United States Economic Update

by NAB Group Economics January 2015

National Australia Bank

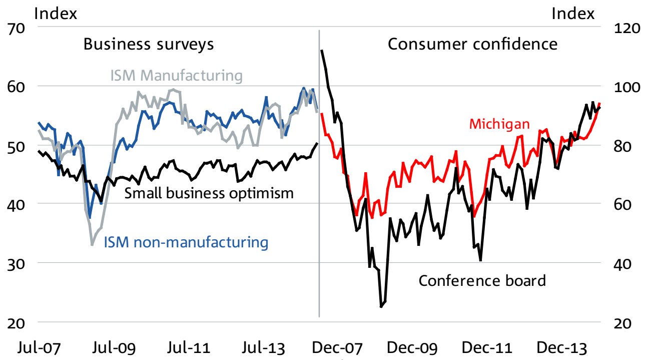
- **The U.S economy is enjoying a strong patch of growth. Overall we have revised up our GDP growth forecasts and now expect 2.4% in 2014 (previously 2.3%) and 3.2% in 2015 (was 3.0%) although 2016 has been revised down from 2.8% to 2.7%.**
- **Inflation is falling reflecting the plunge in oil prices, as well as the appreciation of the US dollar.**
- **Monetary policy is likely to start tightening from mid-year. Low inflation (actual or expected) remains the main risk that may delay rate hikes.**

Economic overview

The U.S economy is currently enjoying a strong patch of growth. The revision to September quarter GDP growth (from an annualised 3.9% qoq to 5.0% qoq) suggests even stronger than previously thought momentum in the economy. Partial indicators suggest that GDP growth will not be as strong in the December quarter, but still point to another solid, above long-term trend, outcome. Activity – particularly consumption – appears to be getting a boost from the plunge in oil prices. While there will be at least some offset from a decline in oil-related business investment, as well as that from the appreciating US dollar on net trade, these are yet to show up in the data.

Although the manufacturing and non-manufacturing ISM surveys have declined from their recent high levels, they remain consistent with above trend growth ahead, and small business confidence is at a recovery high. At the same time, consumer confidence continues to move higher, with the Michigan University and Conference Board measures reaching, in recent months, their highest levels in over seven years.

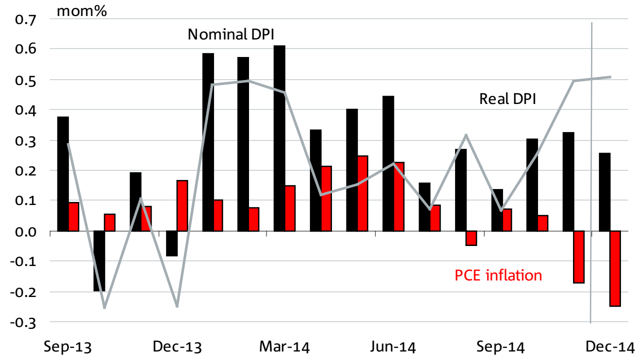
Strong growth reflected in confidence measures



Sources: ISM, Conference Board, Uni.of Michigan/Thomson Reuters, NFIB. Data to Dec '14. NFIB index divided by two.

Households have benefited in recent months from a pick-up in disposable income (DPI). An additional strong boost to finances has come from the slowdown in inflation, with prices actually decreasing in November. The decline in prices looks like it will be even stronger in December and January. Consumption has responded, growing by 0.7% mom in November alone. December month consumption is likely to be softer based on retail sales data and as utility consumption will likely fall due to milder weather, but consumption growth for the December quarter overall appears to have been quite strong.

Boost to h'hold income a positive for consumption

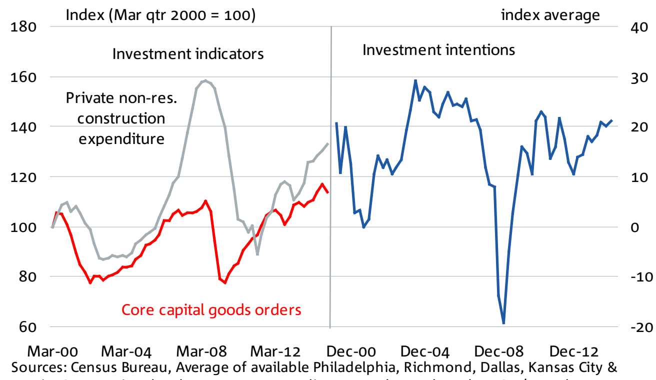


Source: BEA, NAB estimates for December

A combination of rising household spending power and improved confidence should continue to support consumption growth in coming months. Reinforcing this dynamic are continuing gains in household wealth (despite some recent volatility equity prices rose in the December quarter and house prices continue to rise) and easing in lending standards by banks.

In contrast, indicators for business investment suggest that there has been some softening in the December quarter. Durable core (ex defence and aircraft) orders and shipments for October and November are below their September quarter levels, although private non-residential construction expenditure is higher. Business investment in the June and September quarters accelerated taking the annual growth rate to a more than two year high, so the recent softness may represent no more than a pause.

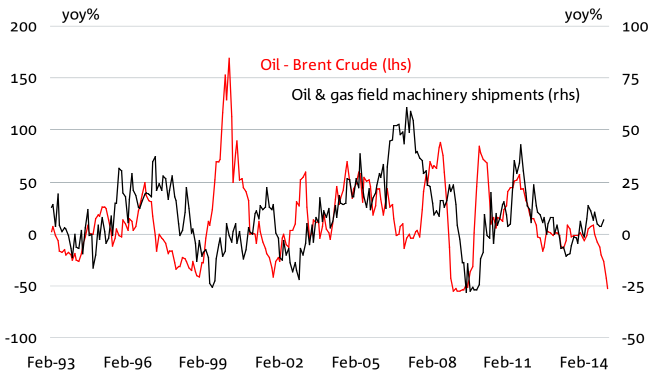
Business investment indicators and intentions



Sources: Census Bureau, Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys. Invest. Indicators Dec'14 qtr based on Oct/Nov. data.

One factor which will weigh on investment in the future is the decline in oil prices. Shipments (and orders) of oil and gas machinery shipments do not appear to have been affected much so far. However, historically the impact of declining prices on oil investment occurs with a lag, and a reduction at some stage is almost certain.

Impact on oil-related investment still to come

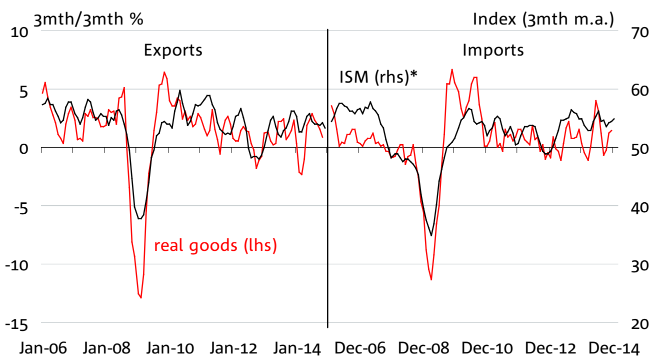


Sources: Census Bureau, ICIS Pricing. Jan '15 Brent Crude based on month to 14 Jan.

Outside of the oil sector, conditions for business investment remain generally favourable. Capacity utilisation is at its highest level in well over six years, and profits are still high (data to September quarter) while credit conditions continue to ease and interest rates are low. The generally positive outlook for the domestic economy means that businesses are more likely to take advantage of the conditions (although concerns around overseas global conditions may be a negative). Consistent with this, capital expenditure intentions – as measured by regional Fed manufacturing surveys – remain solid. That said profits will come under some pressure from declines in the oil industry, while the appreciating dollar will affect profits from overseas operations (in US dollar terms).

Another component of GDP holding up so far in the face of headwinds is net trade (exports less imports). The headwinds are in the form of an appreciating US dollar (up by around 8% over the second half of 2014, and with further gains so far in 2015) and a sluggish world economy. However, the full impact of currency appreciation is only felt with a delay. As a result, despite projecting some strengthening in global activity in 2015, and with the strong domestic economy likely to pull in imports, we expect net trade to act as a drag on activity in coming quarters.

Exports holding up…for now



Sources: ISM, Census Bureau. *Average of ISM manuf./non-manuf. export/import indicators using goods/services trade shares.

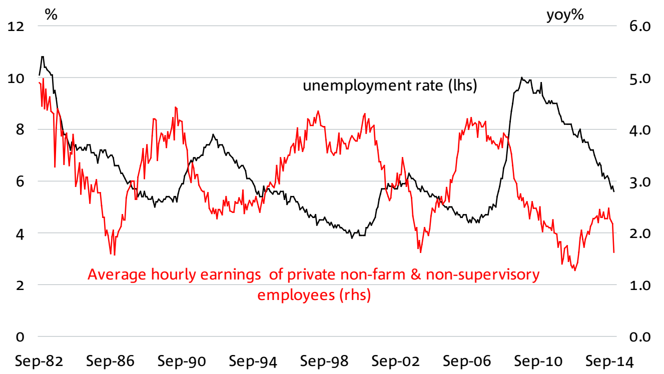
While residential fixed investment grew in the June and September quarters, partial indicators remain mixed. However, reasonably strong growth can be expected in coming years given the current relatively low levels of construction activity, low vacancy rates and (at least for now) low mortgage interest rates. Rising consumer confidence and strong jobs growth may also encourage more people to start-up their own household.

Overall, there are many positive factors operating right now. Household incomes, already benefiting from strong employment growth, are being further boosted by the fall in oil prices, and with confidence rising and balance sheets improving, this will provide support for consumption growth. Investment fundamentals are also positive although oil-related investment will increasingly come under pressure. Residential investment should continue to grow and the headwind from fiscal policy is fading. Moreover, banks continue to ease lending standards for both consumers and business.

We have revised up our forecasts for 2014 from 2.3 to 2.4% and for 2015 from 3.0 to 3.2%, although we have slightly reduced our 2016 forecast to 2.7% (from 2.8%) These changes are mainly because of the upwards revision to September quarter GDP growth and the stronger than expected recent partial data. This may in-turn reflect that the benefits from lower oil prices (principally stronger consumption) are coming through earlier than some of the downsides (reduced oil sector investment). Similarly, the impact of the US dollar appreciation on net trade has yet to show up.

The strength in the economy continues to be reflected in the labour market. Job gains were over 200,000 in December for the eleventh month in a row, taking the annual growth rate to 2.1%, its highest level since early 2006. The unemployment rate also fell in December, and is now at 5.6%. Broader measures of labour underutilisation are also declining and job openings are at their highest level since 2001.

Unemployment rate continuing to fall…wages softer?

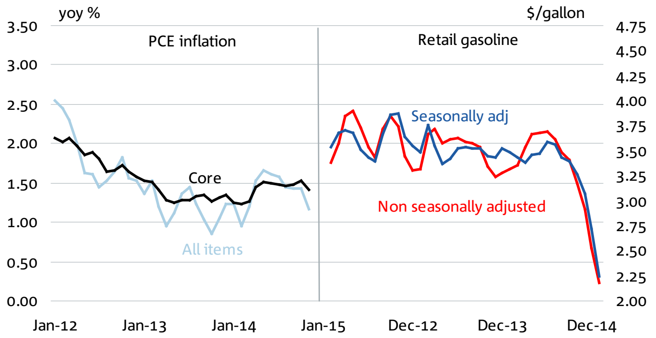


Source: BLS

The major surprise with the employment report was a large dip in average hourly earnings. The Fed has been keen to see some pick-up in wages growth in order to provide comfort to its view that inflation will, over-time, move back up towards its target. While the unemployment rate is now at around levels where you might expect to see some strengthening in wages growth, wages often react with a lag. Other indicators are showing a different story – the quarterly employment cost index (ECI) has shown some acceleration and the NFIB's survey shows the proportion of small businesses planning to raise worker compensation over the next 3-6 months is at its highest level in almost seven years. It is possible that the dip in average earnings series is just statistical noise, but the Fed will watch this closely, as it will the December quarter ECI report (due late this month).

On the inflation side, the slide in global oil prices is putting significant downwards pressure on consumer inflation. The personal consumption expenditure (PCE) price index declined 0.17% mom in November, while the CPI fell 0.26% mom. On an annual basis, headline inflation is clearly moving down and this process will only accelerate in December and January given the downward pressure from oil prices, as well as from the appreciation in the US dollar. Even core inflation (PCE ex energy and food) was weak in November, with core PCE prices barely moving, although this followed a relatively strong result in October and on an annual basis core inflation is broadly tracking sideways.

Inflation moving down due to oil price plunge



Sources: BEA, BLS, EIA, gasoline prices seasonally adjusted by NAB using CPI seasonal factors. Jan 2015 gasoline prices based on month-to-date data.

Monetary policy overview

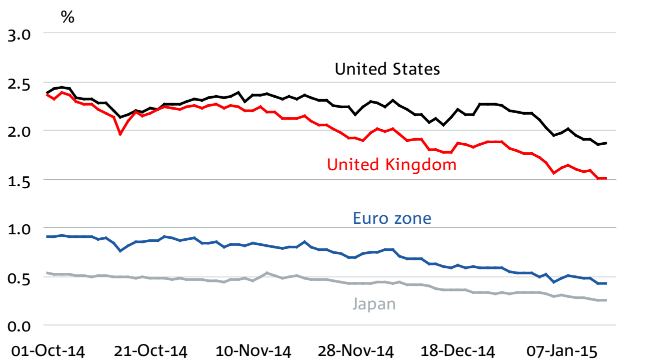
For the Fed, a key issue will be what happens to core inflation. Most Fed members think that the impact of falling oil prices will be temporary and that inflation will move back towards their 2% goal. The minutes from the Fed's December meeting revealed that the Fed would be prepared to start lifting rates even with core inflation at current levels as long as it was reasonably confident it would reach its target over time. As a result, if core inflation were to start clearly moving down this would likely delay the timing of Fed funds rate increases.

Our forecasts basically have annual core inflation tracking sideways for much of the year before starting to rise at the end of the year. With the unemployment rate continuing to fall (and other labour market indicators watched by the Fed also improving) we are still comfortable with our view that the Fed will start to increase policy rates in the June quarter.

The most likely meeting for this to occur in is the June meeting. The risks around this projection are weighted towards a delay in fed funds hikes. The Fed has indicated that it will be 'patient' in normalizing policy (i.e. raising rates) and the Chair has indicated that this means no rate increases for two meetings. So potentially rates could be raised in the April meeting if the unemployment rate continues to fall faster than expected (and core inflation at least holds at current levels). The risk of a delay is mainly centred on a greater than expected pass through of oil price declines and dollar appreciation to core inflation, or a downwards move in survey based measure of inflation expectations (measures derived from financial markets have already declined).

While the Fed is debating when to start raising its policy rate – an overnight rate – longer-dated interest rates are going their own way. The US 10 year government bond yield has fallen by almost 40 bps from its high point in December 2014. This is not just an U.S. occurrence, with yields falling in other advanced economies as well. While the U.S. generally provides the direction for worldwide yields, the causation can run the other way. This appears to be the case right now given recent or prospective easing by other major central banks (Japan, Euro zone), uncertainty about the strength of the global economy, and the slide in oil prices which is fuelling deflation concerns.

10 year government bond yields



Source: Bloomberg. Data are up to 14 Jan. 2015

For more information, please contact

Tony Kelly +613 9208 5049

antony.kelly@nab.com.au

US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %									
					2014				2015				2016	
	2013	2014	2015	2016	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components														
Household consumption	2.4	2.5	3.3	2.7	0.3	0.6	0.8	**1.0**	**0.9**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.3	6.5	6.2	0.0	2.3	1.9	**1.0**	**1.6**	**1.6**	**1.7**	**1.6**	**1.5**	**1.4**
Government spending	-2.0	-0.1	0.7	0.8	-0.2	0.4	1.1	**-0.2**	**0.0**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**
Inventories*	0.0	0.0	-0.1	0.0	-0.3	0.3	0.0	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.1	-0.1	-0.2	-0.4	-0.1	0.2	**0.0**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.4**	**3.2**	**2.7**	**-0.5**	**1.1**	**1.2**	**0.7**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*-2.1*	*4.6*	*5.0*	*3.0*	*2.8*	*2.6*	*2.7*	*2.8*	*2.8*	*2.7*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.1	1.0	2.1	0.3	0.6	0.3	**-0.1**	**-0.5**	**0.4**	**0.5**	**0.6**	**0.6**	**0.5**
Core	1.3	1.5	1.6	2.1	0.3	0.5	0.3	**0.32**	**0.31**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.7	5.0	4.6	6.6	6.2	6.1	**5.7**	**5.5**	**5.2**	**5.1**	**5.0**	**4.9**	**4.8**
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**	**0.50**	**0.75**	**1.00**	**1.25**	**1.75**
10-year bond rate	3.03	2.17	3.00	3.00	2.72	2.53	2.49	2.17	**2.50**	**2.50**	**2.75**	**3.00**	**3.25**	**3.25**

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

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

Vyanne Lai
Economist
+(61 3) 8634 0198

Phin Ziebell
Economist – Agribusiness
+(61) 0475 940 662

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
Senior Economist – Industry Analysis
+(61 3) 8634 3837

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

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

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
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

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

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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

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

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

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