth and inflation around its target. It probably represents an attempt to keep current long-term bond yields down as much as anything. Most versions of the 'Taylor rule' would suggest a fed funds rate of over 4% in these circumstances. This is not our forecast as the delay in starting to increase rates implied by the Fed's forward guidance means policy will take time to catch up to levels prescribed by typical interest rates rules; somewhere in-between the two extremes seems realistic.

Fed indicating when fed funds rates starts rising it will be slowly



Sources: Federal Reserve, NAB. Taylor rule in chart is the one developed by Rudebusch in The Fed's Monetary Policy Response to the Current Crisis, FRBSF Economic Letter, 2009-17)

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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	1.9	2.4	0.4	0.4	0.6	0.5	**0.4**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Private fixed investment	6.2	8.3	4.9	8.3	0.7	2.8	-0.4	1.6	**1.6**	**2.1**	**2.2**	**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**	**-0.5**	**0.0**	**-0.1**	**-0.1**	**0.0**
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	0.0	-0.1	0.0	0.2	-0.1	0.0	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.8**	**1.6**	**2.7**	**0.7**	**0.0**	**0.3**	**0.6**	**0.5**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline		(yoy%)												
Headline	2.6	1.7	1.1	1.8	0.4	0.4	0.3	0.0	**0.5**	**0.3**	**0.4**	**0.5**	**0.4**	**0.5**
Core	1.8	1.7	1.2	1.9	0.4	0.3	0.3	0.16	**0.39**	**0.35**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment Rate (%)	8.7	7.8	7.2	6.8	8.0	7.8	7.7	7.6	**7.3**	**7.2**	**7.1**	**7.0**	**6.9**	**6.8**
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	2.61	**3.00**	**2.75**	**2.70**	**2.75**	**2.90**

Source: NAB Group Economics

*Contribution to real GDP

** History are quarterly averages, projections are end quarter

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