U.S. Economic Update

by NAB Group Economics

12 May 2016

- **The U.S. economy had a weak start to 2016, but we forecast it to rebound, with moderate growth expected through to 2018.**
- **Labour market still solid, despite slightly slower than expected April non-farm employment growth.**
- **Productivity growth in the U.S. remains weak, reflecting a variety of factors.**

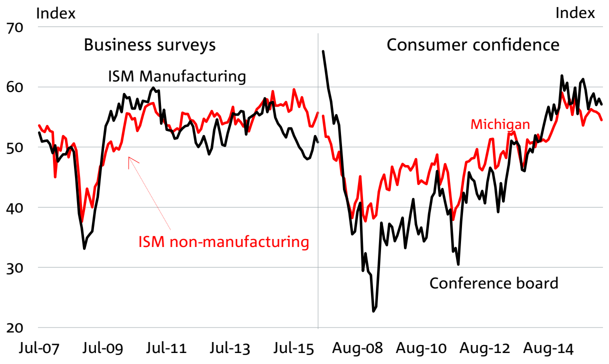
The advance estimate of US Gross Domestic Product (GDP) indicates that growth was very weak at the start of the year. GDP growth was only 0.1% qoq, or 0.5% annualised in the March quarter. As we noted at the time, the details were mixed with residential investment growth again strong and there was also a pick-up in public demand. However, the headwinds from business investment and net trade intensified, and there was a further slowdown in inventory accumulation.

However, quarterly GDP data are volatile and, due to a similar start to 2015, the annual growth rate remained at around 2% in the March quarter.

There are few indicators of actual activity available yet for the June quarter, although motor vehicle sales rebounded strongly in April, growing by 5.1% mom, reversing most of the previous months fall.

The ISM business surveys also point to a rebound in activity. While the manufacturing index gave up some of its recent gains in April, it was the second month in a row where it was in positive, above 50, territory (following five months below 50). The non-manufacturing index – which covers a far greater proportion of the economy – is at a higher level and rose for the second month in a row.

With consumer confidence steady, business indicators signal a rebound

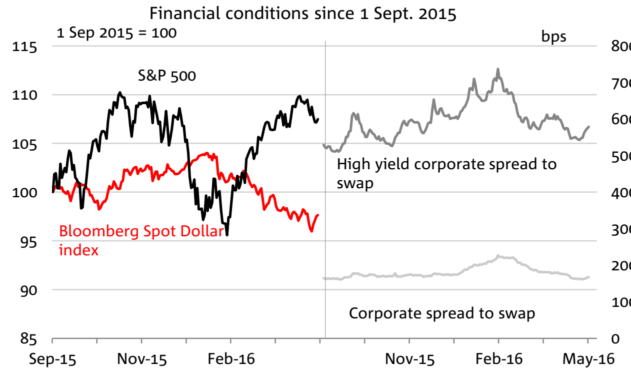


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

One possible explanation for the slowdown in GDP growth, and the deterioration in business indicators in late 2015 and early 2016 was a sharp deterioration in financial conditions, as measured by a broad range of indicators.

However, these indicators started to recover from late January and several are back to where they were around November last year. In the case of the US dollar, it is now around where it was in around mid-2015. The strength of the dollar has been a factor behind the weakness in several sectors of the economy, principally those more highly exposed to trade such as manufacturing.

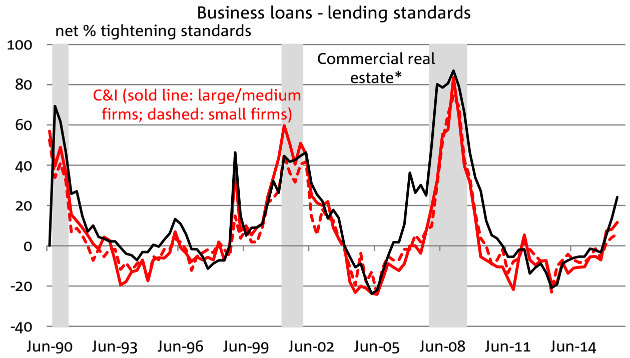
Recent improvement in financial conditions



Sources: Bloomberg (LUCI), Fed. Reserve, Thomson Reuters Datastream. Data to 6 May2016

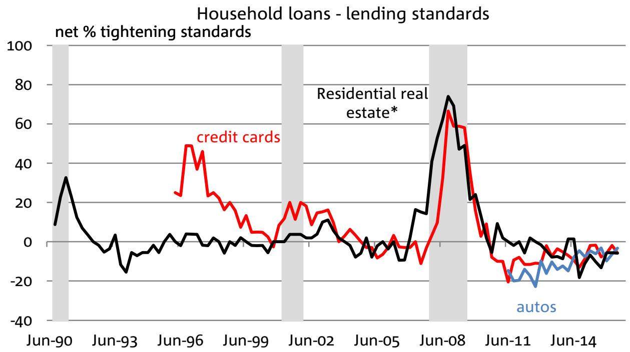
However, not all indicators have improved. The recently released Federal Reserve Senior Loan Officer Survey, which essentially covered changes over the March quarter, indicates that a majority of banks have continued to tighten loan standards on business loans. While this may be particularly the case for energy related loans, it is more widespread than this as illustrated by the tightening in commercial real estate (CRE) loan standards.

Banks continue to tighten business loan standards…



* From Dec 13 qtr simple average of three CRE components. Shaded areas are recession periods

…but easing consumer/residential mortgage standards



* Res. Mortgages 2007Q2: 2014 Q4 are prime & from 2015 Q1 average of GSE eligbile, Govt, QM non-jumbo, non-GSE eligible, QM jumbo

That said, banks are not tightening lending standards across the board. Consumer and residential real estate lending standards continue to be eased by a modest number of banks.

We expect that the economy will rebound in the June quarter and grow at a moderate pace over the rest of this year and into the next. This should lead to further declines in the unemployment rate and a gradual rise in inflation.

Factors likely to support growth include solid consumption growth, further strong growth in residential investment and (a light) tailwind from fiscal policy. Consumption growth will be supported by solid household balance sheets and the strong labour market. These factors will also support housing investment, as will low mortgage rates (although they will likely rise over time), easing bank lending standards, and low inventories of houses for sale.

However, some parts of the economy are still facing headwinds. Corporate profits have declined, and while this is particularly so for the energy sector, they appear to have at least levelled out in other sectors. A combination of low productivity and stronger wages growth is likely to keep the pressure on margins, while at the same time banks are tightening lending standards. Manufacturing has also had to contend with a large appreciation of the U.S. dollar and weak external demand. However, with oil prices showing some recovery (and expected to continue to gradually trend up), and the dollar reversing some of its past gains, these headwinds appear to be softening.

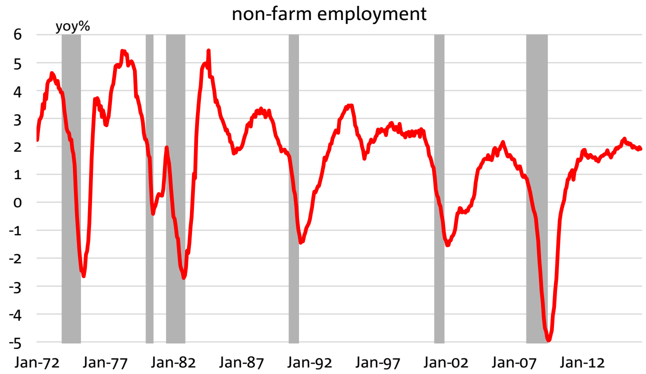
Net trade also continues to feel the impact of past US dollar appreciation, as well as lack lustre global growth. The recent fall in the dollar should alleviate some of this pressure. However, global growth is likely to remain subdued. As a result, net exports will likely remain a drag on growth, although it should lessen over time.

Given the continued improvement in the labour market, and signs that inflation is starting to move back towards the Fed's target, we still expect gradual interest rate rises. We expect that the next hike will be in the September quarter, but the Fed will want upcoming data release to confirm that the weak first quarter was only temporary.

Labour market

The main release of economic data since the GDP report has been the April labour market data.

Jobs growth remains strong

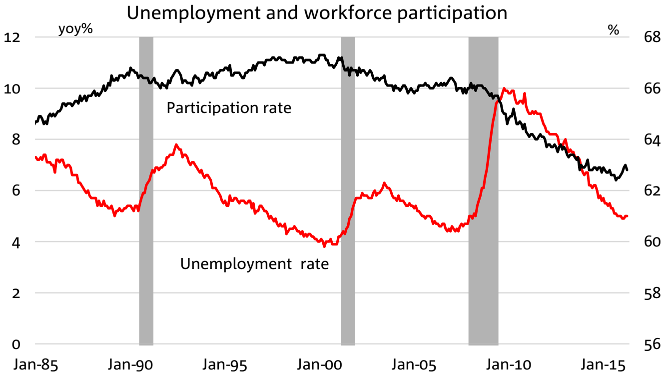


Sources: BLS, NBER, NAB. Shaded areas represent recession periods.

Non-farm employment growth was below expectations at 160,000, but similar growth was recorded in January this year and August and September last year without indicating any slowdown. The annual growth rate has been either 1.9% or 2.0% since last September, almost twice the rate of population growth. Another timely labour market indicator, initial jobless claims, has not showed any softening.

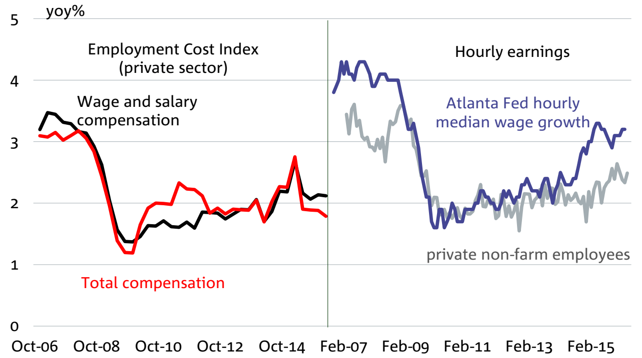
At this pace, therefore, further falls in the unemployment rate could be expected over time. However, the unemployment rate, at 5%, is where it was back in October 2015. This is due to an increase in the participation rate over that period. While demographic (e.g. aging) and other factors are pushing the participation rate down over time, this trend accelerated following the 2007-09 recession. With the unemployment rate now at relatively low levels, it could be that some of the fall in participation due to the recession is being reversed. While keeping the unemployment rate up for now, it actually represents a further sign of the ongoing recovery in the labour market.

Progress on unemployment rate has stalled for the right reason…rising workforce participation



Sources: BLS, NBER, NAB. Shaded areas represent recession periods.

Further signs of strengthening wage growth



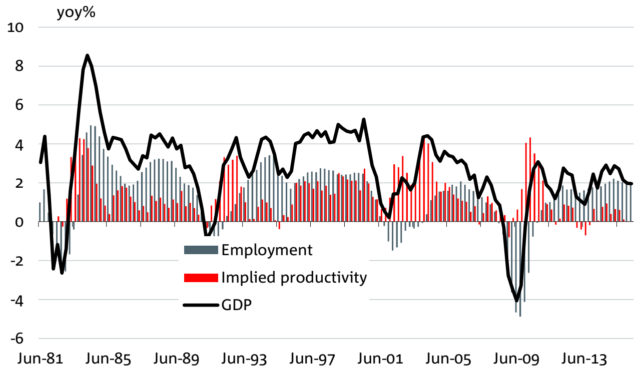
Sources: BLS, Atlanta Federal Reserve, NAB. Employ. Cost Index growth rates based on seasonally adjusted data

Wages growth also looks like it may be showing some strengthening. Growth in hourly earnings for private non-farm employees has clearly strengthened over the last year. The Atlanta Fed's wage growth measure has also moved higher. Only the quarterly Employment Cost Index total compensation measure shows no upturn; however, this is entirely due to one quarter (the June 2015 quarter) which looks to have been strongly affected by changes in incentive pay.

Productivity trends

The combination of strong job gains but weak GDP implies low productivity growth. A simple measure of labour productivity can be derived by dividing GDP by non-farm employment. As can be seen in the chart below, after an initial rebound as the economy began to move out of recession, this recovery has been characterised by very weak productivity growth.

Low productivity recovery



Sources: BEA, BLS, NAB

The closest parallel is the early 1990s recovery which, after an initial surge, had a period of low productivity (although not as long as the current one). Productivity growth did eventually strengthen later in the 1990s, which is widely attributed to the IT 'revolution'.

Implicitly we are expecting the same. While our GDP forecasts don't change much over 2017 to 2019, employment growth at current levels is likely unsustainable over this timeframe. As noted before, employment growth is much stronger than population growth, and over time population aging and other factors are likely to be a drag on workforce participation, further constraining employment growth.

Why the productivity slowdown has occurred is still open to debate.

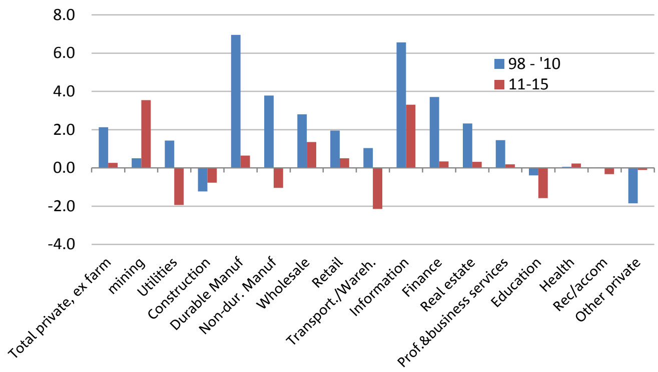
We noted in our [March 2016 U.S. Economic Update] that labour intensive sectors are currently the stronger performing parts of the economy. Not surprisingly, the labour intensive sectors also tend to have relatively low labour productivity, so this compositional change in the economy might explain some of the recent weakness in productivity.

However, its importance shouldn't be exaggerated. The decline in the productivity growth is widespread across most industry sectors, including traditionally high productivity growth sectors such as manufacturing.

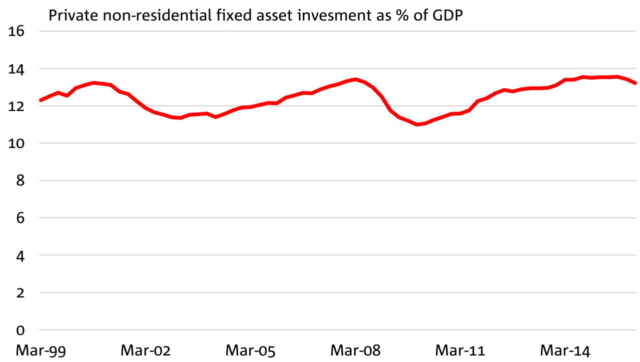
As noted earlier, business fixed asset investment (equipment, software, buildings etc) has been weak recently. Less equipment per worker could be a factor. Looking at the proportion of gross private fixed non-residential investment to GDP, suggests that the level of business investment is above average.

However, GDP growth itself has been only moderate. Moreover, as a nation's capital stock rises over time, just to maintain the stock (due to obsolescence, wear and tear) requires a higher level of investment. Indeed growth in the stock of fixed assets has slowed.

Productivity slowdown across most industries

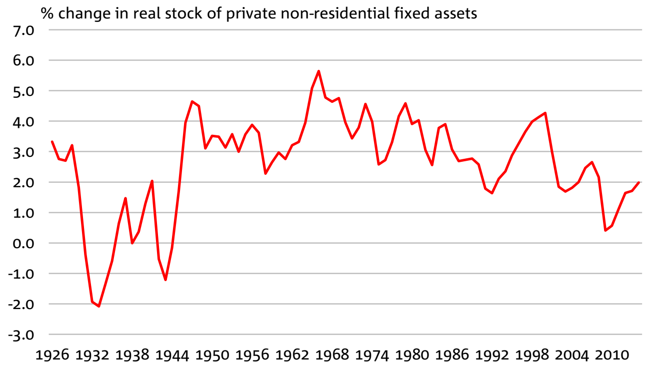


Relative to GDP, business investment is above average



Sources: BEA, NAB

But growth in stock of fixed assets has slowed



Sources: BEA, NAB

However, while this may be a factor, a slowing in the rate of growth in the capital stock has been the general trend since the 1960s, so it is not clear that it explains the extent of the productivity slowdown either.

Indeed, many possible explanations have been provided for the slowdown in productivity growth. Apart from the factors already mentioned, other possibilities include:

- All the technological changes that can cause big changes in productivity (e.g. electricity) have been invented and largely diffused through the economy. The IT revolution provided a short boost to productivity, but its affects have already faded.
- The 2007-09 recession caused massive dislocation to the economy and it takes time for resources to find a more productive use.

- There has been a loss of dynamism in the U.S. economy; fewer new business start-ups, reduced labour mobility etc.
- Recent job entrants tend to be lower skilled, depressing average productivity measures, exacerbated by the bulge of high productivity baby boomers now exiting the labour force.
- Growth in education attainment (e.g. number of people attending university) has slowed.

In all likelihood it is a combination of many factors that have caused the productivity growth slowdown. Some may well be reversed – the impact of the dislocation caused by the recession should fade over time; some possibly could be reversed (micro economic reforms to encourage dynamism); others may not be possible to reverse (there is a limit to how many people can go to university, and as the recovery continues even more marginal productivity workers might be drawn into the workforce). Some factors might change, e.g. as labour becomes more scarce (and probably more expensive), businesses may invest more in new equipment.

How these various factors play out will be crucial for the performance of the U.S. economy (and livings standards of households). Research suggests that forecasting productivity growth is particularly difficult (if not possible); implicitly our GDP forecasts assume productivity growth does strengthen over the next several years, but to a level on the low side of historical experience.

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US Economic & Financial Forecasts

	Year Average Chng %					Quarterly Chng %									
						2015		2016				2017			
	2014	**2015**	**2016**	**2017**	**2018**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
US GDP and Components															
Household consumption	2.7	3.1	2.5	2.2	1.9	0.7	0.6	0.5	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.3	4.0	2.3	4.4	3.5	0.9	0.1	-0.4	**1.2**	**1.3**	**1.2**	**1.1**	**1.0**	**0.9**	**0.9**
Government spending	-0.6	0.7	1.3	1.6	1.6	0.4	0.0	0.3	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.2	-0.3	-0.1	0.0	-0.2	0.0	-0.1	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	-0.3	-0.3	-0.1	-0.1	0.0	-0.1	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.4**	**1.8**	**2.1**	**1.9**	**0.5**	**0.3**	**0.1**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*2.0*	*1.4*	*0.5*	*2.5*	*2.4*	*2.2*	*2.1*	*2.0*	*2.1*	*2.0*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.1	0.5	1.6	2.1	2.2	0.3	0.1	0.1	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**
Core	1.4	1.4	1.8	2.0	2.2	0.3	0.3	0.5	**0.4**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	4.4	4.4	5.1	5.0	4.9	**4.9**	**4.8**	**4.7**	**4.6**	**4.5**	**4.5**	**4.4**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	0.25	0.50	1.00	1.75	2.50	0.25	0.50	0.50	**0.50**	**0.75**	**1.00**	**1.00**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.27	2.50	2.75	2.50	2.04	2.27	1.77	**2.00**	**2.25**	**2.50**	**2.50**	**2.75**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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