United States Economic Update

by NAB Group Economics 17 July 2015

- **After declining in the March quarter, partial data indicate that the economy resumed growing in the June quarter.**
- **Due to the revision to first quarter GDP we have raised our 2015 GDP forecast from 2.3% to 2.4%.**
- **We still expect that the the first increase in the fed funds rate will be in September although the risk around this is for a later start.**

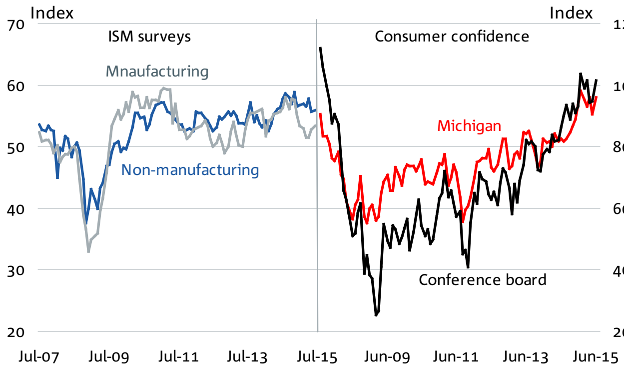
Economic Overview

Following a mild slump in the first quarter, the U.S. economy appears to have resumed growing in the June quarter based on available partial data. Consumption, business investment, government demand have all stabilised if not improved, but export activity remains weak.

The size of the contraction in March quarter GDP has been revised down – to just -0.2% qoq on an annualised basis (previously -0.7%). As a result, we have slightly raised our 2015 GDP growth forecast to 2.4% from 2.3%. This represents a modestly above trend rate of growth.

Consistent with this, business survey measures are also positive. After stabilising in April, the ISM manufacturing survey has improved in each of the last two months. At the same time, the non-manufacturing indicator remains at a solid level. Similarly, consumer sentiment, which had given up some of its late 2014/early 2015 gains, has recovered and is almost back to its post recession highs.

Business activity & consumer sentiment positive



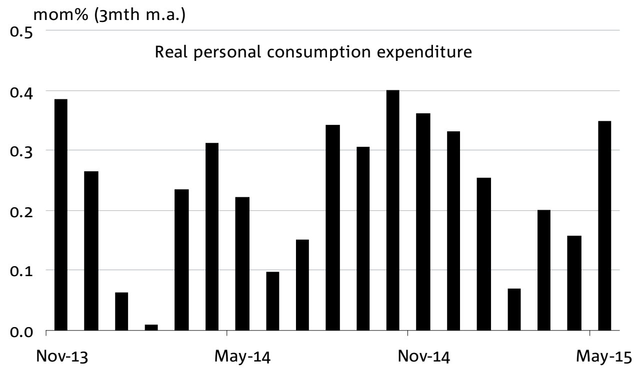
Sources: ISM, Conference Board, Uni.of Michigan/Thomson Reuters.

That said, based on partial indicators for the quarter, it is unlikely that there will be a surge in GDP growth in the June Quarter GDP like that experienced last year. This may reflect some additional headwinds affecting the US economy this time around. These include the negative affects on certain sectors from the plunge in oil prices and the significant appreciation of the US dollar.

It is worth noting that the BEA will be revising its seasonal adjustment process in the June quarter advance estimate. The June quarter release will also include revisions to prior quarters/years so it is possible that a new (hopefully more accurate) pattern of growth will emerge.

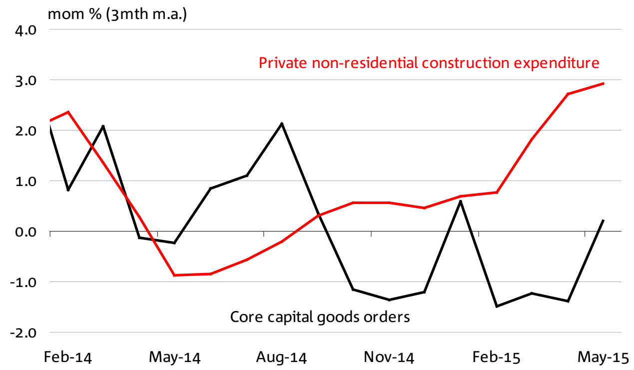
Private consumption growth has strengthened from the lows reached earlier in the year. Growth was particularly strong in March (0.5% mom) and May (0.6% mom). However, April was flat and the early signs suggest June will also be relatively weak, with nominal retail sales declining. Nevertheless, looking through the month-to-month volatility, the recent rebound in confidence, continuing improvements in household wealth, easing credit conditions, as well as solid employment and income growth, should continue to support solid growth in consumption in coming months. As the labour market tightens, wage pressures should also increase, further lifting household incomes.

Rebound in consumption from early year weakness



Sources: BEA, NAB

Business investment also improving



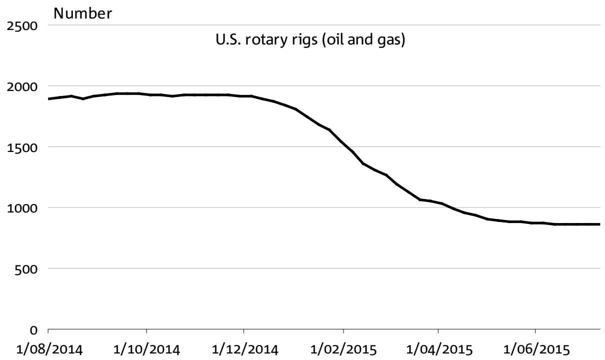
Sources: Census Bureau, NAB

Signs of an upturn are also evident in business investment, although some indicators remain weak, particularly for the oil sector. Core (non-defence excluding transport) capital goods orders fell in May (dragged down by a large fall in mining machinery orders) but on a smoothed (3mth average) basis recorded their first positive reading since January. On a cautionary note, however, regional manufacturing survey indicators of capital expenditure intentions remain weak.

Clearer improvement is evident in private non-residential construction expenditure. In the first two months of the June quarter it was up 7.4% on the previous quarter.

The non-residential construction data do not cover the mining sector, and investment in this sector looks to have experienced a large fall in the June quarter. The oil and gas 'rig count' was down by around 35% in the June quarter, following a 27% decline the previous quarter. However, these quarterly averages hide a recent stabilisation – the rig count bottomed out in mid-June, and there has even been a pick-up in recent weeks, albeit very small.

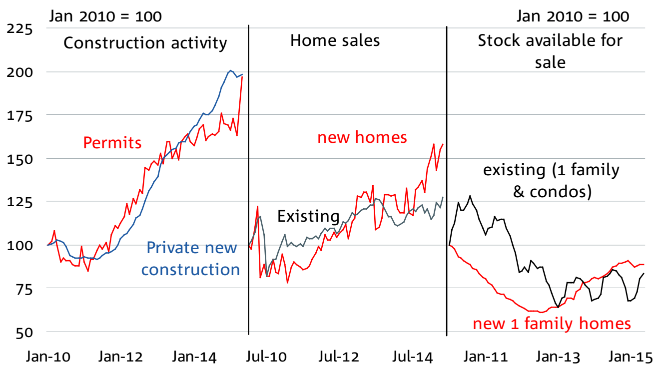
Big fall in energy investment…but the worst may be over



Sources: Baker Hughes Incorporated, Datastream

Manufacturing is particularly exposed to the rapid run-up in the US dollar over the last year and parts of the sector also link in to the oil industry. However, as these headwinds fade, so should the drag on total business investment. As with consumers, businesses are also benefiting from easing lending standards. Overall, the outlook for investment is somewhat clouded, but we are factoring in some improvement from the very weak start to the year.

Housing indicators point to stronger investment growth



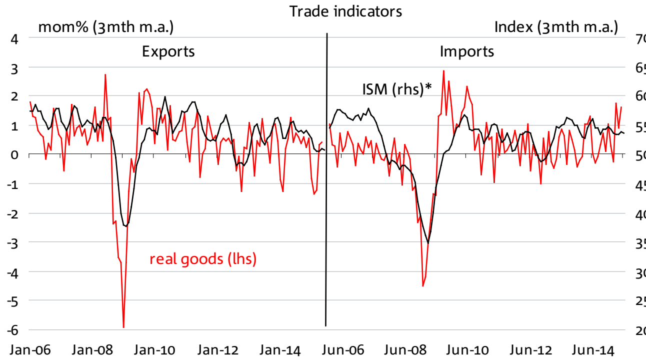
Sources: Census Bureau, NAB

Improvement is also evident in the housing sector. Private new residential construction expenditure has resumed growing in the last two months. More importantly, building permits surged 20% over the two months to May, suggesting a renewed pipeline of work going forward. With vacancy rates and new home inventories low, and with new home sales rising, builders can be expected to continue adding housing stock in the future. Further support will likely come from continued employment growth, banks starting to ease mortgage lending standards and still low mortgage rates. These factors will also support existing home sales which have also grown strongly in recent months.

Exporters, however, are continuing to struggle. After increasing in February and March – following the end to west coast port disruptions – real goods exports declined in May leaving the trend pretty flat. This is also signalled by the ISM export indicators which are hovering around the neutral 50 mark. Headwinds to the export sector include subdued global conditions and the loss of competitiveness due to the 12% appreciation of the dollar over the year to June.

This same factor is a positive to importers as is the continued above trend growth in the United States. The headwinds to the tradeable sector are likely to continue although they may moderate. While we don't expect any significant improvement in global conditions in coming years, the pace of dollar appreciations should slow.

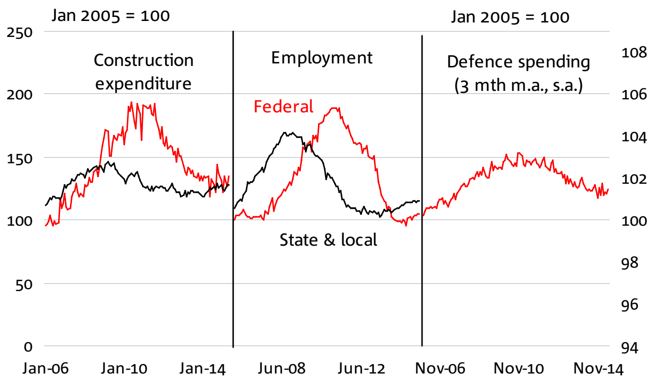
Exporters still struggling



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

We have been noting for a while now that fiscal policy headwinds have also largely ended. The reduction in the Federal government's budget deficit (as a percentage of GDP) in fiscal 2015 is expected to be well down on recent years. One component of fiscal policy is direct government spending, which actually fell in the December and March quarters. However, this appears unlikely to be repeated in the June quarter with partial indicators such as employment, construction expenditure and defence spending (the major component of federal spending) all tracking higher in the June quarter.

Government demand slowly turning up



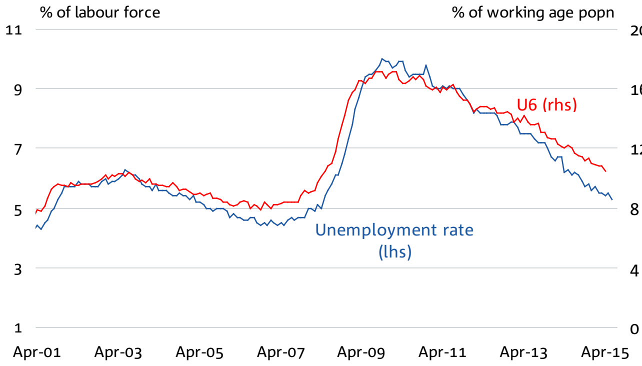
Sources: Census Bureau, BLS, Financial Management Service, NAB

Fed targets and monetary policy

Labour market improvement has been of the more constant factors in recent years, even with the large quarter-to-quarter fluctuations in GDP. Annual non-farm employment growth remained above 2.0% in June – almost double the population growth rate. Given this, the unemployment rate is trending down and fell in June to 5.3%, a new post-recession low. The unemployment rate is now within touching distance of the Fed's (central tendency) estimate of the long-run unemployment rate.

Some Fed members still consider that the unemployment rate currently understates labour market slack. Broader measures of labour market slack – such as the 'U6' measure which includes part-timer workers who would like a full-time job as well as individuals who, despite not currently looking for a job, would like one – are further away from their pre-recession levels. However, recent research also suggests that at least some of the increase in involuntary part-time employment is due to structural factors, so the 'U6' measure probably overstates slack. The truth is probably somewhere in between but, by any measure, labour market underutilisation is falling.

Labour market continues to improve



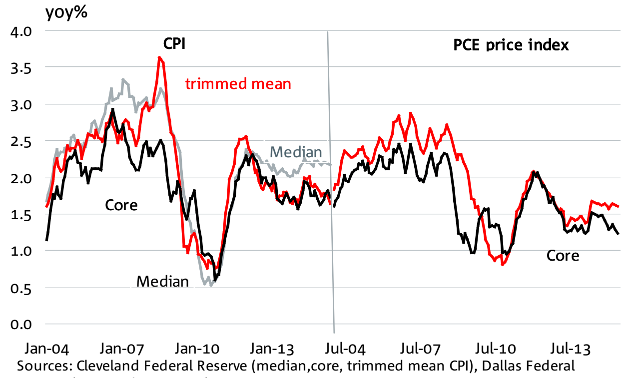
Source: Bureau of Labor Statistics

In contrast, little or no progress is being made on the Fed's inflation goal, which is inflation of 2% over the long-run. In June, the annual growth rate in the headline personal consumption expenditure (PCE) price index annual growth was only 0.2%. A large part of this weakness is due to oil prices, but even after excluding energy and food costs (the core measure) prices were only growing by 1.2% yoy, their lowest level since early last year.

However, over the last four months, core PCE prices have risen at a 1.7% annualised rate. While this is too small a sample to be certain inflation has turned around, other core inflation measures have held up better.

In her recent testimony to Congress, the Fed Chair, Janet Yellen, indicated that she viewed the low inflation readings as reflecting "…influences that are likely to be transitory". In particular, she cited steep declines in oil prices and low prices of non-energy imported goods (i.e. dollar appreciation). The Fed Chair expects that as these factors fade, inflation will move back towards target, which is also our view.

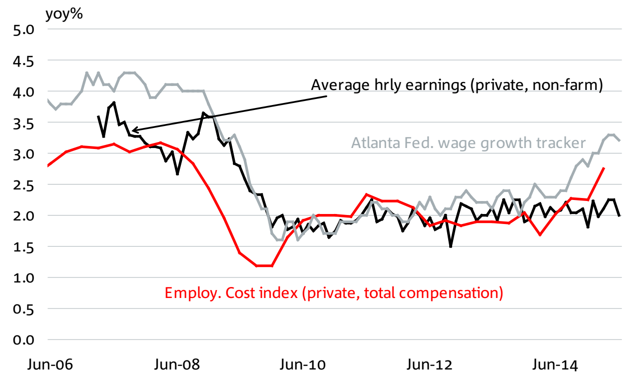
Core inflation measures



Sources: Cleveland Federal Reserve (median,core, trimmed mean CPI), Dallas Federal Reserve (Trimmed mean PCE), BEA, NAB

A related debate has been about the strength of wages growth. While not necessary for the Fed to start lifting rates, confirmation wages growth is strengthening would add to the case to do so. Data on wages growth has been mixed, with the quarterly Employment Cost Index and the monthly average hourly earnings data sending different signals. The latest contribution to this topic is a 'wage growth tracker' developed by the Atlanta Fed. It uses microdata to develop a measure of annual wage growth based on individuals who were both in the current sample and that of twelve months ago; this should reduce the impact of compositional changes. Like the Employment Cost Index, it indicates that wage growth is strengthening.

Further signs wages are picking up



Sources: BLS, Atlanta Federal Reserve, NAB

This provides additional support for our view that the Federal Reserve will start increasing the fed funds rate in September this year. The pace of subsequent increases is expected to be gradual by past standards.

While the Fed continues to signal that it expects to start lifting rates later this year, the risk is that this process will start later than September rather than earlier. While in the June meeting, 15 out of 17 Fed members considered, based on their outlook for the economy, a rate rise this year would be appropriate, only a slight majority (10 out of 17) thought two or more rate hikes would be appropriate, in contrast to the clear majority at the March meeting.

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US Economic & Financial Forecasts

	Year Average Chng %			Quarterly Chng %									
				2014		2015				2016			
	2014	2015	2016	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components													
Household consumption	2.5	3.0	2.8	0.8	1.1	0.5	**0.7**	**0.8**	**0.7**	**0.7**	**0.6**	**0.7**	**0.6**
Private fixed investment	5.3	4.5	6.6	1.9	1.1	-0.1	**1.1**	**1.8**	**1.8**	**1.7**	**1.6**	**1.5**	**1.3**
Government spending	-0.2	1.0	1.4	1.1	-0.5	-0.2	**0.8**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.1	-0.2	0.0	0.0	0.1	**-0.1**	**0.0**	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.0**
Net exports*	-0.2	-0.7	-0.3	0.2	-0.2	-0.5	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**
Real GDP	**2.4**	**2.4**	**2.7**	**1.2**	**0.5**	**0.0**	**0.7**	**0.8**	**0.7**	**0.6**	**0.6**	**0.7**	**0.6**
Note: GDP (annualised rate)				*5.0*	*2.2*	*-0.2*	*2.7*	*3.1*	*3.0*	*2.6*	*2.5*	*2.7*	*2.5*
US Other Key Indicators (end of period)													
PCE deflator-headline													
Headline	1.1	0.8	2.1	0.3	-0.1	-0.5	**0.5**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.4	1.4	1.9	0.3	0.3	0.2	**0.4**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.1	4.7	6.1	5.7	5.6	5.4	**5.2**	**5.1**	**4.9**	**4.8**	**4.7**	**4.7**
US Key Interest Rates (end of period)													
Fed funds rate (top of target range)	0.25	0.75	1.75	0.25	0.25	0.25	0.25	**0.50**	**0.75**	**0.75**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.75	3.00	2.49	2.17	1.92	2.35	**2.50**	**2.75**	**2.75**	**2.75**	**3.00**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP

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