more give, less take

United States Economic Update

by NAB Group Economics 12 November 2015

- **There is still solid underlying momentum in the economy despite the slowdown in U.S. GDP growth in the September quarter. Moderate GDP growth is expected to continue.**
- **The likelihood of a fed funds rate hike in December has increased. Subsequent hikes will be gradual.**
- **Manufacturing continues to struggle, due to dollar apprecation and, more recently, an inventory correction.**

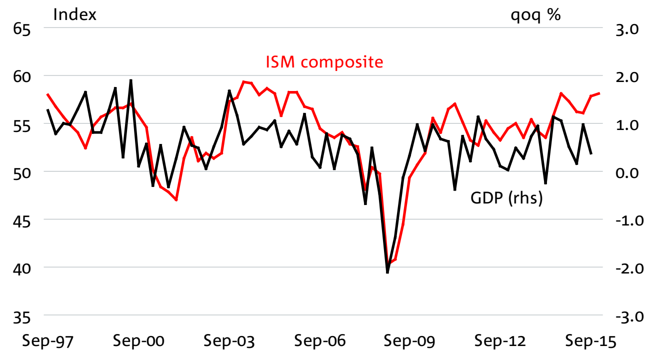
While U.S. GDP growth slowed noticeably in the September quarter to 1.5% qoq annualised (from 3.9% annualised in the December quarter), the economy still appears to have solid underlying momentum.

In part, the slowdown is likely a correction to the very strong June quarter. Moreover, the slowdown was primarily driven by an inventory correction, which should only be a relatively temporary factor (although it may continue into the December quarter). More details on the advance GDP estimate can be found here.

More recent data – in particular the ISM business surveys and the October employment report – support the view that the economy remains on a sound footing, but that not all parts of the economy are equally strong.

Our composite of the ISM manufacturing and non-manufacturing ISM (weighted according to their respective GDP shares) in October was marginally above the already strong September quarter level. Combined, the ISM surveys are at a level consistent with strong economic growth.

ISM surveys show a still solid economy

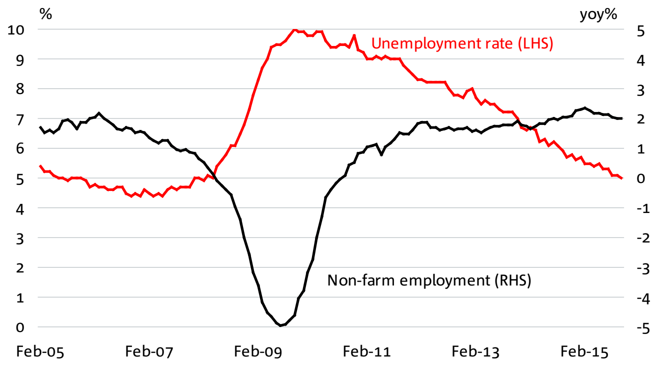


Sources: BEA, ISM, NAB. * weighted average of manuf. & non-manuf. ISM surveys (based on GDP shares). Dec qtr 15 ISM composite based on October 2015.

October's employment report came after a notable softening in job gains in August and September had raised concerns about the labour market. However, other labour market indicators – such as initial jobless claims – had not show any weakening. The across the board strength of the October report suggests these other indicators were providing a better signal.

The net gain in non-farm employment, of 271,000, was the strongest reading for the year. The annual growth rate in employment, which removes a lot of the month-to-month volatility, is 2.0% which is well above growth in the labour force (0.5% yoy) and working age population (1.2%). The unemployment rate also fell to 5.0%, its lowest level since April 2008. The number of people working part-time for economic reasons, but who would prefer a full time job also declined sharply for the second month in a row.

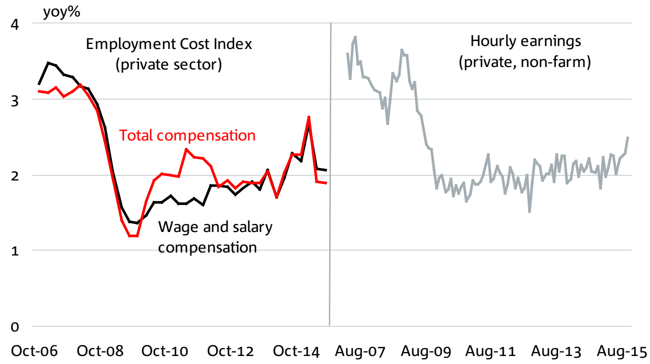
Labour market recovery remains on track



Sources: BLS, NAB

There was even a sign that the long awaited strengthening in wages growth may be underway. The growth rate for all private non-farm employees hourly earnings, rose to 2.5% yoy. While still well below pre-recession levels, it is a new high for the recovery. The quarterly Employment Cost Index (ECI) data have also been pointing to a modest upturn in wages growth. However, growth in the ECI total compensation measure (which includes non-wage benefits such as health care) is tracking sideways. Moreover, the monthly wages data are quite volatile so it is difficult to draw definitive conclusions on the direction of labour cost growth.

Tentative signs of a wages uplift

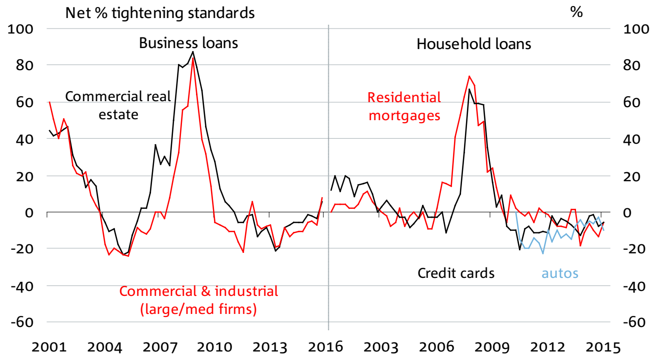


Sources: BLS, NAB. Employ. Cost Index growth rates based on seasonally adjusted data

We expect that the economy will continue to grow at a solid pace given the strong underlying momentum in consumption and residential investment. The drag on business investment from lower oil prices should slow as prices stabilise, although investment from businesses exposed to the U.S. dollar (particularly in manufacturing) will continue to come under pressure. Moreover, the headwind from fiscal policy is largely over.

Another tailwind to the economy has been easing lending standards. However, the latest Federal Reserve Senior Loan Officer Opinion survey suggests that this may be fading. More survey respondents indicated that they tightened lending standards than eased them for Commercial & Industrial and Commercial Real Estate loans, for the first time in several years.

Bank lending standards…business easing over?



Source: Federal Reserve, NAB. CRE from Dec. '13 Qtr is a simple average of the 3 categories. Res. Mortgages 2007Q2: 2014 Q4 are prime & from 2015 Q1 average of GSE eligbile, Govt, QM non-jumbo, non-GSE eligible, QM jumbo

In interpreting the result, it is worth noting that in the July survey, respondents indicated that for most commercial loan types, standards were generally around or easier than their typical level in the period since 2005. The small net tightening in the October survey would not change this conclusion. Moreover, the October survey was conducted in the aftermath of a major stock market correction so another reading is required to confirm a change to the trend. At the same time, lending standards continue to ease for consumer loans and for home mortgages.

All this adds up to continuing solid domestic final demand. Final sales to domestic purchasers are growing reasonably strongly; it increased by 2.8% over the year to the September quarter (compared to 2.0% for GDP).

However, notwithstanding a neutral impact in the September quarter, net exports are tending to drag on the economy as the tradeable sector faces a loss of competitiveness from a higher dollar and exporters are facing a lack lustre world economy. With further U.S. dollar appreciation expected, this is likely to continue to be the case over the next year.

The rise in the US dollar at least in part reflects the anticipated formal tightening of U.S. monetary policy through increases in the fed funds rate. After the stock market correction in August, we moved our call for the first fed funds rate hike to December. While the Bloomberg market implied probability of a rate hike in December was only around 25% in mid-October, this has since risen to almost 65% in reaction to the Fed's October meeting statement and the October employment report. As a result, long-term bond yields have also increased representing a tightening in financial conditions.

Yields rising as a fed funds rate hike looms near

Source: Bloomberg. Last observation is 10 November 2015

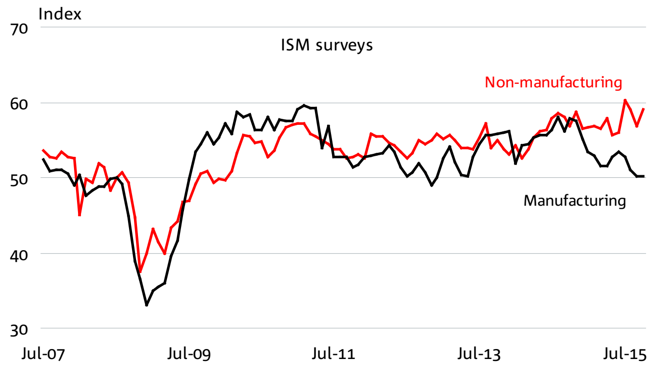
However, yields still remain within the range they have been over the last year. When the Fed does start to move we anticipate they will move rates up only very gradually. After a December rate hike, our forecasts have only a further 75bps of rate increases over 2016, which would take the top of the fed funds rate target band to 1.25%. Moreover, in what are increasingly inter-twinned global financial markets, with some other advanced economy central banks considering loosening policy, we are not expecting major rises in U.S. yields.

Given the combination of tailwinds and headwinds, we expect that the economy will continue to grow at a moderate rate, with growth in 2015 and 2016 anticipated to be similar to that experienced last year (at around 2½%). Growth at this pace will lead to further falls in the unemployment rate, resulting in a build up of inflationary pressures which should move inflation back towards the Fed's 2% target.

A solid economy does not mean good news for all

Despite this reasonable overall economic environment, some sectors are struggling. In particular, the impact of the stronger dollar is being felt by the U.S. manufacturing sector. The USD increased by around 17% on a trade weighted basis between July 2014 and October 2015. This represents a loss of competitiveness for exporters and for businesses which compete against imports.

Manufacturing struggling

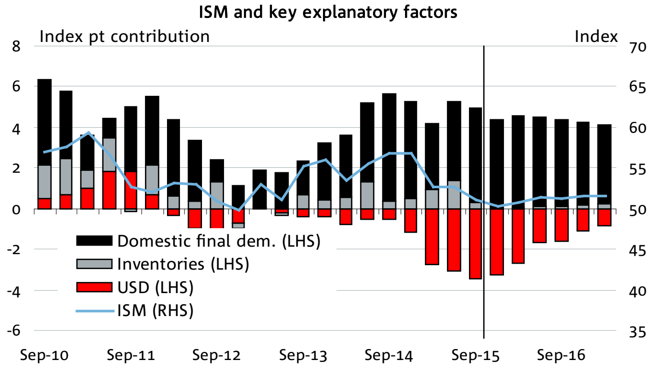


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

The pressure on the manufacturing sector can be seen in the ISM business surveys. As noted before, our composite measure is quite strong. However this hides a strong non-manufacturing (services and construction) performance while the manufacturing reading is barely above 50 (with 50 indicating a sector neither growing or falling).

To better understand why the manufacturing ISM has declined – and what might happen from here – we have constructed a simple model. Domestic demand growth, manufacturing inventory growth and the dollar are used to explain the ISM. As the chart below shows, the model suggests that there are two main forces at work. The strength in domestic demand has been, and is expected to remain a support. At the same time the dollar has been exerting a powerful drag. This may have peaked, given our outlook for the currency, although stronger expected additional currency appreciation – e.g another 10% from October levels - could easily drive the ISM below 50, as could a continuation of the recent inventory correction. Another reason for the decline in the September quarter was a slowdown in inventory accumulation and while this may continue into the current quarter it shouldn't be more than a transitory factor.

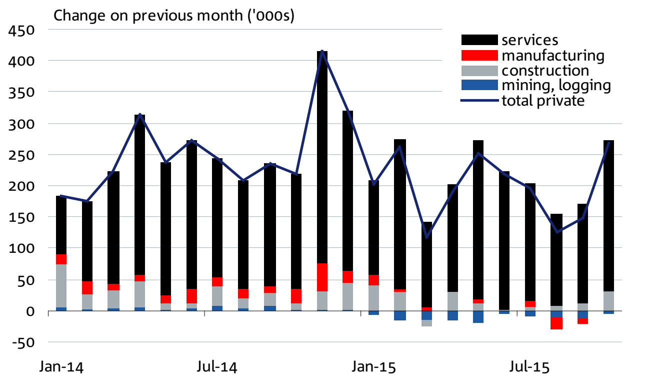
Drivers of the manufacturing ISM



Sources: ISM, BEA, Federal Reserve, NAB. Residual components not shown.

This change in the manufacturing sector's fortunes can also be seen in the labour market. Over 2014, manufacturing was contributing to overall jobs growth, as were mining and logging. However, manufacturing employment gains slowed down over the first half of 2015 and more recently employment has declined in the sector.

Changing composition of jobs growth



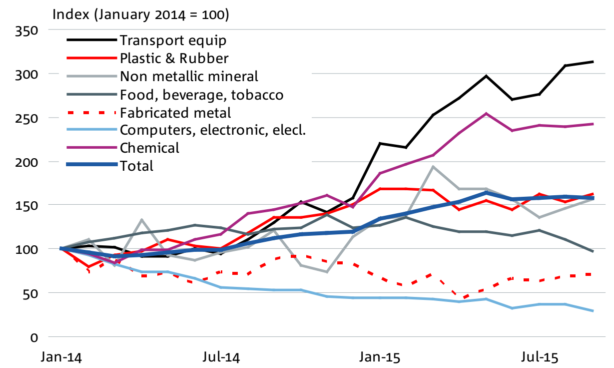
Sources: BLS, NAB

It is a similar story with mining, although as it is a smaller, and very capital intensive part of the economy, its contribution to employment growth was only small even when it was growing strongly. Moreover, given the speed and extent of the fall in oil prices, employment in the sector started declining sooner than in manufacturing.

Even during 2014, the main contributor to employment growth was the services sector, and it has remained strong through 2015.

Of course, within the manufacturing sector, there is a wide divergence, as other factors are also at play. For example, the chemical sector is a major user of energy, and would be expected to benefit from the decline in energy prices (particularly natural gas). Certainly, investment in construction in the sector has taken off as can be seen in the chart below, with its share of total manufacturing construction activity rising from around one-third at the start of 2014 to over half in September 2015. Construction investment in the smaller (at least in terms of construction activity) transport equipment category has seen even more rapid growth, but other sectors such as computing/electronics and fabricated metal have seen a fall in construction investment.

Manufacturing construction expenditure



Sources: Datastream, NAB

For more information, please contact

Tony Kelly +613 9208 5049
antony.kelly@nab.com.au

US Economic & Financial Forecasts

	Year Average Chng %			2015				2016			
	2014	2015	2016	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components											
Household consumption	2.7	3.2	2.8	0.4	0.9	0.8	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**
Private fixed investment	5.3	4.3	5.9	0.8	1.3	0.7	**1.6**	**1.7**	**1.6**	**1.5**	**1.3**
Government spending	-0.6	0.8	1.5	0.0	0.6	0.4	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.1	-0.2	0.2	0.0	-0.3	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	-0.4	-0.5	0.0	0.0	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.4**	**2.5**	**0.2**	**1.0**	**0.4**	**0.6**	**0.7**	**0.6**	**0.6**	**0.6**
Note: GDP (annualised rate)				*0.6*	*3.9*	*1.5*	*2.5*	*2.7*	*2.6*	*2.6*	*2.4*
US Other Key Indicators (end of period)											
PCE deflator-headline											
Headline	1.1	0.5	2.0	-0.5	0.5	0.3	**0.2**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.4	1.4	1.8	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	5.6	5.4	5.1	**5.0**	**4.8**	**4.7**	**4.6**	**4.6**
US Key Interest Rates (end of period)											
Fed funds rate (top of target range)	0.25	0.50	1.25	0.25	0.25	0.25	**0.50**	**0.50**	**0.75**	**1.00**	**1.25**
10-year bond rate	2.17	2.50	2.75	1.92	2.35	2.04	**2.50**	**2.50**	**2.75**	**2.75**	**2.75**

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

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

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

Vyanne Lai
Economist
+(61 3) 8634 0198

Amy Li
Economist – Australia
+(61 3) 8634 1563

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

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

Tapas Strickland
Economist
+61 2 9237 1980

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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