United States Economic Update

by NAB Group Economics 9 October 2015

- **Measured employment growth has been softer in last two months. But the data are noisy and other indicators do not show any labour market softening.**
- **The US economy is expected to continue growing at a moderate pace, with GDP growth of 2.5% expected in both 2015 and 2016. The September quarter looks like it may be on the soft side, continuing recent volatility in GDP growth.**
- **December is still the most likely month for the Fed to start lifting rates; but there is a clear risk that it might be delayed.**

The surprises keep coming; starting in August there was a large fall in share prices, and in September there was a weak – by recent experience – jobs report (and August was revised lower).

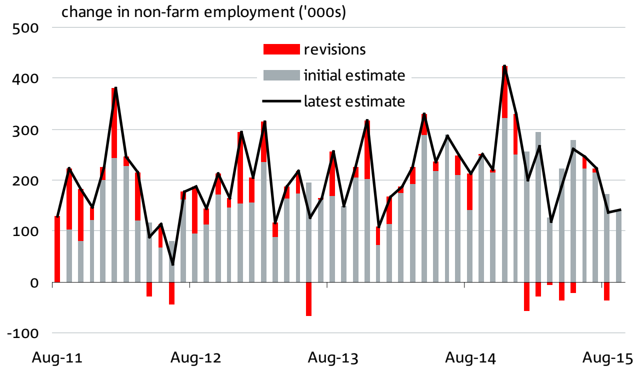
Non-farm employment grew by 142,000 in September, following a similar outcome (after revisions) in August. Does this portend a weakening in the labour market and economy which will put the recovery at risk and lead the Fed to (again) delay lift-off for the fed funds rate?

Any conclusions at this stage are necessarily tentative but our view is that employment growth may well have softened from recent strong growth rates, but that the labour market is still improving. As a result, the unemployment rate – and other measures of labour market underutilisation – is likely to keep falling.

This view is based on the following observations:

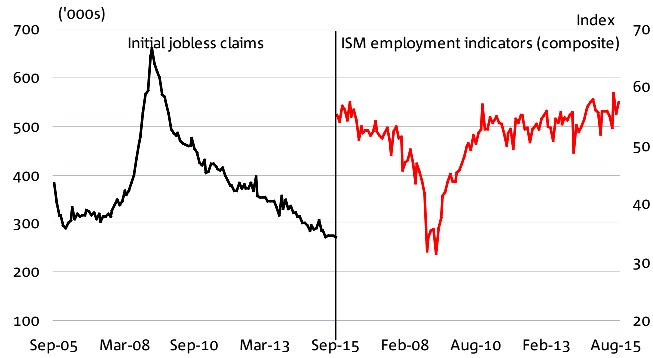
- Over recent years we have had previous episodes of slowdowns in jobs growth over several months which have not signalled any permanent downshift in jobs growth. Jobs data are noisy, even over several months, and also subject to considerable revision.
- There is no corroboration coming from other labour market indicators. Initial jobless claims are if anything trending down and a weighted average of the employment indicators in the ISM surveys shows no downturn.
- Jobs growth had already softened prior to the most recent data – through 2014/early 2015 it was running above a 2% annualised rate; in each of the last two quarters the annualised growth rate has been 1.7%.
- The 2014/early 2015 growth rate was not sustainable, and the modest shift downwards is more than strong enough to cause further drops in the unemployment rate over time (even the August/September 'weak' results are enough to do this).

Labour market indicators:
(a) we have had false dawns before



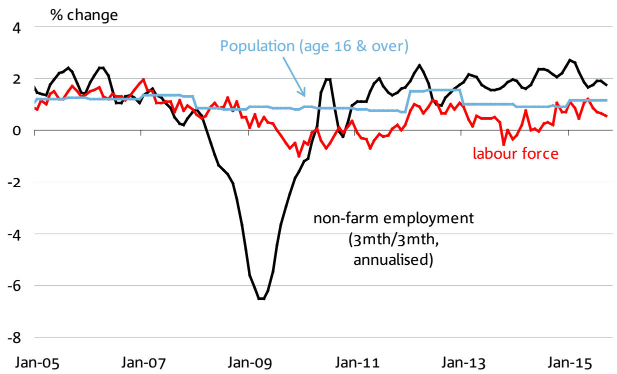
Sources: Philadelphia Federal Reserve, BLS, NAB

(b) other indicators show no labour mkt weakening



Source: ISM, Dept of Labor, NAB. ISM composite based on manufacturing/non-manufacturing shares of private employment. Data to September.

(c) even recent lower growth will lower unemployment



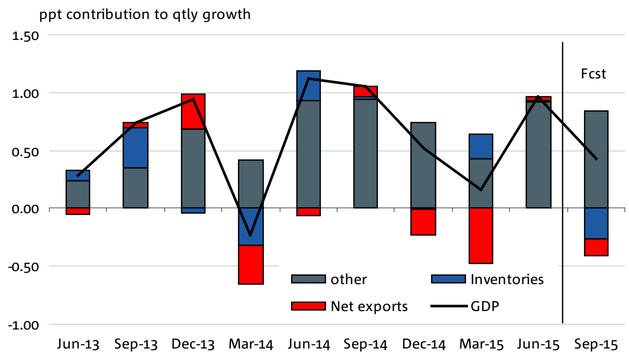
Sources: BLS, NAB

The concerns over employment growth have taken the focus off the unemployment rate. It was steady in September at 5.1%, holding onto its large 0.2ppt decline in August. The broader 'U6' measure of labour market underutilisation –which includes 'discouraged' workers and part-timers who would like a full time job but can't get one for economic reasons - fell in both August and September.

It is the case that the manufacturing sector (as well as energy) continues to struggle, likely reflecting the combination of dollar appreciation and a lacklustre world economy.

Moreover, at this stage it looks likely that GDP growth will be sub-par in the September quarter, continuing the trend of considerable quarterly volatility. We have revised down our expectations for growth in the quarter to 1.7% qoq (annualised rate). The downwards revision in part reflects weak export data for August – while these data are volatile the dollar/global economy factors are clearly weighing on net exports. Growth is also likely to be constrained by a slow down in inventory accumulation. However, even if growth does slow for these reasons, domestic consumption and investment demand remains solid (the 'other' category in the chart below).

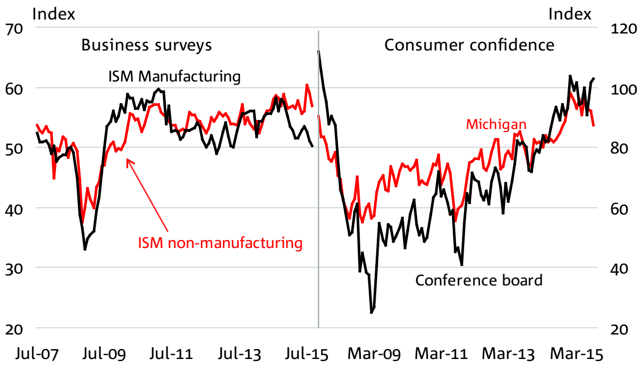
Downshift in Q3 GDP?



Sources: BEA, NAB. The 'other' component is similar to the NIPA category final sales to domestic purchasers

Despite these headwinds, and the volatility we have seen in GDP, the economy appears to be holding up. The non-manufacturing ISM index, even with a fall in September, is still at solid levels. As manufacturing only has around a 12% share in the economy a combined measure of the ISM surveys is consistent with plus 2% growth in the eocnomy, if not more.

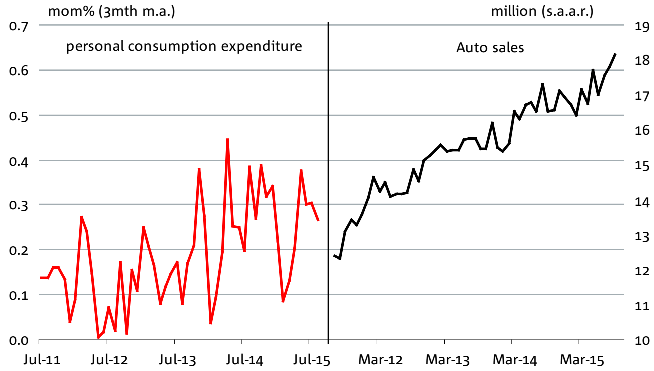
Business conditions and consumer confidence



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

Measures of consumer confidence have diverged somewhat recently but, taken together, they suggest confidence remains higher than it was last year. While the recent downturn in equities is a negative for wealth, consumers have benefited from the fall in oil prices and the higher US dollar (through lower prices), as well as the strong growth in jobs over the last few years. As a result consumption has been reasonably strong. Auto sales in September – the first guide to consumer activity for the month– rose by 2% to their highest level in over a decade.

Consumption growing strongly

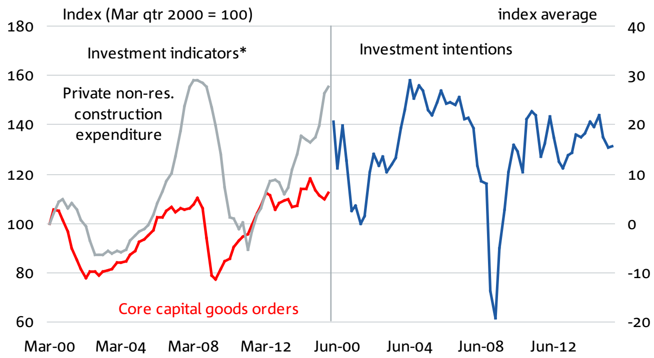


Sources:BEA, Autodata. PCE data to August, auto sales to September 2015

After slowing noticeably in the December quarter last year, business fixed investment growth strengthened over the course of the first half of this year, reaching 1.0% qoq in the June quarter. Private non-residential construction remains high after a period of rapid growth while capital goods orders may have turned the corner after being moribund for around a year.

Clouding the investment outlook how, are regional manufacturing survey indicators on investment intentions which remain soft, although they have at least stabilised.

Business investment showing improvement

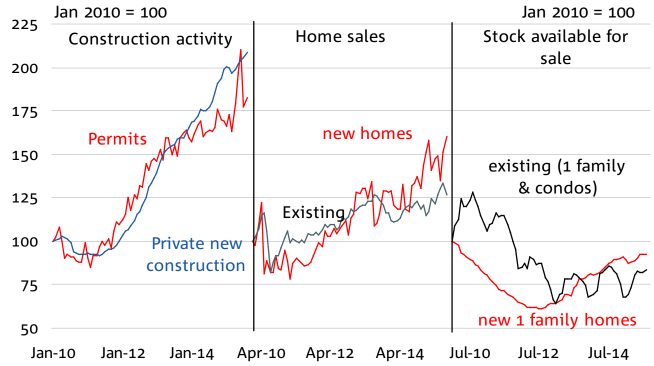


Sources: Census Bureau, Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys. * Sep qtr '15 is average of July & August.

Solid domestic activity and easing credit conditions should underpin business investment in the future, although further recent declines in oil prices are a risk to mining related investment. The rig count, after stabilising in late June, has started falling again in recent weeks. Corporate profits have been largely unchanged over the last year, 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.

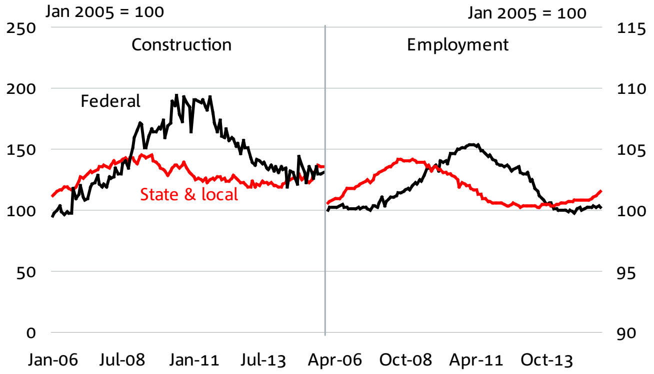
Housing activity indicators



Sources: Census Bureau, NAB

Meanwhile, the headwind from government fiscal policy has largely ended. Government employment is trending up (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 for the full year still needs to be agreed, although a temporary funding bill will allow the Government to keep operating until 11 December. 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. The two issues are likely to be resolved together, but there is always the risk that brinksmanship will create uncertainty and disrupt financial markets.

Overall, we expect that the economy will continue to grow at a moderate rate. While we have lowered our September quarter estimate, our annual forecasts are unchanged, partly because the Bureau of Economic Analysis revised up the June quarter outcome. We are expecting growth of 2.5% in both 2015 and 2016.

Growth at this level will be more than sufficient for the unemployment rate to continue trending down.

Monetary Policy

Every data release these days is viewed through the prism of what it means for monetary policy – that is, the timing of lift-off for the fed funds rate.

The Chair of the Federal Reserve in a speech on 24 September laid out her thinking behind why it was likely to be appropriate to raise rates this year. These include:

- The current near zero rate of inflation mainly reflects temporary effects (dollar appreciation, oil prices).
- Even so, to be confident that inflation will return to the Fed's 2% target, the Fed needs to be reasonably confident of continued solid economic growth and further gains in resource utilization (lower unemployment), and for inflation expectations to hold steady. The Fed expects labour market conditions will improve further heading into 2016.
- Rates need to be lifted ahead of inflation returning to target due to the lagged effect of monetary policy and because of financial stability concerns.

Assuming inflation expectations stay steady, this leaves the key factor as the outlook for the economy, particularly the labour market.

Given this, the recent weaker employment data, in isolation, do reduce the short-term chance of a lift in rates. However, for the reasons we have already outlined, we don't think a couple of months of softer data – data which include falls in the unemployment rate and an in broader measures of labour underutilisation – fundamentally changes the outlook for the U.S. economy .

It is also worth noting that the Fed's economic projections already contain an expectation that the rate of decline in the unemployment rate will slow. The unemployment rate is currently 5.1%, down 0.8ppts over the last year. However, the Fed median member projection only has a further 0.3ppt decline. This probably partly reflects an expectation that a tighter labour market might draw more people back into the labour force, or that some part-time jobs will switch to full-time so the expected fall in labour underutilisation might be greater than a simple reading of the unemployment forecast would suggest. Nevertheless, we expect Fed members are being too conservative, and that the unemployment rate will fall faster than they expect.

As a result, we still expect a December rate hike, although it is not set in stone and future data will have to be watched closely. The employment report does, however, reinforce our view that an October lift-off is unlikely and that the main risk around our call is that the rates lift off will be delayed until 2016.

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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	3.2	2.9	1.1	0.4	0.9	**0.9**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**
Private fixed investment	5.3	4.7	6.4	0.6	0.8	1.3	**1.4**	**1.8**	**1.7**	**1.6**	**1.5**	**1.3**
Government spending	-0.6	0.7	1.3	-0.4	0.0	0.6	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.1	-0.2	0.0	0.2	0.0	**-0.3**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.7	-0.4	-0.2	-0.5	0.0	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.5**	**2.5**	**0.5**	**0.2**	**1.0**	**0.4**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Note: GDP (annualised rate)				*2.1*	*0.6*	*3.9*	*1.7*	*2.5*	*2.5*	*2.5*	*2.5*	*2.4*
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**	**0.3**	**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	4.6	5.7	5.6	5.4	**5.1**	**5.0**	**4.8**	**4.7**	**4.7**	**4.6**
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	2.04	**2.50**	**2.50**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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