US Economic Update – US GDP, 2013 Q4

National Australia Bank

- **US GDP rose by a reasonably strong 3.2% (annualized rate) in the December quarter, completing a strong second half to the year.**
- **Consumption growth was stronger as were net exports but residential investment went into reverse and public demand was very weak due to the October government shutdown. Inventories look high, but excluding this factor reveals an economy which strengthened over the year.**
- **GDP growth was 1.9% in 2013 and we expect GDP will grow by 2.8% in 2014 and by 2.9% in 2015.**

US GDP in the September quarter grew by a reasonably strong 0.8% qoq or at an annualised rate of 3.2%. While this represents a deceleration from the strong September quarter pace, the growth over the six month period was the fastest half-yearly growth rate in almost two years.

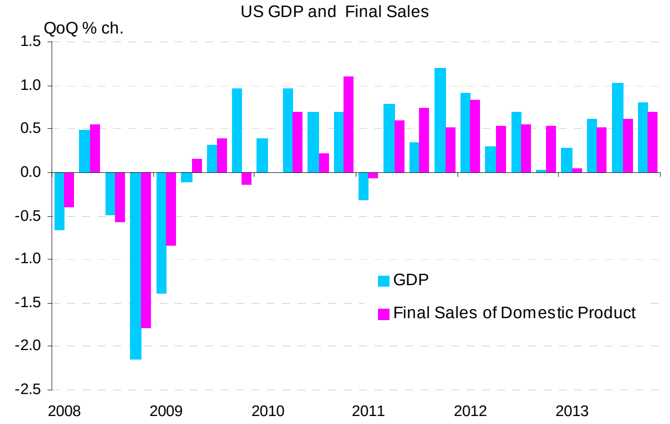
One factor boosting GDP growth in the last two quarters has been rapid inventory accumulation which is not sustainable. However, looking at final sales of domestic product (which excludes inventories) the picture is of a strengthening economy. Moreover, the stronger December quarter outcome came despite the partial Government shutdown in October, which contributed to a large reduction in public spending.

The strengthening in final sales of domestic product in the December quarter reflected stronger private consumption growth and net exports while business investment growth was similar to the previous quarter. However, previously strong residential investment went into reverse.

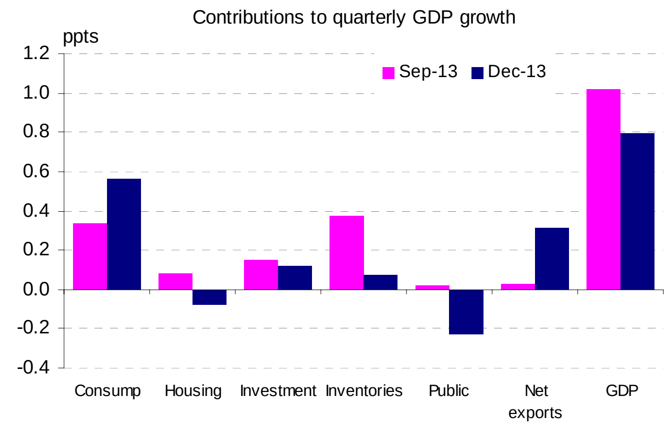
Private consumption growth in the quarter was the fastest in three years. Despite some slowdown, durable goods consumption growth remained the fastest growing category. Non-durable goods and services consumption growth strengthened in the quarter, to their highest levels in 2-3 years. In the case of services consumption, this appears to reflect a weather impact as the ‘housing and utilities’ component, which recorded a large 0.6% decline in the September quarter bounced back to grow by 0.3% qoq. Excluding this component, consumption growth strengthened over the course of 2013, suggesting that consumers have absorbed the impact of the start of the year tax increases.

Business fixed investment grew by 0.9% qoq, only a little below the previous quarter’s growth rate, but there was a change in composition. Equipment investment which was basically flat in the September quarter picked up in the December quarter to grow at its fastest rate for a year. In contrast, there was a small decline in non-residential structures investment following two quarters of strong growth.

Growth strong in second half of 2013



…consumption, net exports strengthened in Q4, govt. down



Q4 2013 GDP Details

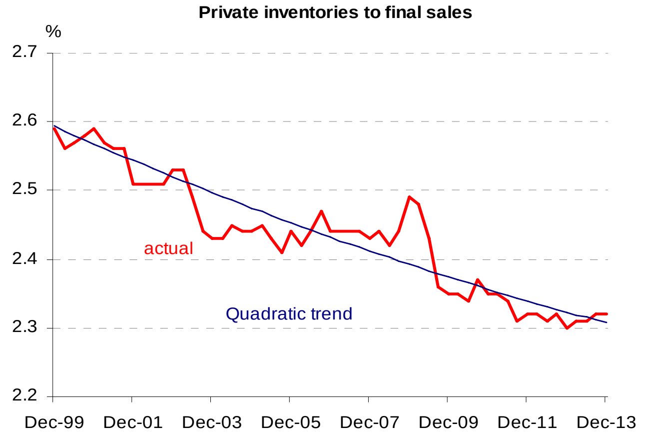
	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.8	0.6	2.3
Fixed investment	0.2	0.0	2.9
Structures	-0.3	0.0	-0.5
Equipment	1.7	0.1	3.0
Intellectual property	0.8	0.0	2.8
Residential	-2.5	-0.1	6.3
Ch. in inventories		0.1	
Public Demand	-1.3	-0.2	-2.3
Net exports		0.3	
Exports	2.7	0.3	5.4
Imports	0.2	0.0	2.7
GDP	0.8	0.8	2.7

Source: US Bureau of Economic Analysis

Growth in total business investment over the year to the December quarter was a very modest 2.1%, well below the 5.0% yoy in the December quarter 2012.

The rate of inventory investment strengthened even further from its very rapid September quarter pace. Part of the strength in inventories was again due to the farm sector consistent with the overall easing in drought conditions in the United States between 2012 and 2013. However, non-farm inventories also grew rapidly and the inventories to sales ratio is starting to look slightly above trend. Accordingly, our forecasts allow for deceleration in inventory accumulation over 2014, although a risk is that the correction is sooner and sharper.

Inventories above trend – correction likely over 2014



Sources: Bureau of Economic Analysis, NAB

After a couple of years of rapid growth, housing investment recorded its first decline since the September quarter 2010, likely reflecting the rapid increase in mortgage interest rates between May and August 2013 of around 1 percentage points. Nor was it a small fall, at -2.5% qoq it unwound the previous quarter's growth and as a result residential investment was basically flat over the second half of 2013. Investment in new dwelling construction continues to rise (albeit at a slower pace) but there was a large decline in the 'other structures' component. This includes ownership transfer costs (commissions etc) from house sales which have been falling.

Net exports made its strongest positive contribution to growth in three years, reflecting rapid export growth (2.7% qoq) and subdued import growth (0.2% qoq). The recent weakness in imports is surprising given the improvement in the U.S. economy and the appreciation of the dollar, and the ISM surveys' import measures suggest the low December quarter growth rate won't be sustained.

There was a big reduction in public demand in the quarter. Federal government spending is being cut back, but this was exaggerated by the partial government shutdown for around half of October. As a result after declining by -0.4% qoq in each of the previous two quarters, federal spending fell by 3.3% qoq in the December quarter. At the same time there as another small rise in state and local government demand.

Inflation remains subdued and well below the Fed's 2% longer-term goal. The headline personal consumption expenditure (PCE) price index grew only 0.2% in the December quarter and over the last year by only 0.9%. December quarter prices were held down by a decline in energy prices. As a result core inflation (ex energy and food) was a bit stronger in the quarter and over the last year has increased by 1.1%.

Assessment

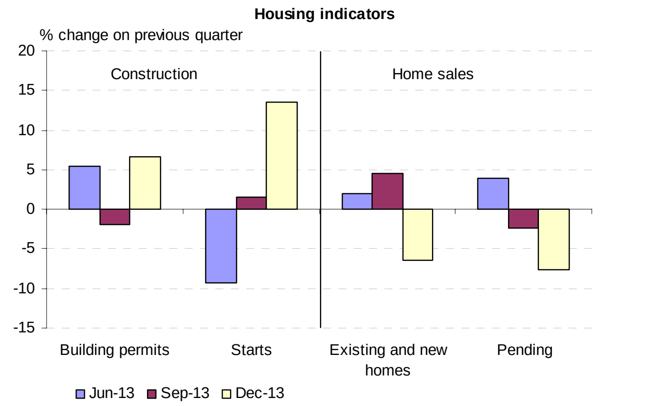
The December quarter accounts were broadly in line with market, and our own, expectations. As a result, we have left unchanged our forecasts for GDP growth of 2.8% in 2014 and 2.9% in 2015.

We expect GDP growth in the March quarter to show some further deceleration. This in large part reflects an expected slower pace of inventory accumulation which will likely be a drag on growth in 2014.

Consumption growth is also expected to step back a bit from the strong level recorded in the December. The full monthly split of December quarter consumption is not yet available but, based on the quarterly result, and the October and November month data, it looks like consumption growth decelerated in the December month. Nevertheless, with household wealth continuing to trend up, employment growing, and banks gradually easing lending standards, the trend in consumption growth should be solid.

Signals for housing investment in the March quarter are quite mixed. Reflecting this, we are currently factoring in a resumption of growth in the March quarter, but still down on the growth rates seen over recent years. Both building permits and housing starts grew strongly in the December quarter following some recent weakness. However, it is possible that severe weather may delay construction. Moreover, home sales look week; in particular, pending sales declined 9% mom in December suggesting weak home sales for the current quarter. This may be weather related so a bounce back is possible, although January does not appear to have been any better weather wise (and possibly worse).

Housing indicators mixed



Sources: Census Bureau, National Association of Realtors, NAB

However, mortgage rates have broadly stabilised since August, and when households adjustment to the higher level is complete we expect housing investment to resume its rapid growth. This reflects the fact that the level of residential investment is still very low as is the inventory of homes available for sale. Moreover, by historical standards mortgage rates are still relatively low, there are signs that banks are starting to ease mortgage lending standards and the ongoing recovery in the labour market should encourage more people to start their own households.

High and growing profits, coupled with banks also easing lending standards for business loans, should lead to stronger business investment growth. Regional federal reserve surveys of capex intentions were higher in the second half of the year than the first and picked up noticeably in January, which is a positive sign. A short-term risk is that the end of tax breaks at the end of 2013 may have boosted end 2013 investment and there may be a correction in early 2014.

Exports should be also be supported by improving global economic conditions, although we expect further appreciation of the dollar to constrain net export performance. As noted before, the advance estimate for December quarter import growth looks weak given developments in the economy and when compared to surveys, so we expect to see this turn around.

Federal fiscal policy will continue to be contractionary, but not to the same extent as in 2013. In the March quarter itself public demand should bounce back after being held back in the December quarter by the Government shutdown. Not only is the headwind from fiscal policy becoming more muted but fiscal policy uncertainty is lower. A spending bill for this financial year has been passed (i.e. no immediate risk of another shutdown) and while the debt ceiling, which needs to be increased soon, could cause another bout of uncertainty, there is a reasonable prospect of an orderly (by congressional standards) increase this time around.

The December quarter GDP outcome should not change the outlook for monetary policy given that it was broadly in line with expectations. The Fed in its January meeting continued the process of reducing its asset purchase (QE) program and this is likely to continue through much of 2014, with the program expected to end by the December quarter 2014. The Fed's unemployment rate threshold is close to being reached after a large decline in the unemployment rate in December. This would mean that its forward guidance would no longer be a constraint on any fed fund rate increases. However, any increases in the fed funds rate appear a long way off, as the Federal Reserve is downplaying the importance of the unemployment threshold. We expect that the first increase in the Fed funds rate will not be until the September quarter 2015.

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US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %							
					2013		2014				2015	
	2012	2013	2014	2015	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components												
Household consumption	2.2	2.0	2.6	2.6	0.5	0.8	**0.7**	**0.6**	**0.6**	**0.7**	**0.6**	**0.7**
Private fixed investment	8.3	4.3	6.2	7.6	1.4	0.2	**1.6**	**2.1**	**2.1**	**2.1**	**1.8**	**1.7**
Government spending	-1.0	-2.2	-0.4	0.3	0.1	-1.3	**0.6**	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**
Inventories*	0.2	0.2	-0.1	-0.1	0.4	0.1	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	0.1	0.1	0.3	0.0	0.0	0.3	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.8**	**1.9**	**2.8**	**2.9**	**1.0**	0.8	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)												
PCE deflator-headline	(yoy%)											
Headline	1.7	0.9	1.5	1.9	0.5	0.2	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Core	1.7	1.1	1.6	2.0	0.3	0.3	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.8	7.0	6.3	5.9	7.2	7.0	**6.7**	**6.5**	**6.4**	**6.3**	**6.2**	**6.1**
US Key Interest Rates (end of period)												
Fed funds rate	0.25	0.25	0.25	0.75	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
10-year bond rate	1.76	3.03	3.00	4.00	2.61	3.03	**2.9**	**2.8**	**2.8**	**3.0**	**3.3**	**3.5**

Source: NAB Group Economics

*Contribution to real GDP

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