more give, less take

United States Economic Update

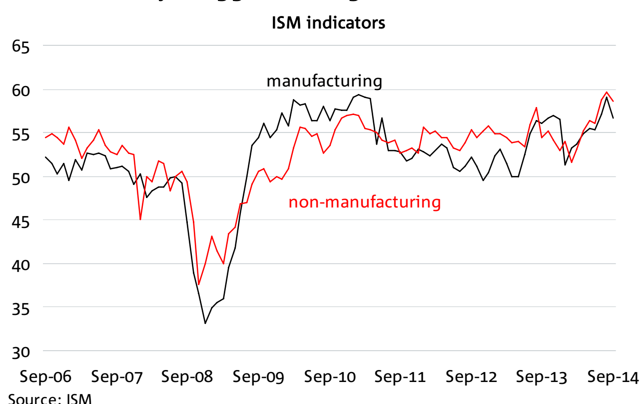
by NAB Group Economics 7 October 2014

- **Indicators point to above trend growth in the September quarter of just over 3% qoq.**
- **Jobs growth was strong in September and the unemployment rate fell below 6% for the first time in over six years.**
- **Inflationary pressures have eased in recent months. However, we still expect a gradual acceleration in inflation over time.**

Indicators for the U.S. economy suggest that it grew at an above trend rate in the September quarter; we are expecting growth of just over 3% qoq (annualised rate). The positive sentiment around the economy was only reinforced by the September employment report, which showed the unemployment rate falling below 6% for the first time in over six years.

In recent updates we have noted that the ISM manufacturing and non-manufacturing business surveys have indicated a strong degree of momentum exists in the economy. Both measures gave up some of their recent gains in September, but remained at still strong levels (consistent with around a 4% annualised GDP growth rate).

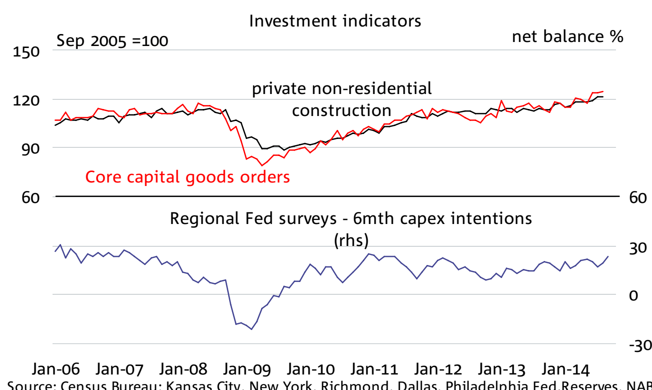
Business surveys suggest strong momentum in Q3



The manufacturing surveys of five regional federal reserves provide indicators on future capital expenditure – or business investment – intentions. In September, the simple average of these indicators reached its highest level in over three years and, perhaps more importantly given the month-to-month vagaries of these data, there has been a clear upwards trend since late 2012. Both equipment and non-residential structures investment grew rapidly in the June quarter following a soft start to the year, and the strong growth in core (ex defence and aircraft) capital goods orders (up almost 8% over the six months to August) suggests this is continuing for equipment investment. Non-residential construction data have been a bit softer so far in the September quarter, but are still trending up.

There was a large fall in business profits in the March quarter (which was not fully recovered in the June quarter), but at this stage, the downside risk that this posed to the investment outlook does not appear to be being realised. Coupled with continued improvements in credit conditions, this suggests that the outlook for business investment is reasonably positive.

Positive business investment outlook



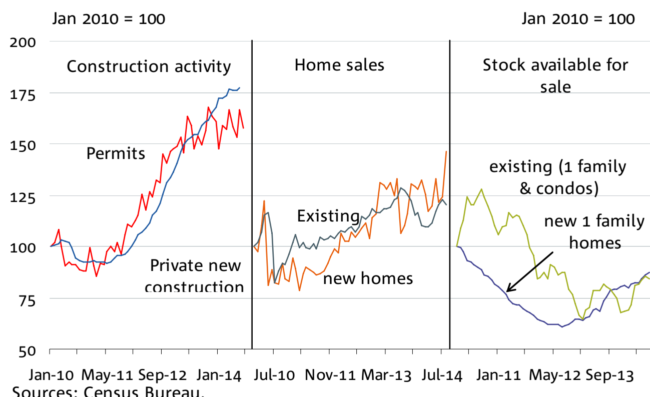
Consumer confidence also appears to be improving, albeit slowly. Consumption growth spiked up in August – growing by 0.5% mom but this followed a weak July result and a decline in September auto sales (which unwound August's upwards spike) suggests that September may be soft. However, continued strong employment growth – which in time should also produce upwards pressure on wages – should support continuing solid consumption growth. Moreover, in the short-term at least, recent declines in gasoline prices (and associated softer inflation readings) are a plus for household budgets.

One support for household consumption has been gains in household wealth driven by increases in house prices and equities. While equities continue to trend up (with the odd downwards blip), house price growth has clearly softened. The national Case-Shiller house price index (HPI) declined in each month between April and June. Growth resumed in July but it was only modest. The Federal Housing Finance Agency's HPI is still showing rising house prices, but at a slower rate.

The slowdown in house price growth has come at the same time as it appears that housing construction and sales may be coming out of the flat period that started in the second half of last year, although the volatility in the data make it difficult to be too confident of this. In particular, new homes sales grew by 18% mom in August, suggesting a more positive underlying trend than had previously been apparent. At the same time, while building permits and starts both declined in August, the July/August average is above the previous quarter's. 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.

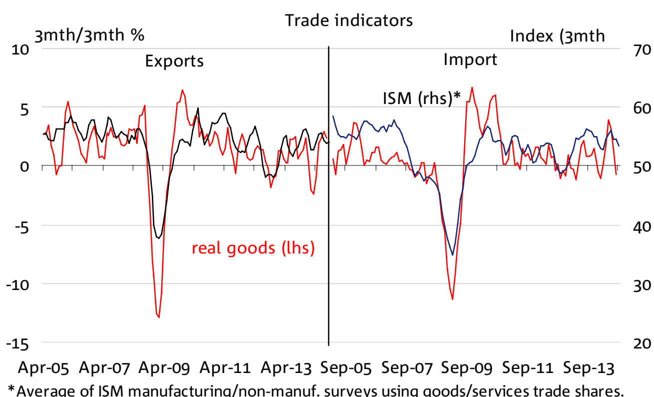
Housing activity appears to be picking up again



Sources: Census Bureau,

Trade data are 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 August while imports declined over the same period. That said, trade data are volatile, and imports look weak relative to the indicators in the ISM surveys. As a result some bounce back in coming months wouldn't be a surprise. Moreover, the United States is on a solid growth path while the Euro zone has hit another flat spot, and the USD trade-weighted exchange rate (the Fed's Broad Dollar Index) has appreciated by around 4.7% since the end of June (to 3 October). While the appreciation of the USD was not a surprise, it has happened more quickly than expected. These factors, together with a correction to the recent weak import data, means that we now expect net exports will be a drag on growth in coming quarters.

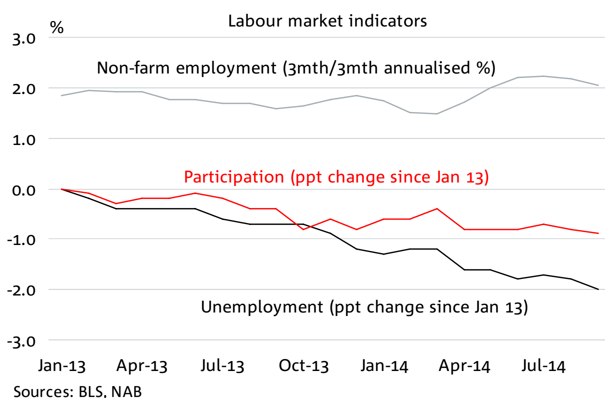
Net exports a positive for Sept. quarter but will it last?



*Average of ISM manufacturing/non-manuf. surveys using goods/services trade shares.

Looking at the labour market, the September employment report was strong. Non-farm employment expanded by 248,000 and there were upwards revisions to prior months. The unemployment rate fell by 0.2ppts to 5.9% the first time it has been below 6% since mid-2008. 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 -0.2ppts. While a second consecutive fall in the participation rate also contributed to the decline in unemployment; it is only a bit lower than its end 2013 level – the decline in unemployment this year is being driven by job gains, which have strengthened.

Strengthening employment driving unemployment fall



Sources: BLS, NAB

The other much anticipated indicators in the jobs reports these days are those relating to wages growth. However, average hourly earnings were unchanged in the month and the annual growth rate was a still subdued 2.0%. Therefore no signs of wage pressures yet, although other indicators – such as from the NFIB small business survey – suggest it is just a matter of time.

Overall, we remain comfortable with our view that in the rest of 2014 and into 2015 there will be solid, above trend growth. With 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 drifted down over the year so far, although we expect that this will not continue. We have revised up our forecast for 2014 growth from 2.1% to 2.2% mainly reflecting the upwards revision to June quarter GDP growth in the BEA's third estimate (from 4.2% to 4.6% qoq annualised).

The main risks right now appear to be external – in particular, the continued difficulties in the Euro-zone and geo-political concerns. Domestically, potential risks relate to policy – Federal budget battles might return following congressional elections later this year. Last years 'taper tantrum' episode also suggests that the Fed's task in navigating the exit from a long period of low interest rates (and the use of unconventional tools) won't be easy.

Inflation outlook

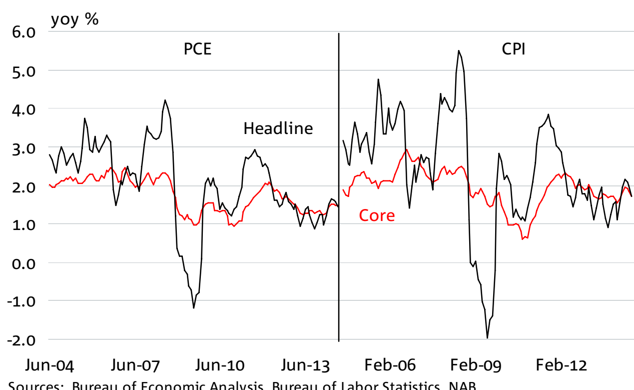
The focus on wages measures noted above is because of the importance of inflation – as well as labour markets – for the timing (and pace) of future fed funds rate hikes. In our July 2014 US Economic Update we had a close look at the inflation outlook. Our main takeaway was that with slack in the economy declining – not only in the labour market but also in other sectors – inflation looked set to continue rising, but only gradually.

At that time the annual growth rate in the Fed's preferred measure – the personal consumption expenditure (PCE) price index –had increased from 0.8% to 1.8% yoy between

October 2013 and May 2014, and core PCE inflation (which excludes food and energy prices) had risen from 0.8% yoy to 1.5% yoy over the same period.

However, since then inflation readings have softened, particularly in July and August. The headline inflation rate is now 1.5% yoy, while core measure has remained at 1.5% yoy. The question is does the recent turnaround signal that inflation is going to be stuck below the Fed's 2% target for a long time to come, if not start to decelerate?

Inflation has softened in recent months

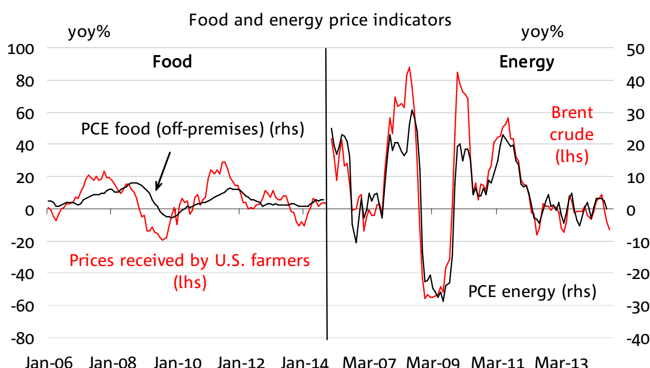


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, NAB

The short answer, we believe, is no. Inflation is still higher than where it was at the start of the year, and while there will continue to be short-term ups and downs, we expect it will *gradually* rise over time.

The recent downturn in part reflects commodity price moves (as did the rise in inflation up to May) which tend to be volatile. Some of the biggest turnarounds have been in categories affected by commodities – energy and clothing (which follows cotton prices with a lag). Oil prices which were as high as $US 115/barrel in June have fallen to just above $US 91 in early October. However, while the fall to-date will exert further downward pressure on September/October inflation readings, the view of our commodity team is that oil prices will likely move higher from here. Food inflation has also moderated a little in recent months, and this may continue further with prices received by US farmers declining since May.

PCE inflation by category



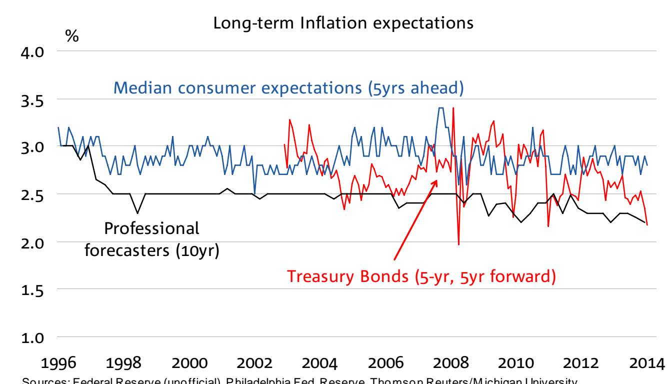
Sources: Thomson Reuters, USDA, BEA, NAB

The appreciation of the USD – which we expect will continue over time – will be a more permanent factor constraining inflation. As already noted the USD has appreciated noticeably in recent weeks. However, in month average terms, on a trade weighted basis, it was only up 2.8% in September from the start of the year (although if early October are levels are sustained this will move to around 4%). Over the course of 2013 it appreciated 3%, so it is not exactly a new factor and does not indicate a strong additional deflationary impulse, at least at this stage, although we have marked down our 2014 forecast a little.

While the currency is likely to be a continuing constraint on inflation, declining spare capacity – not just in the labour market, but also in industrial capacity and housing (where vacancy rates are trending down) should translate into additional price pressures. As we have noted in previous monthly updates there is nothing unusual about current rates of inflation – in terms of deviation from inflation expectations – when mapped against the lagged unemployment rate.

The Fed views inflation expectations as an 'anchor' for inflation, with short-term deviations due to currency or commodity price movements only temporary, but with inflation likely to revert to its expected level (as long as it is supported by appropriate monetary policy). Some measures of longer-term inflation expectations derived from bond market yields have declined recently to low levels by historical standards. Any further declines will cause concern at the Fed, especially if corroborated by falls in consumer expectations or other measures.

Some softening in inflation expectations



Sources: Federal Reserve (unofficial), Philadelphia Fed. Reserve, Thomson Reuters/Michigan University

The fall in the unemployment rate in September raised speculation about when the Fed might start to raise rates. However, with wages and inflation still subdued, and with weakness in some measures of inflation expectations, the Fed will be in no rush to raise rates. As a result we remain comfortable with our view –based on our forecasts for further labour market improvement and a gradual pick-up in inflation - that the Fed will not raise rates until the June quarter of 2015. However, further monetary loosening – in the form of QE asset purchases – is set to end following the Fed's policy meeting later this month.

For more information, please contact

Tony Kelly +613 9208 5049
antony.kelly@nab.com.au

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	**0.5**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.8	7.9	6.1	1.6	1.5	0.0	2.3	**2.2**	**2.1**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.0	-0.6	0.3	0.8	0.0	-1.0	-0.2	0.4	**0.0**	**0.0**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.0	0.0	-0.1	0.0	0.3	-0.1	-0.3	0.3	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.1	0.0	-0.1	0.1	0.3	-0.4	-0.1	**0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.2**	**3.0**	**2.8**	**1.1**	**0.9**	**-0.5**	**1.1**	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*4.5*	*3.5*	*-2.1*	*4.6*	*3.1*	*2.8*	*2.7*	*2.9*	*2.9*	*2.9*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.5	1.8	2.0	0.4	0.3	0.3	0.6	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**
Core	1.3	1.5	1.9	2.1	0.4	0.3	0.3	0.5	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.9	5.2	4.9	7.3	7.0	6.7	6.2	6.1	**5.9**	**5.7**	**5.5**	**5.4**	**5.2**
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	2.49	**2.75**	**3.00**	**3.25**	**3.50**	**3.50**

Source: NAB Group Economics

*Contribution to real GDP

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Phin Ziebell
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

International Economics

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Head of Credit Strategy
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

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