U.S. Economic Update, 2015Q2 GDP

by NAB Group Economics 31 July 2015

National Australia Bank

- **U.S. GDP growth accelerated in the June quarter to a rate of 0.6% qoq (2.3% annualised). Following revisions, the economy is now estimated to have grown in the first quarter.**
- **The economy is expected to continue growing at an above trend growth rate. However, our forecasts have been marked down (2.4% to 2.3% in 2015, 2.7% to 2.6% in 2016) due to a likely inventory correction.**

U.S. GDP growth accelerated in the June quarter to 0.6% qoq (2.3% annualised). Moreover, the previous estimate of a small fall in GDP in the March quarter was revised away, with the economy now estimated to have grown by a still weak 0.2% qoq (0.6% annualised) in the quarter.

The details were mixed. Consumption growth strengthened, housing investment grew strongly, exports picked-up, as did government demand. However, business fixed investment declined, although excluding mining structures investment it was healthier. The small detraction from GDP growth from inventories masks another quarter of rapid inventory accumulation, which is unlikely to be sustainable.

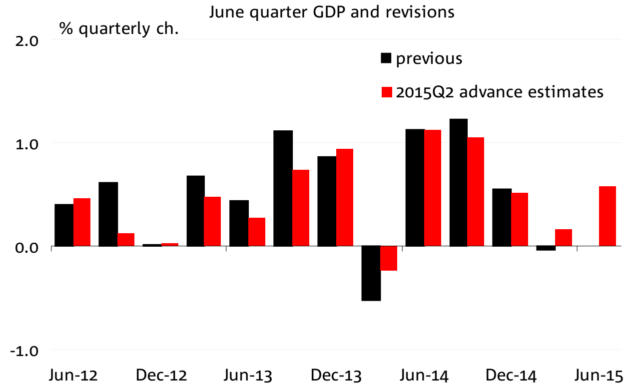
Real private consumption strengthened to 0.7% qoq after a modest result the previous quarter. Over the year consumption growth was 3.1%, well above total GDP growth of 2.3%, highlighting that consumption is currently underpinning growth. This is in part a consequence of last year's oil price plunge, which gave a strong boost to household incomes and confidence, but has also been helped along by the improving labour market. While the household savings rate fell to 4.8% in the quarter it was unchanged from a year ago suggesting that consumers have fully spent the windfall from the oil price fall.

Business fixed investment growth declined in the June quarter, with both equipment and non-residential structures investment down. In contrast, investment in intellectual property products was again solid.

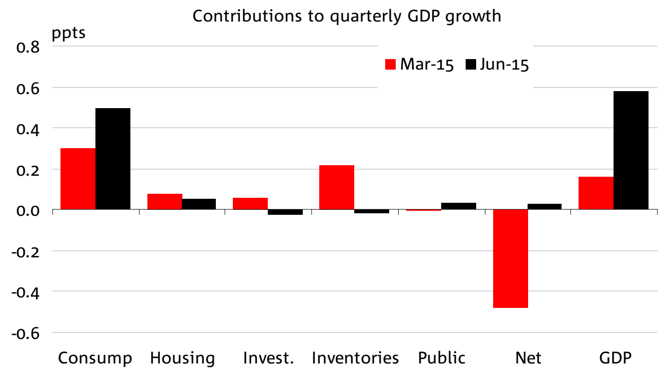
The greatest weakness in investment continues to be in mining. Mining exploration, shafts and wells investment declined 25% qoq, following -14% qoq in the previous quarter. Excluding mining structures investment, business investment grew at a reasonable 1.3% qoq pace, and structures (again ex mining) by a very rapid 8.1% qoq. Manufacturing structures investment has been growing particularly strongly – it was 63% higher than a year ago.

Residential investment growth, while down on the previous quarter, was still a solid 1.6% qoq. Over the last year, residential investment grew by 7.5%. The 'other structures' category (mainly home improvements and ownership

Moderate acceleration in GDP growth in Q2



Details mixed



Sources: BEA, NAB. Data not annualised

2015 Q2 GDP detail

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.7	0.50	3.1
Fixed investment	0.2	0.04	3.6
Structures	-0.4	-0.01	-1.7
Equipment	-1.0	-0.07	2.1
Intellectual property	1.3	0.06	6.6
Residential	1.6	0.05	7.5
Ch. in inventories		-0.02	
Public Demand	0.2	0.03	0.3
Net exports		0.03	
Exports	1.3	0.17	1.5
Imports	0.9	-0.14	4.9
GDP	0.6	0.6	2.3

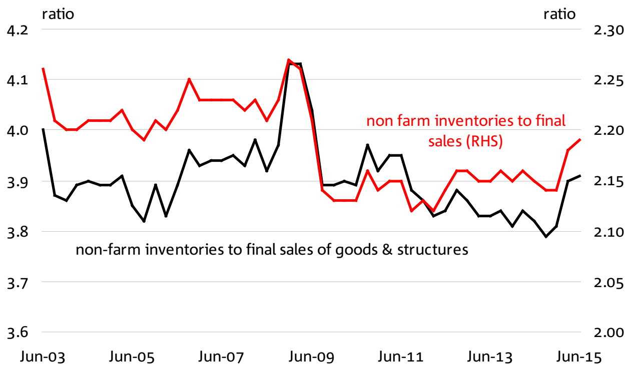
Source: BEA, NAB. Data not annualised.

transfer costs) grew rapidly but the new construction component has slowed. Monthly construction indicators have also slowed recently, but recent strength in building permits suggests that this will be temporary.

Inventory accumulation was its strongest in over four years in the March quarter, and was only slightly weaker in the

June quarter (causing the slight negative contribution to growth). Ratios of non-farm inventories to sales have increased noticeably, suggesting that there will be a correction down the track.

Inventories appear high



Source: BEA

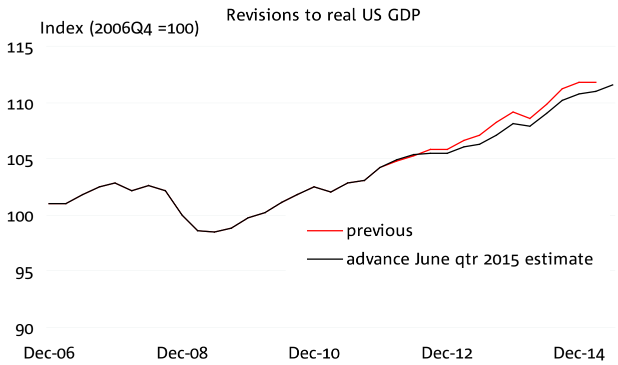
Exports rebounded in the June quarter, growing by 1.3% qoq. However, exports are still lower than they were at end 2014, with exporters facing headwinds from the strong appreciation of the dollar (14% between July 2014 and March 2015) and subdued global economic conditions. Supported by still solid domestic demand, and improved price competitiveness due to the dollar appreciation, import growth has been more rapid, although it slowed somewhat in the June quarter.

Government consumption and investment increased for the first time in three quarters, although only by a subdued 0.2% qoq. The increase was driven by state and local governments, although the pace of decline in federal spending is slowing. This is consistent with our view that fiscal policy (which in addition to direct consumption and investment also takes into account taxation and transfer payments) is no longer a drag on the economy.

Assessment

The June quarter growth rate was broadly in line with what has been seen in the recovery so far; at 2.3% annualised it is only a touch above the average 2% growth rate experienced over the last five years. While low by historical standards, this rate of growth has been more than sufficient to see improvement in the labour market, consistent with the view that the potential growth rate of the US economy has slowed. Our view has been that potential growth is currently around 2% but the risk is that it is even lower.

Pace of recovery revised down



Sources: BEA, NAB

This message was reinforced by revisions to historical data included in the June quarter estimates. The average annual growth rate from 2011 to 2014 was marked down from 2.3% to 2.0%.

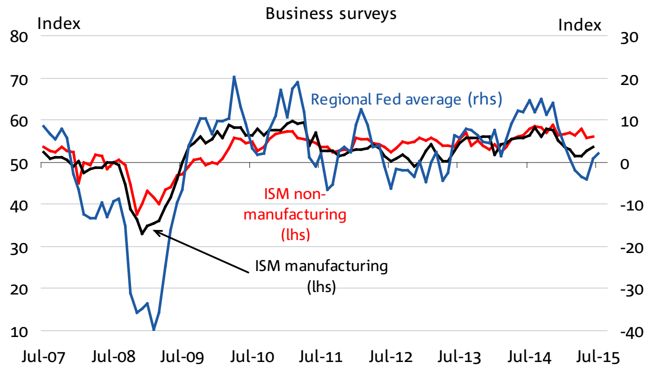
The latest initial jobless claims data – also out overnight – remain at around 15 year lows, suggesting that the labour market continues to improve.

Looking forward we expect that the economy will continue to grow at an above trend rate. Household spending will continue to be supported by rising wealth, improving credit conditions as well as solid employment and income growth. As the labour market tightens further, wages growth should also strengthen (there are some signs this is already happening).

Residential investment should also continue to grow strongly. Residential vacancy rates are at low levels, and there are signs that more people are starting new households which will further encourage new construction.

Solid domestic activity and easing credit conditions should underpin business investment, particularly as mining investment bottoms out (the oil and gas rig count stopped falling in late June). Manufacturers, in particular, have also been adversely affected by the stronger US dollar, weakness in the mining sector, as well as subdued global economic conditions. While this will continue to represent a headwind, there are signs that these headwinds may be moderating. The average of regional Federal Reserve surveys improved again in July.

Manufacturing sector stabilising



Sources: ISM, Philadelphia, Dallas, Kansas City, Richmond, New York Federal Reserves, NAB

While our outlook for the economy is essentially unchanged we have slightly marked down our forecasts for 2015 and 2016 by 0.1ppt. While the upwards revision to the March quarter was largely cancelled out by a slightly lower than expected June quarter, the greater than expected strength of inventory accumulation – and the likely correction (which we have spread out over several quarters) – means our estimates for coming quarters have come down.

The June quarter GDP result probably does not have significant implications for the Fed's monetary policy settings.

We have been expecting the Fed to start lifting rates this year (our call is for September but could easily be later in the year). The Fed's July meeting statement indicated that it only need to see 'some' further improvement in the labour market before it considered conditions right to start the tightening cycle and the June quarter GDP result (and jobless claims data) suggests the economy is still growing fast enough to achieve this.

The Fed also wants to be confident that inflation will move back towards its 2% target. The Fed Chair has indicated in the past that it is improvement in the labour market which will give the Fed confidence, as long as inflation expectations and inflation doesn't deteriorate any further. The core personal consumption price index grew at an annualised rate of 1.8% in the June quarter leaving the annual growth rate unchanged at 1.3%. One quarter's result is not enough evidence that inflation is moving back up but does suggest it is no longer falling.

Once the Fed does start tightening we continue to expect that the pace of subsequent increases will be gradual by past standards.

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US Economic & Financial Forecasts

	Year Average Chng %			Quarterly Chng %								
				2014	2015				2016			
	2014	**2015**	**2016**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
US GDP and Components												
Household consumption	2.7	3.0	2.8	1.1	0.4	0.7	**0.8**	**0.7**	**0.7**	**0.6**	**0.7**	**0.6**
Private fixed investment	5.3	4.0	6.3	0.6	0.8	0.2	**1.6**	**1.8**	**1.7**	**1.6**	**1.5**	**1.3**
Government spending	-0.6	0.4	1.3	-0.4	0.0	0.2	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.2	-0.2	0.0	0.2	0.0	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.7	-0.3	-0.2	-0.5	0.0	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**
Real GDP	**2.4**	**2.3**	**2.6**	**0.5**	**0.2**	**0.6**	**0.6**	**0.7**	**0.6**	**0.6**	**0.7**	**0.6**
Note: GDP (annualised rate)				*2.1*	*0.6*	*2.3*	*2.4*	*2.6*	*2.6*	*2.6*	*2.7*	*2.6*
US Other Key Indicators (end of period)												
PCE deflator-headline												
Headline	1.1	0.7	2.1	-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	0.2	0.2	0.4	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.1	4.8	5.7	5.6	5.4	**5.3**	**5.1**	**5.0**	**5.0**	**4.9**	**4.8**
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	**0.50**	**0.75**	**0.75**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.75	3.00	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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