United States Economic Update

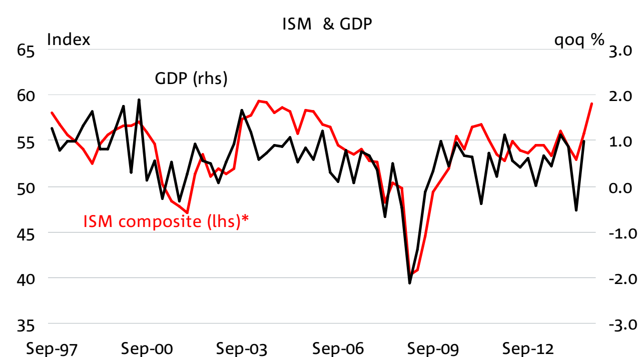
by NAB Group Economics 9 September 2014

- **Indicators remain generally positive, consistent with our forecast of solid, above trend, growth of 3.0% qoq (annualised) in the September quarter.**
- **While August's employment gain (142,000) was below expectations, the recovery in the labour market remains on track.**
- **When the Fed starts raising the fed funds rate (which we expect in the June quarter 2015), it will continue to target a range. The Fed is likely to set the interest rate on excess reserves at the top of the range, and the rate for its overnight reverse repurchase agreements program at the bottom.**

While for the most part only July data are available for the September quarter – making it too early to get a firm reading on the likely growth in the quarter – recent indicators continue to be generally positive and consistent with our forecast of solid, above trend, growth of 3.0% qoq (annualised). This is notwithstanding disappointment at the first below 200,000 employment gain since the start of the year. However, even this pace is sufficient to bring unemployment down over time.

The ISM business surveys are suggesting particularly strong momentum in the economy, rising again in August from their already strong July level.

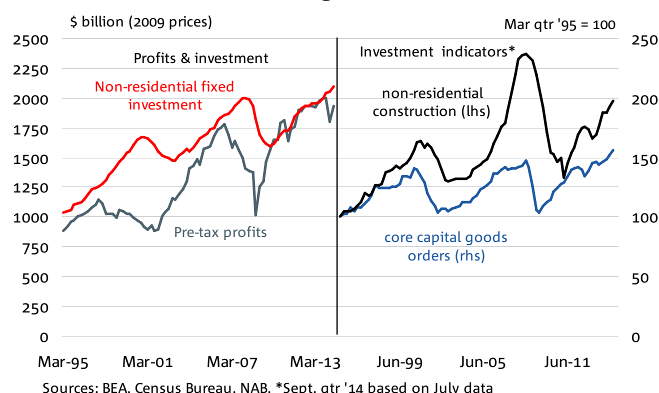
Business surveys suggest strong momentum in Q3



Sources: BEA, ISM, NAB. * weighted average of manuf. & non-manuf. ISM surveys (based on GDP shares). Sep qtr 14 ISM composite average of July & August '14.

These strong business survey results are also reflected in measures of business investment. While core (non-defence ex aircraft) capital goods orders fell a little in July this was after a large jump in June. Moreover, they are above the level of shipments, signalling the latter will continue to rise. Private non-residential construction also got off to a strong start early in the quarter. Looking further forward, the Fed regional surveys on capex intentions in August recovered some of the ground lost in July to be around their average for the year (and well above last year's level). Coupled with a reasonable bounce back in profits in the June quarter, and continued improvements in credit conditions, this suggests that the outlook for business investment looks reasonable.

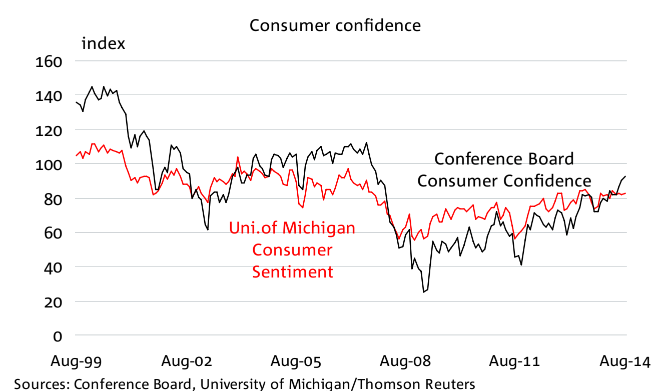
Business investment looking solid



Sources: BEA, Census Bureau, NAB. *Sept. qtr '14 based on July data

For households, the Conference Board's consumer confidence measure rose again in August, and is at highest level in almost in seven years. The survey's expectations component – an indicator of future household spending – has also been improving. That said, the University of Michigan's consumer sentiment index has not been showing the same rate of improvement. Overall, confidence looks to be slowly returning to pre-recession levels.

Consumer confidence appears to be rising

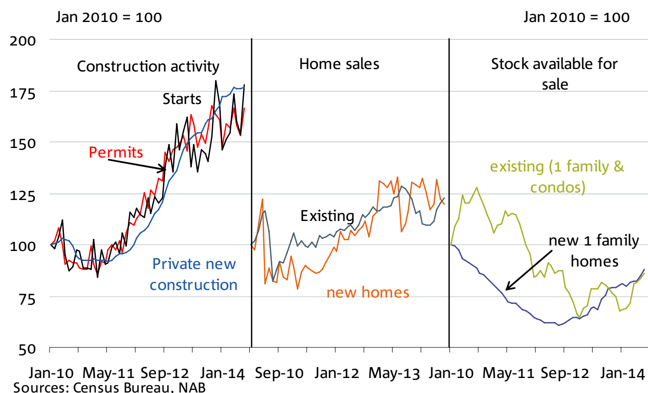


Sources: Conference Board, University of Michigan/Thomson Reuters

The gains in consumer confidence suggest that the soft reading for consumption in July of -0.2% mom will prove to be transitory. In part, the weak result reflected low power consumption due to mild weather. Moreover, household incomes have been rising solidly of late – annual real disposable income growth was 2.6% yoy in July, its strongest growth rate since 2012. As a result the savings rate has been rising, and is at its highest level since 2012, suggesting there is scope for households to increase spending, particularly given continued increases in household wealth. The strong 6.4% mom growth in sales of motor vehicles in August, which more than reversed July's fall, only reinforces this view.

Residential housing has been a relatively weak over the last year or so. While indicators are still mixed, they are consistent with further growth in the September quarter. Building permits and starts both rose strongly in July, but the data have been volatile and there is no clear trend. Construction expenditure is still rising, but more slowly reflecting the delayed impact of the slowdown in starts. However, existing house sales are growing again and the builders' survey has also shown some recent improvement. Construction activity is still low by historical standards and, with continued employment gains likely to support new households starting up, there is still plenty of upside.

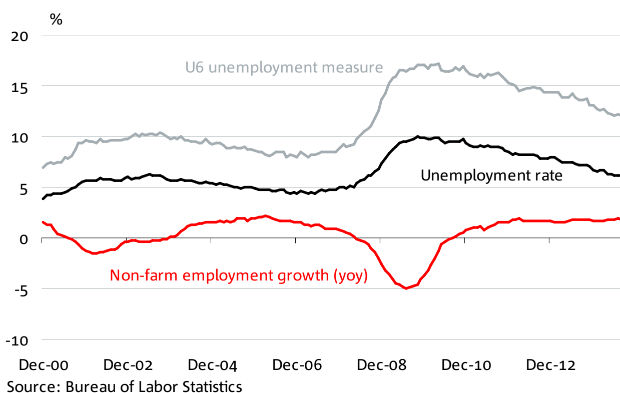
Housing indicators still mixed



Sources: Census Bureau, NAB

Trade data is suggesting that net exports may make a strong contribution to growth in the September quarter, with solid real export growth over the three months to July, while imports declined over the same period. That said, trade data are volatile, and imports in particular look weak relative to the indicators in the ISM surveys and given our view that the economy is growing solidly. As a result some bounce back in coming months wouldn't be a surprise. While we expect world growth to strengthen heading into next year, continued weakness in the Eurozone and a gradual slowdown in China, coupled with expected appreciation of the USD, suggests that net exports will make little sustained contribution to U.S. growth.

Labour market recovery still on track



Source: Bureau of Labor Statistics

On the labour market front, the increase in employment was well below expectations, with non-farm employment only rising 142,000, after six months of above 200,000 gains. The unemployment rate did fall marginally to 6.1%, although this was simply a reversal of July's increase. The broader U6 measure of underemployment (which also includes those marginally attached to the labour force or employed part-time for economic reasons) also fell to a new post-recession low. Other indicators of the labour market – such as initial jobless claims – do not suggest that there has been any major change to the labour market. The relative weakness in August employment growth therefore probably reflects normal volatility in the data, and perhaps a correction to what had been very strong growth relative to GDP growth. The annual employment growth rate – which looks through the monthly ups and downs - continues to be noticeably stable.

After several months of upwards momentum in inflation, there was at least a temporary pause in July, with both headline and core (ex energy and food) personal consumption expenditure price index growth only growing by 0.1% mom. As a result the annual growth rate was unchanged at 1.6% and 1.5% yoy for the headline and core respectively. Gasoline prices fell in August which will place downward pressure on the headline measure in that month. The USD has started appreciating again and we expect this to continue. As a result, our expectation of only a gradual rise in inflation looks on track.

Overall, we remain comfortable with our view that the rest of the year and 2015 should see solid, above trend growth. The main risks right now appear to be external – in particular, the continued difficulties in the Euro-zone and geo-political concerns. With consumer confidence improving, a generally supportive environment for business investment, considerable scope for further increases in residential investment and the labour market continuing to recover the outlook is positive. Moreover, policy settings are supportive overall – fiscal policy is still contractionary but less so than before and monetary policy is still very loose. While QE asset purchases are expected to come to an end in October, and the day of fed funds rate hikes is getting closer (we expect June quarter 2015), longer term rates have actually been drifting down over year so far, although we expect that this will not continue.

U.S. monetary policy – the mechanics of increasing rates

In last month's update we looked at when the Fed might start the process of tightening monetary policy (both the end of QE asset purchases and rate hikes) and how quickly (and how far) rates will rise afterwards. A related issue is how it would actually implement its proposed actions.

In the past, when the Fed wanted to increase the fed funds rate it would engage in 'open market operations'. This involved selling securities to banks - effectively borrowing from the banking sector and reducing the level of bank reserves (bank deposits with the Fed). By reducing the funds available in the fed funds market (the market for overnight interbank lending of reserves) interest rates would then rise.

This approach worked well when the level of bank reserves was relatively small. Bank reserves pre-recession were around $10 billion but as a result of the Fed's QE asset purchase programs bank they are now close to $2.8 trillion. Open market operations needed to implement an increase in the fed funds rate would effectively involve unwinding

the Fed's QE programs almost overnight. This is clearly not feasible or desirable.

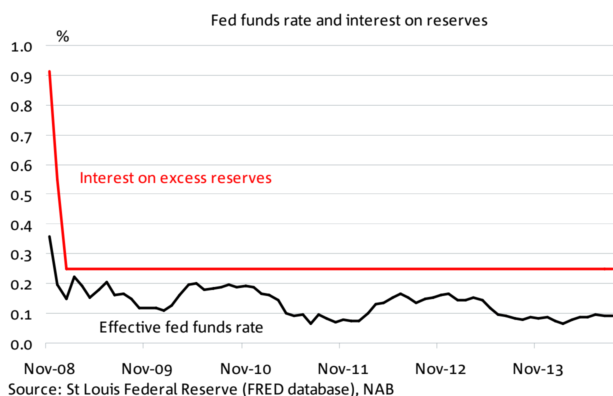
In recent years the Fed has put in place, and tested, tools in addition to its normal open market operations to facilitate increases in the fed funds rate. These include:

- A term deposit facility
- Interest on reserves – both required and excess reserves; and
- A Fixed rate overnight reverse repurchase agreements (or reverse repos) program[1]. Unlike the Fed's normal use of repos the interest rate would be set in advance (rather than the quantity).

Term deposits are another way of reducing the level of bank reserves in the system. While the Fed does not appear to be thinking of making use of this facility, it is still tinkering with its design suggesting that its use cannot be ruled out if its other tools do not work as expected.

Interest on required and excess reserves has been set at 0.25% since late 2008. This is the same level as the top of the Fed's target band for the fed funds rate (0 to 0.25%). At first glance, it might appear that the moving the interest rate on excess reserves in line with the fed funds target would be sufficient. After all, why would a bank lend in the fed funds market at a rate below what it can obtain from depositing its money with the Fed? This should set a 'floor' below which the fed funds rate would not fall. In practice, interest on reserves has proven to be a 'soft' floor, with the actual fed funds rate trading below it.

Interest on reserves provides only a soft floor



Source: St Louis Federal Reserve (FRED database), NAB

The reason for this appears to be that some institutions which are active in the fed funds market (housing finance agencies) do not receive interest on excess reserves. While banks would be expected to compete to borrow from these institutions so that they can deposit the money at the Fed, driving the rate up to that of interest on excess reserves, in practice his has not happened. The housing finance agencies appear to deal with a relatively small number of counterparties, and regulatory ratios and fees have limited bank competition and arbitrage opportunities.

The issue then is, if the fed funds rate target and interest on excess reserves were both increased, would the fed funds rate continue to trade around 15bps below the interest rate on excess reserves or would the gap get bigger?

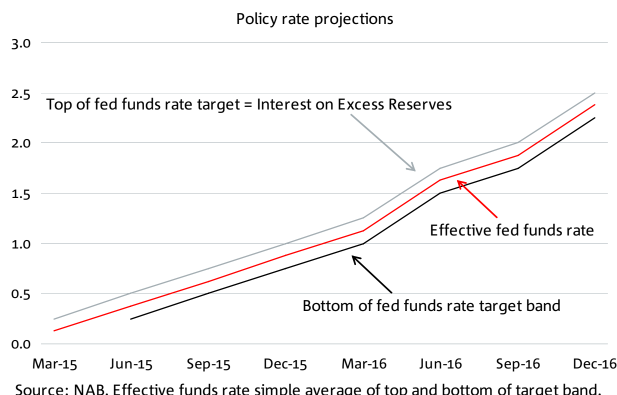
Because of the uncertain answer to this question, fixed rate overnight repos will be used to set a firmer floor on rates. They are similar to interest on reserves in that they are also an overnight interest rate. However, the program has a much wider range of counterparties. As a result, the agencies currently lending funds under the interest rate on excess reserves would now have the option of entering a reverse repo with the Fed. This way, overnight fixed-rate repos offer the option of a harder floor. Moreover, because the repo market is a widely used one (unlike the fed funds market which has relatively few active participants and trades) it might provide a closer link to other interest rates that the Fed is trying to affect by its actions.

However, it is clear that the Fed has some misgivings about utilising this tool, and is likely to limit it to a supporting role. These concerns relate to the potential to shift activity out from the banking sector to the shadow banking sector and the fear that such a program might exacerbate market disruption in the event of a financial panic (as investors sell risky assets knowing they can buy safe assets from the Fed).

Because of these considerations, the minutes to the Fed's July FOMC meeting indicated that the primary tool for raising the fed funds rate would be interest on excess reserves. As is currently the case, the Fed would continue to target a range for the fed funds rate (we expect it to retain a 25bp range).

The interest on excess reserves would then be set at the top of the target fed funds rate range. Fixed-rate overnight repos would be used as a backstop and set at, or close to, the bottom of the range, with the size of the program probably capped, to limit its size. The chart below shows how these rates are likely to move given our fed funds rate projections (we have simply set the effective fed funds rate to be an average of the top and bottom of the target range for illustrative purposes).

Expected policy rates



Source: NAB. Effective funds rate simple average of top and bottom of target band.

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[1] The sale of a security to another party with an agreement to repurchase that same security at a specified price at a specific time (next business day for an overnight repo) in the future. 'Fixed rate' means that the Federal Reserve fixes the interest rate and participants express their interest by indicating the amount of repos they would like at that rate.

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	2.4	2.3	2.6	2.6	0.5	0.9	0.3	0.6	**0.7**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.5	7.7	6.0	1.6	1.5	0.0	2.0	**2.1**	**2.1**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.0	-0.7	0.2	0.8	0.0	-1.0	-0.2	0.4	**0.0**	**-0.1**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.0	0.0	0.0	0.0	0.3	-0.1	-0.3	0.3	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.2	0.0	-0.1	0.1	0.3	-0.4	-0.1	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.1**	**3.0**	**2.8**	**1.1**	**0.9**	**-0.5**	**1.0**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*4.5*	*3.5*	*-2.1*	*4.2*	*3.0*	*2.9*	*2.9*	*2.9*	*2.9*	*2.9*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.6	1.7	2.0	0.4	0.3	0.3	0.6	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.3	1.6	1.9	2.0	0.4	0.3	0.3	0.5	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	6.0	5.4	5.0	7.3	7.0	6.7	6.2	**6.1**	**6.0**	**5.8**	**5.7**	**5.5**	**5.4**
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	0.25	0.25	1.00	2.50	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.50**	**0.75**	**1.00**
10-year bond rate	3.03	2.75	3.50	3.00	2.61	3.03	2.72	2.53	**2.40**	**2.75**	**3.00**	**3.25**	**3.50**	**3.50**

Source: NAB Group Economics

*Contribution to real GDP

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