United States Economic Update

by NAB Group Economics 11 September 2015

- **The Fed is still likely to start lifting rates this year, but we now expect this to be in December rather than September.**
- **The US economy is expected to continue growing at an above trend rate. We now expect growth in both 2015 and 2016 to be 2.5% (previously 2.3% and 2.6% respectively).**
- **The unemployment rate continues to fall, but inflation remains low.**

Change to Fed funds rate call

The major event over the last month was an external shock – namely concerns over China's economy - which led to an increase in financial market volatility and a large fall in share prices. The S&P500 share market index fell 10% in one week in August. While it has regained some of the lost ground the extent of the correction is still the largest since August 2011.

Large stock market correction in August

Sources: Datastream, NAB. Sep-15 is average of daily values 1 to 9 September

Shortly after the 2011 episode, the U.S. Federal Reserve loosened monetary policy in response (in the form of the so-called 'operation twist'). Of course, at that time there were concerns over the U.S. moving in recession, a downgrading of its long-term credit rating, the risk of Government default and European sovereign debt fears. The U.S. economy is much stronger now, so the reaction this time is likely to be to delay the start of the fed funds rate tightening cycle.

As a result, we recently changed our call for the first Fed funds rate hike from the September meeting next week to December. With still low inflation readings and some Fed members concerned about further U.S. appreciation and commodity price falls, our September call had already been line ball.

At the time we changed the call we viewed the risks around a December call as two-sided. If markets were to quickly recover lost ground, volatility was to fall back and U.S. activity data reports were strong then September or October could still be in play. Alternatively, if the stock market declines proved to be an indicator of a world economy even softer than thought, then the Fed could delay any action until 2016.

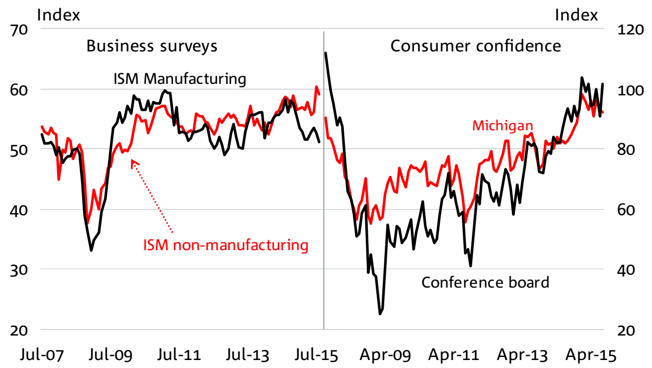
At this stage, the former scenario of strong economic data is the one playing out, although the stock market hasn't fully recovered. As a result, there is still some speculation that the Fed will raise rates in September. Once the Fed does start tightening we continue to expect that the pace of subsequent increases will be gradual by past standards.

Economic overview

The Bureau of Economic Analysis' advance estimate of June quarter GDP growth was significantly revised upwards last month, from 2.3% qoq (annualised) to 3.7%. This reflected upwards revisions to business investment and public demand in particular, as well as residential investment, net exports, consumption and inventories. The strong June quarter result needs to be read together with the weak March quarter outcome, with GDP growing at a moderate annualised rate of 2.2% over this period. Moreover, the higher estimate for inventories is unfavourable for the September quarter, as it increases the likelihood of an inventory correction.

Inventories may be a factor in the fall in the ISM manufacturing index in August to its lowest level in over two years, although at above 50, it is still consistent with positive growth. Within the survey details, there was a noticeable jump in readings of customer inventories. The export orders index was also weak, highlighting the negative impact of the US dollar appreciation on the sector.

Business activity and consumer confidence



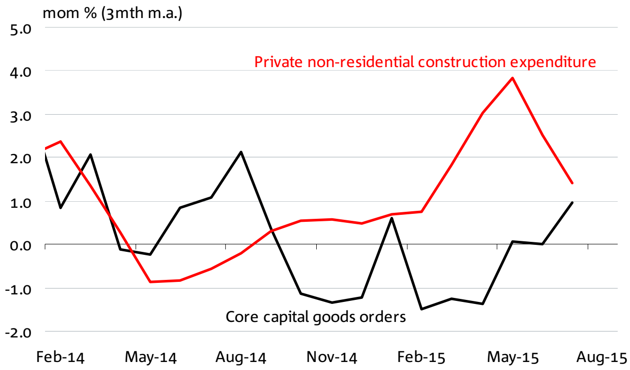
Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

That said, the non-manufacturing ISM indicator remains high. With the manufacturing share of the economy only a little over 10%, a weighted composite of the two ISM surveys remains consistent with reasonably strong growth. At the same time, consumer confidence remains elevated, although how the recent share market turbulence will affect confidence is still fully to be seen.

The most recent data on consumer activity are generally positive. Consumption grew 0.2% in July and is already 0.4% above its June quarter average. Moreover, vehicle sales grew by a solid 1.5% mom in August pointing to further growth in that month. Looking forward, household spending will be supported by improving credit conditions as well as solid employment growth. As the labour market tightens further, wages growth should strengthen. Rising wealth has also been a positive factor, but the fall in share prices, if sustained, represents a drag, although some short-term offset is likely to come from the recent boost to household budgets from recent falls in gasoline prices.

After slowing noticeably in the December quarter last year, business fixed investment growth has picked up modestly, reaching 0.8% qoq in the June quarter. Available partial data suggest that this improvement is continuing. Private non-residential construction data remain strong while capital goods orders appear to have turned the corner after being moribund for around a year.

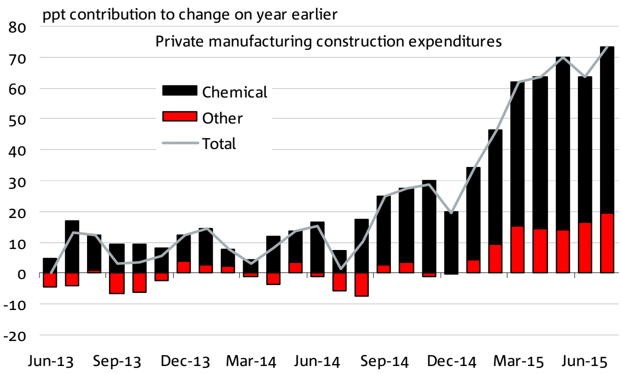
Business investment strengthening



Sources: Census Bureau, NAB

That said regional manufacturing survey indicators on investment intentions are still soft, suggesting a limit to how much capital goods orders might pick up. In stark contrast, manufacturing investment in structures has accelerated, growing by more than 70% over the year to August. This has been led by the chemicals sector, a major beneficiary of the large fall in energy prices.

Not all manufacturing indicators are weak

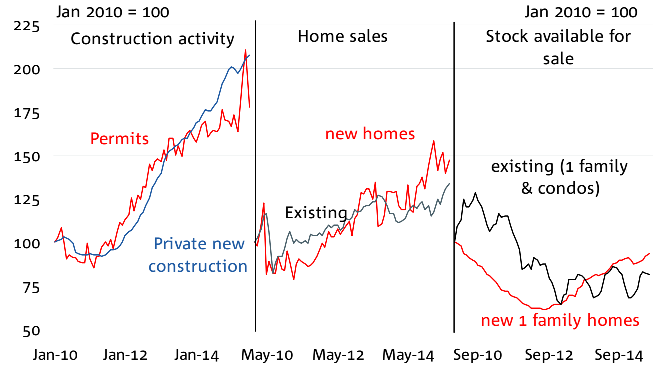


Sources: Census Bureau, NAB

Solid domestic activity and easing credit conditions should underpin business investment in the future, although recent further declines in oil prices are a risk to mining related investment (which had bottomed out in late June according to rig counts). Corporate profits have been broadly unchanged for 1½ years, but remain at high levels and so should be still providing some support to investment.

Residential investment should also continue to grow strongly. The slowdown in new construction spending earlier in the year was short lived and housing sales have also moved up. With new home inventories and residential vacancy rates still low, credit conditions gradually easing and signs that more people are starting new households, the strength in housing still has a while to run.

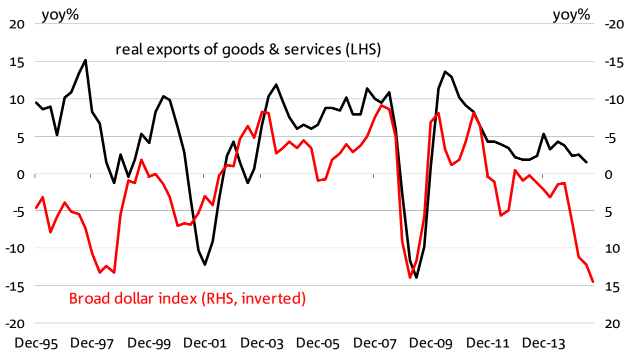
Housing activity indicators



Sources: Census Bureau, NAB

Headwinds are still coming from US dollar appreciation and the sluggish global economy. The US dollar rose a further 2% (based on the Fed's Broad Dollar Index) in August and is up 16% on a year ago. At the same time there are no signs of an overall pick-up in global growth; indeed we recently shaved our [global forecasts](). As a result, of the recent increase in the dollar and continued global weakness, we have lowered our expectations for next exports.

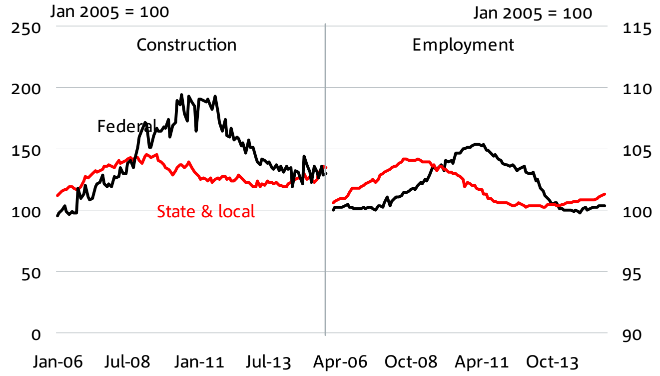
US dollar headwind



Sources: BEA, Federal Reserve. Sep 15 qtr BDI based on July & August average

Meanwhile, the headwind from government fiscal policy has largely ended. Both state and Federal government employment is trending up again (albeit slowly) and state government investment is also rising.

Public demand indicators starting to trend up



Sources: Census Bureau, Bureau of Labor Statistics, NAB

There are, however, still risks around potential deadlock in Congress over budgetary matters. Federal government funding post 30 September is still to be sorted out, and the Federal government's debt limit will need to be increased soon. The CBO projects that this will need to occur sometime by mid-November to early December in order to prevent the Treasury running out of cash.

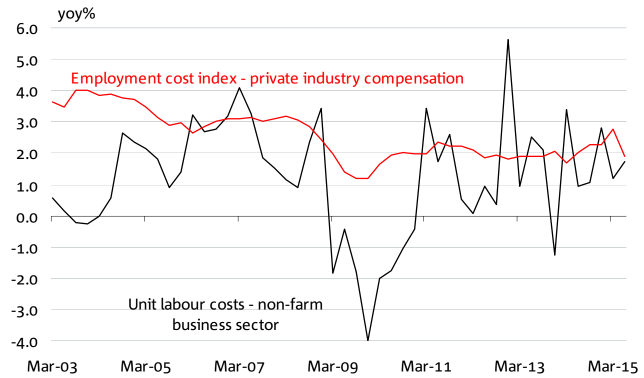
Overall, we expect that the economy will continue to grow at an above long-term growth rate. Because of the revisions to June quarter growth, we have revised up our 2015 forecast to 2.5% from 2.3%. At the same time, we have lowered out forecast for 2016 slightly to 2.5% (previously 2.6%) largely due to the change in the outlook for net exports reflecting the recent dollar appreciation and the subdued global environment.

Consistent with an economy growing at an above long-term trend growth (which we estimate is around 2%), the labour market continues to show improvement. Employment growth continues to be well above growth in the working age population and the labour force. Consequently, the unemployment rate is trending down; and fell by a further 0.2ppts in August to 5.1%. Broader unemployment measures are also falling (although not quite as rapidly) and the job openings rate is at its highest level since the data became available (2000).

The missing labour market element continues to be no clear signs of a strengthening in wages growth. Possible explanations for this include: the unemployment rate is overstating how much the labour market is tightening, there is normally a delay between labour market tightening and wages growth, and wages are being held down by low productivity growth.

Which is the correct explanation (if not some combination) has implications for the inflation outlook and monetary policy. For example, if weak wages growth reflects greater slack then this would suggest that the Fed should run a looser policy than if it was to reflect a lack of productivity growth. With low productivity growth wages growth does not need to be as high to generate inflationary pressures. This can be seen in the chart below - while wages growth is currently weak by past standards, the low productivity growth of recent years means that unit labour cost growth is closer to pre-recession norms.

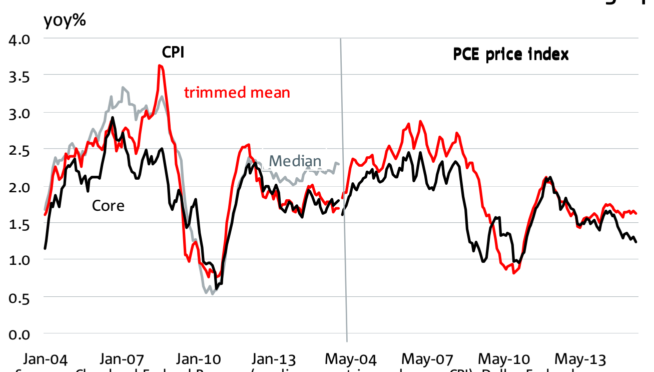
Wages growth and labour costs



Sources: BLS, NAB

Nevertheless, in part due to the impact of US dollar appreciation and the large fall in oil prices in the second half of last year, inflation is still low, and well below the Fed's 2% target. The Fed's favoured measure – the personal consumption expenditure (PCE) price index – in July was only 0.3% higher than a year ago. The core (ex energy and food) measure was higher, but still subdued at 1.2%. That said, over the last six months headline and core inflation has been stronger (growing at an annualised pace of 2.2% and 1.7% respectively). With alternative inflation measures also holding up better, there is some debate within the Fed on where inflation is currently at, despite the low headline readings.

Annual PCE Inflation low but other indicators holding up



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

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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	3.1	2.8	1.1	0.4	0.8	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**
Private fixed investment	5.3	4.6	6.5	0.6	0.8	1.0	**1.6**	**1.8**	**1.7**	**1.6**	**1.5**	**1.3**
Government spending	-0.6	0.7	1.4	-0.4	0.0	0.7	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.2	-0.3	0.0	0.2	0.1	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.7	-0.4	-0.2	-0.5	0.1	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.5**	**2.5**	**0.5**	**0.2**	**0.9**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Note: GDP (annualised rate)				*2.1*	*0.6*	*3.7*	*2.1*	*2.5*	*2.4*	*2.5*	*2.5*	*2.5*
US Other Key Indicators (end of period)												
PCE deflator-headline												
Headline	1.1	0.6	2.0	-0.1	-0.5	0.5	**0.3**	**0.2**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.4	1.4	1.9	0.2	0.2	0.5	**0.3**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	5.7	5.6	5.4	**5.2**	**5.0**	**4.8**	**4.8**	**4.7**	**4.7**
US Key Interest Rates (end of period)												
Fed funds rate (top of target range)	0.25	0.50	1.50	0.25	0.25	0.25	**0.25**	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**
10-year bond rate	2.17	2.50	2.75	2.17	1.92	2.35	**2.25**	**2.50**	**2.50**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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