United States Economic Update

by NAB Group Economics July 2014

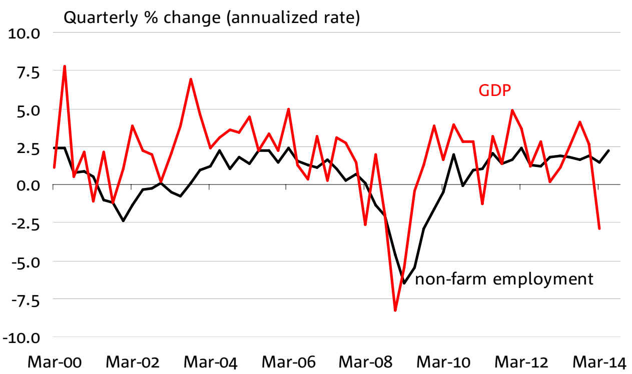
- **The large fall in March quarter GDP is not matched by other indicators. Data for June quarter suggest growth will resume.**
- **Inflation has strengthened in recent months. With slack in the economy declining – not only in the labour market but also in other sectors – inflation looks set to continue rising, but only gradually.**

A tale of ‘two’ economies

At the start of the Charles Dickens novel A Tale of Two Cities ‘It was the best of times, it was the worst of times…’. If the latest data are to be believed, something similar could be said of the U.S. economy.

The GDP data were revised late last month to show a recession like fall in GDP in the March quarter of -2.9% qoq (annualized). In contrast, the labour market recovery showed signs of strengthening. The unemployment rate fell another 0.2ppts in June to 6.1% and non-farm employment grew by 2.2% in the June quarter (annualized), its fastest quarterly growth rate in over two years.

GDP and employment telling different stories

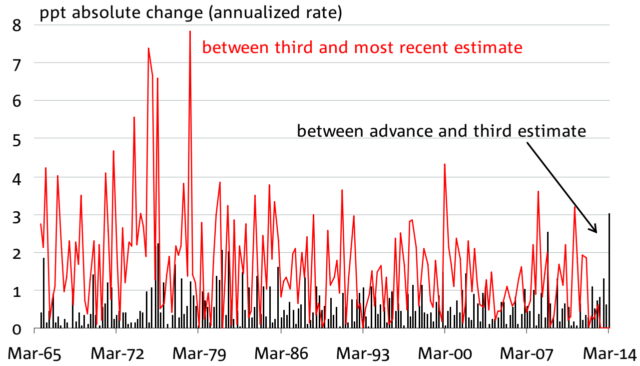


Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, NAB

GDP and employment growth tend to track fairly closely, with GDP growth generally stronger and leading employment growth. The recent data are well outside the norm; the differential could be explained by productivity but there is no reason to believe it has plunged and productivity is calculated using the same output/labour data and so is not an independent check.

While there is a lot of focus on GDP – as it is the broadest measure of economic activity –measuring it is no simple task and estimates are subject to considerable revision. The March quarter broke a record, as it had the single largest revision to growth between the advance and third estimate since at least mid-1965. Even after the third estimate GDP is subject to annual revision (with these published in the advance June quarter estimate of each year; with the next one due at the end of this month). These subsequent revisions tend to be even larger than the initial (advance to third) estimates. Employment data are also subject to revision but changes in the unemployment rate tend to be small, making it a more reliable indicator of current trends.

Record breaking revisions so far to March quarter GDP



Sources: Philadelphia Federal Reserve, BEA, NAB

As we noted following the GDP release, a range of indicators such as business surveys, consumer confidence, industrial production, as well as the labour market, do not point to any major downturn in the economy. The since released ISM surveys for June point to an economy growing strongly. Available partial activity data for the June quarter are also consistent with growth turning positive.

The main areas of weakness are in consumption and net exports. After strong growth in February and March, consumption actually fell in both April and May and looks like it will be relatively subdued in the June quarter. This is in part explained by declining utility consumption (as weather conditions normalised after the cold winter) and weak health care consumption. Health care consumption in May is back to where it was in October last year. Possible reasons might be a mild flu season and the impact of new health care laws arrangements. However, given the solid upwards trend in health care consumption over time it is not likely to be sustained particularly given the increase in the number of people with health insurance.

Consumption more broadly should gain support from the strong employment growth, which contributed to a 3.0% (annualized) increase in real disposable income over the three months to May. As the labour market continues to recover, this will translate into stronger wages growth at some point. Solid income growth, supported by slowly improving consumer confidence, should support consumption growth over the year ahead.

In contrast business investment appears to have strengthened in the June quarter. Similarly, after declining in the last two quarters, residential investment looks set to resume growing in the June quarter. While private new residential construction growth has been slowing, sales of existing and new houses have rebounded recently (and the latter should, in time, support construction).

On the trade front, net exports look set to detract again from growth in the June quarter, despite a strong pick-up in real goods exports in May. More importantly, both imports and exports have strengthened from their March quarter levels; the former is consistent with an improvement in domestic demand and the later in overseas demand.

Fiscal headwinds are also fading. While fiscal policy is again contractionary this year, it is less so than last year. Monetary policy remains loose with the fed funds rate not expected to start rising until around mid-2015. While the Fed's asset purchase program continues to be wound down ('tapering'), with the end of asset purchases likely to be announced following the Fed's October meeting, any run-down in the stock of assets purchased by the Fed looks unlikely to happen before any change to the fed funds rate.

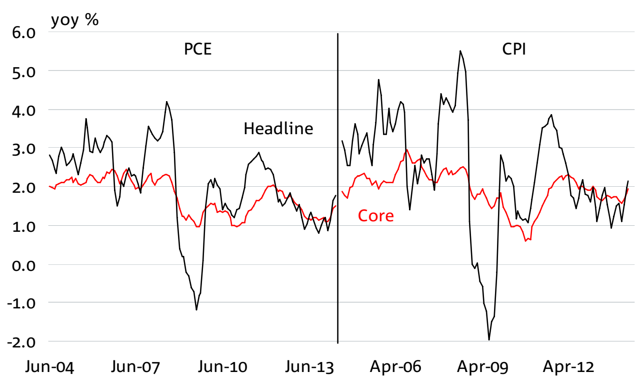
Overall, we expect growth of 1.6% this year, revised down from 2.2%. The downwards revision mainly reflects the BEA's changes to the March quarter, as well as a more modest bounce back in the June quarter in line with the most recent partial indicators. We are still forecasting 3% growth in 2015.

Inflation - developments

As the unemployment rate moves within sight of the level that Fed members believe is consistent with its employment mandate the focus on inflation – the other part of its 'dual' mandate – is increasing.

It was the combination of high unemployment and below target (2%) inflation that has justified the Fed's near zero fed funds rate and asset purchase programs. Indeed at times since the recession there have been concerns about the prospect of deflation.

Inflation on the rise

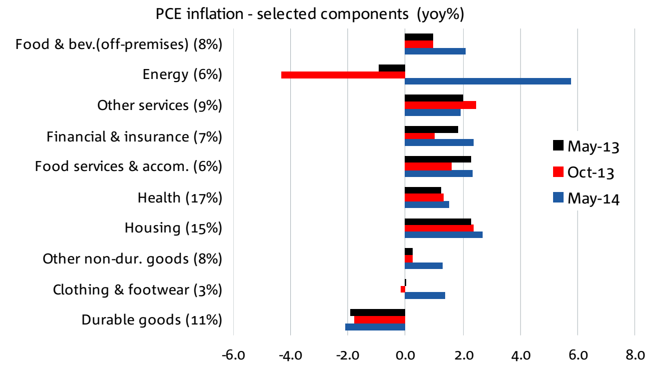


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, NAB

This concern is receding as inflation has risen in recent months. The annual growth rate in the CPI has risen from 0.9% in October 2013 to 2.1% in May 2014. Similarly, the Fed's preferred measure – the personal consumption expenditure (PCE) price index –has increased from 0.8% to 1.8% yoy over the same period. Nor has this just reflected changes in volatile food and energy prices; core PCE inflation is up from 0.8% yoy last October to 1.5% yoy in May,. Since December core PCE prices have grown at an even faster annualised 1.7% pace. The question is will this trend be continued and, if so, how rapidly will inflation rise.

Looking at the composition of the changes, price growth has picked up across many of the major categories. The biggest turnaround is in energy prices, with the other commodity affected items of food (for off-premises consumption) and clothing (linked to cotton prices) also strengthening. Health and housing – which have large weights – have also picked up. In contrast, durable goods prices (autos, TVs etc) continue to fall, although the decline of 2.1% over the year to May is only a little faster than the 1.9% average annual decline recorded since 1995.

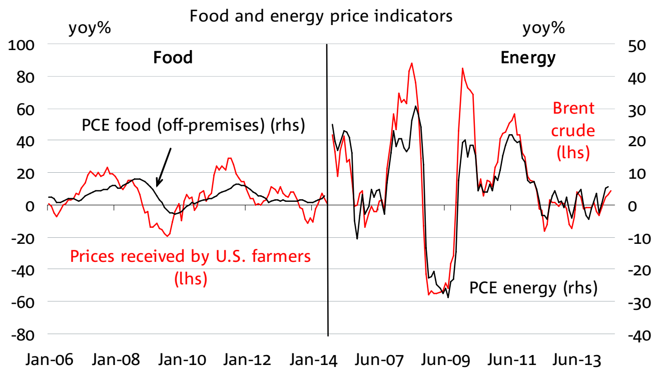
Inflation on the rise in most broad categories



sources: BEA, NAB. Share of total nominal consumption over 12mths to May 14 in brackets

Food and energy prices are closely linked to commodity prices. Brent crude prices were up 6.7% over the year to May 2014 and increased further in June (8.6% yoy) due to the impact of geo-political tensions. However, they have since come off their peaks and our expectation is for some further moderation going forward. Natural gas prices in the U.S. also rose due to the harsh winter, but have since come-off and this looks to be flowing through to utility prices.

Commodity price impacts may peak in June quarter

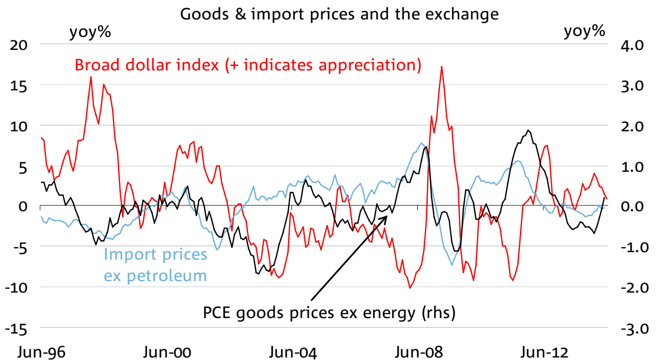


Sources: Thomson Reuters, USDA, BEA, NAB

Annual food price inflation in May was at its highest since June 2012, as the impact of a turn for the worse in drought conditions in some parts of the country flowed through to some agricultural, and with a lag, retail food prices (pig meat prices were also affected by a virus). However, prices received by U.S. farmers peaked in April and have declined over the last two months suggesting that food price inflation will moderate in the September quarter given the lag of several months between farm and consumer prices.

Consumer goods prices follow a similar path to those of imported goods, consistent with tradeable nature of many goods. Import prices will reflect overseas price pressures – which right now are relatively subdued – as well as movements in the USD. Import prices have been constraining inflation for over two years but the impact has waned a little of late, at the same time as the USD has stopped appreciating. The Fed's trade weighted index – the Broad dollar index in June was 0.6% down from its February level. However, our [currency team](#) expect that the USD will strengthen over time which should provide some continuing downward pressure on domestic prices.

External factors influence goods inflation

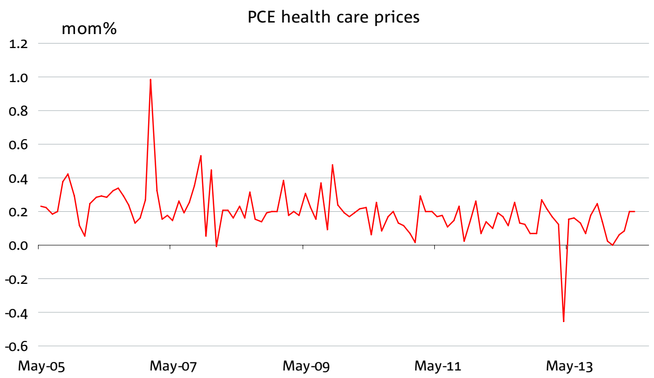


Sources: BEA, Census Bureau, Federal Reserve, NAB

In contrast, services inflation tends to be more stable and higher than goods inflation; the higher level likely reflecting lower productivity gains in the services sector. The two largest components of the services sector are health care and housing – together they constitute around one-third of consumption.

Health care inflation of 0.2% (over 2% annualised) in April and May represents a return to its more normal level after a period of weak growth. However, with the large changes underway in the health insurance sector (and not yet fully implemented) it is too early to say that things have returned to normal. Also worth noting is that last year there was a large decrease in health care costs in April (-0.5% mom) related to changes in Medicare payment rates and some major drugs becoming generic. As this dropped out of the annual PCE inflation calculation in April (and was replaced with 0.2% mom in April 2014) it added 0.1 ppts to annual PCE inflation (or almost one-third of the increase in annual core PCE inflation since October). However, this is a once-off effect and should not be extrapolated.

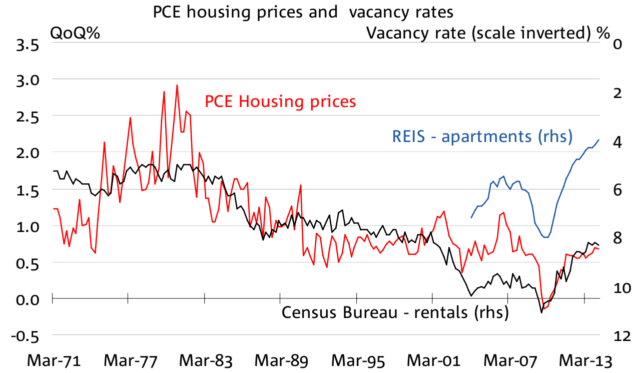
Health care inflation back to more typical levels recently



Sources: BEA, NAB

In contrast there is a clear upward trend in PCE housing prices. PCE housing prices do not measure the price of homes (which have also been increasing), but rather rental payments both by renters and owner-occupiers (an imputed rental paid to themselves). Tenant occupied PCE housing inflation has been stronger than owner-occupied PCE housing inflation but the broad trend is similar. Rental vacancy data shows vacancy rates are trending down and with strong employment growth likely to boost the number of new households, and new home construction still low by historical standards, the upwards trend in housing costs may continue for a while.

Vacancy data suggests further housing cost pressure



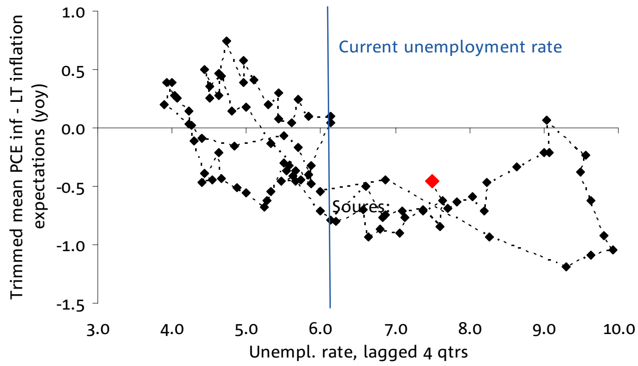
Sources: Census Bureau, REIS, BEA, NAB

Inflation – the broader picture

Another way to look at inflation is to take a more top down view. As we noted in our [February 2014 monthly update](#) one approach is based on the idea that longer-term inflation is centred on inflation expectations but that the amount of economic slack (unused plant or unemployed labour) will cause deviations from this level.

Despite concerns about low inflation at the time, we noted in our February update that inflation was not particularly low given the amount of slack in the economy, and that it should rise as slack declined, given that inflation expectations have remained within their historic bounds (what the Fed refers to as 'well-anchored'). This story has essentially not changed.

Inflation likely to pick-up further as unemployment falls



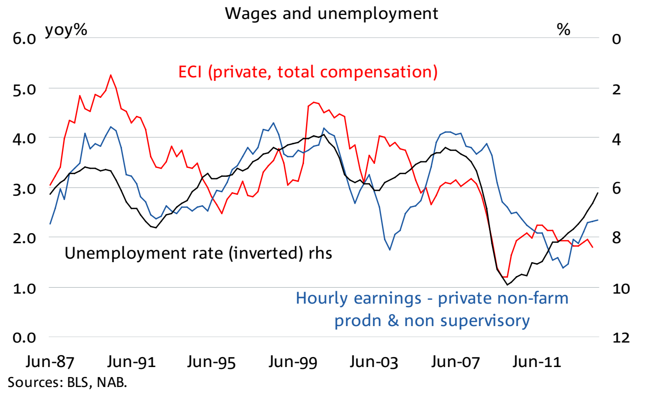
Sources: Dallas Federal Reserve, BLS, NAB. June qtr '14 inflation is a NAB estimate

The above chart (see February update for details) maps the deviation between inflation and inflation expectations against the unemployment rate. In the chart the unemployment rate is lagged by four quarters, but changing it to a shorter lag (e.g. two quarters or contemporaneous) doesn't change the story. With the unemployment rate continuing to fall inflation pressures will rise. It is worth noting that unemployment is only just on the cusp of the level that is sometimes associated with future inflation above long-term inflation expectations.

In this case we have measured slack through the unemployment rate. An obvious transmission from unemployment to inflation is through wages and this has been getting a lot of attention recently. Before looking at wages in more detail it is worth noting that the unemployment rate is not the only measure of slack. Industrial capacity can be idle and, as we have seen above, slack as measured by the vacancy rate is important for explaining PCE housing inflation. In the case of industrial capacity utilisation it too has been trending up - the Fed's measure is currently around a six year high.

Nevertheless, with wages (and other employee benefits) the largest single component of business costs, they are important. Measures of wage costs currently provide mixed messages – the private ECI total compensation measure (which includes non-wage benefits) does not yet shown any signs of accelerating, whereas the private non-farm production and non-supervisory employees hourly wage series is trending up although growth is still modest. Overall, given the decline in unemployment seen so far, wage (and non-wage benefits) growth appears a bit muted.

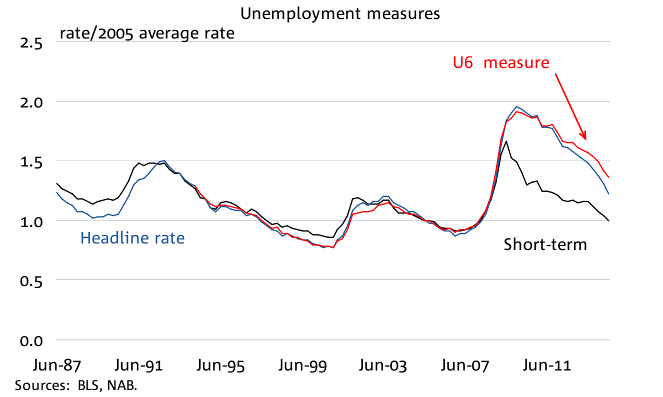
Unemployment rate increasingly consistent with future wage acceleration



There is debate about whether the short-term unemployment rate (those unemployed for less than 26 weeks) is more relevant to wage determination as the long-term unemployed may be less employable and so exert less downwards wage pressure. The short-term unemployment rate is closer to its pre-recession level than the headline rate. However, on this basis the lack of clear wages growth is even less explainable, although it may just reflect lags in the wage setting process.

Another possibility is that the unemployment rate is understating the amount of labour market slack – a favourite topic of the Fed Chair. A broader measure of slack is the U6 measure of unemployment which also includes part-time workers who want, but cannot get, a full-time job because of economic reasons as well as those marginally attached to the labour force. This measure is further away from its pre-recession level as can be seen in the chart below which shows how close the various unemployment measures are to their 2005 (pre-recession) levels. Nevertheless, it is still falling and so, even if this does explain the lack of a clear signal on wages so far, it still suggests that wages growth should start to pick-up down the track.

Measuring 'slack' imprecise – has implications for timing of wages growth

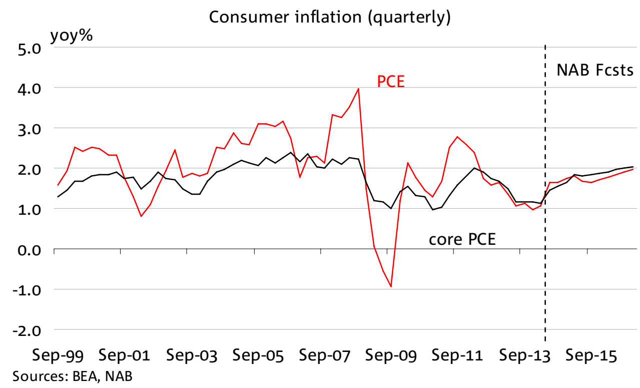


This is also the clear message of the NFIB small business survey. It shows increasing numbers of businesses are finding it hard to fill jobs – this measure is back at around its pre-recession peak. As a result, an increasing number of survey respondents have (or are planning to) increase worker compensation.

Inflation – the outlook

With inflation expectations well anchored and slack in the economy declining – not only in the labour market but also in the industrial and housing sectors –inflation looks set to continue moving back towards the Fed's 2% target. However, some of the recent increase in inflation represents base effects and increases in commodity prices which appear to be moderating. Therefore, the pace at which inflation will strengthen is likely to be more muted than that seen in recent months. Moreover, if the USD appreciates going forward, as we expect, this will also constrain inflation, as would our expectation for some moderation in international oil prices.

Inflation to rise but not rapidly



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US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %									
					2013		2014				2015			
	2013	2014	2015	2016	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	2.0	2.2	2.6	2.6	0.5	0.8	0.3	**0.5**	**0.7**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.5	4.4	7.9	6.1	1.4	0.7	-0.4	**2.0**	**2.3**	**2.2**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.2	-1.1	0.2	0.8	0.1	-1.3	-0.2	**0.2**	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.2	-0.2	0.0	0.0	0.4	0.0	-0.4	**0.2**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.1	-0.2	0.0	-0.1	0.0	0.2	-0.4	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.9**	**1.6**	**3.0**	**2.8**	**1.0**	**0.7**	**-0.7**	**0.7**	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.8	1.7	2.0	0.5	0.3	0.3	**0.6**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.2	1.7	1.9	2.0	0.3	0.3	0.3	**0.5**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.9	5.3	4.9	7.2	7.0	6.7	6.2	**6.1**	**5.9**	**5.7**	**5.5**	**5.4**	**5.3**
US Key Interest Rates (end of period)														
Fed funds rate	0.25	0.25	0.75	2.25	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.50**	**0.75**
10-year bond rate	3.03	3.00	3.75	3.75	2.61	3.03	2.72	2.53	**2.75**	**3.00**	**3.25**	**3.50**	**3.75**	**3.75**

Source: NAB Group Economics

*Contribution to real GDP

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