US ECONOMIC UPDATE OCTOBER 2016

NAB Group Economics

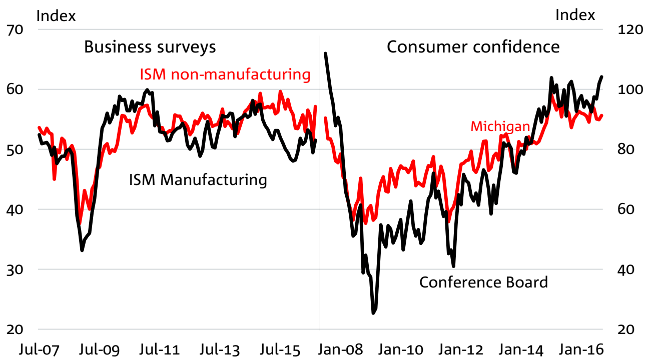
The US economy continues to perform solidly. While GDP growth has been modest, jobs growth remains solid and inflation is edging up. There are signs that consumption growth is starting to moderate but at the same time business investment indicators are showing signs of life. The Fed remains on track to increase rates in December.

Overview and outlook

The latest indicators suggest that the US GDP continues to grow at a modest rate. With productivity growth subdued, this is enough to generate solid employment growth.

The unexpectedly weak August business survey readings were reversed in September. The manufacturing ISM measure returned into positive (above 50) territory, while the non-manufacturing survey rebounded to its highest level in almost a year. Meanwhile, consumer confidence remains solid.

Business surveys bounce back from August slump



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

Reflecting the subdued start to the year, we expect GDP to grow by 1.5% in 2016, followed by 2.1% in 2017. Some of the recent trends are likely to start to reverse – the strength in consumption should moderate but at the same time business investment should not be as weak.

Consumption growth has been a key driver of activity over the last two years, but there are signs it is moderating. This is not unexpected with the tailwind from low oil prices fading. There are also signs that the easing in bank lending standards for consumer loans is slowing and, as the labour market tightens, employment growth is also likely to moderate. However, consumption growth should still remain solid due as wages growth strengthens and because of the support from strong household balance sheets.

At the same time, as the negative impacts on the capital intensive energy and manufacturing sectors from the fall in oil prices and the appreciation of the dollar respectively fade, business investment should see some improvement. Similarly, the impact on export growth from past US dollar appreciation is subsiding, although still subdued world economic growth remains a constraint.

Business investment in inventories has also slowed noticeably since early 2015. But this is unlikely to persist for much longer as, over time, inventories tend to have a neutral impact on growth.

Investment in residential housing has also hit a rough patch. However, the fundamentals are still favourable, with vacancy rates and interest rates low, and new home sales picking up strongly. The continued gains in the US labour market should also encourage more people to start their own household.

We expect the Fed will tighten monetary policy in December, but any further rate hikes will be very gradual. The outlook for fiscal policy is clouded by the election; but with fixing the US government's high debt levels not a focus of political discussion, federal fiscal policy should be neutral at worse.

Review of economic indicators

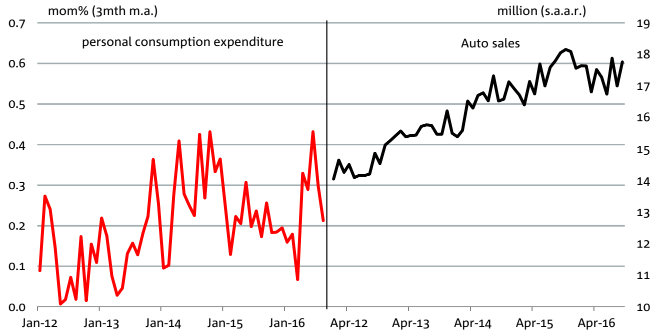
There was a small 0.1% mom decline in household consumption in August. This came after a couple of very strong months and on a three-monthly trend basis, growth still looks solid. Auto sales bounced back in September suggest that the August fall is not the start of a downwards trend, although it is consistent with a moderation of the recent strong growth rates.

Household net worth increased by over $1 trillion in the June quarter 2016 and, as a percentage of household disposable income, remains at a high

Date **14 October 2016** | Author **Antony Kelly** – Senior Economist – International

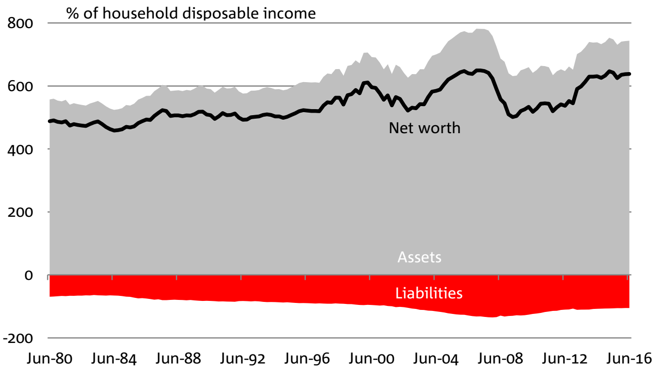
level. This reflects both a reasonably high level of household assets as well as subdued liabilities which remain well below pre-GFC levels as a percentage of disposable income. The healthy state of the overall household balance sheet should support future consumption growth.

Despite August correction, consumption still solid…



Sources:BEA, Autodata. PCE data to August, auto sales to September 2016

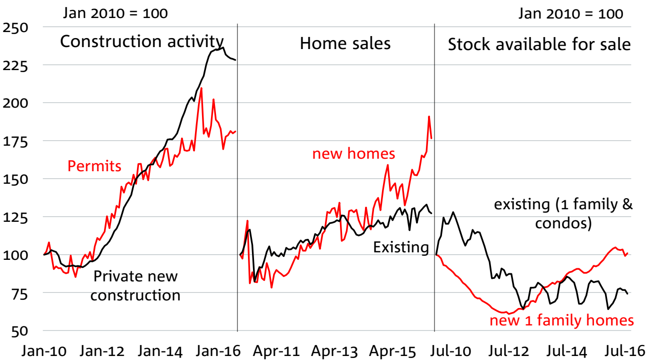
…helped by a healthy household balance sheet



Sources: Federal Reserve, NAB

In contrast, residential investment looks set to record its second consecutive quarterly decline in the September quarter. July and August new residential construction expenditure and existing home sales are tracking lower than in the June quarter. The weakness in construction is despite starts and housing under construction all rising in recent quarters (and so far in the September quarter). A positive remains stronger new home sales which should support new construction activity in time.

Housing indicators mixed



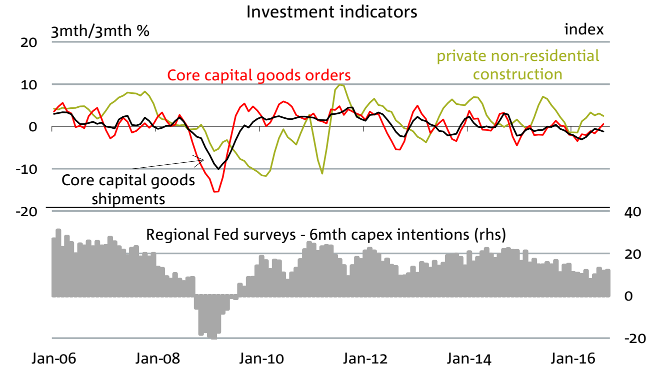
Sources: Census Bureau, NAB

While housing investment may (we expect temporarily) be in the doldrums, there are signs of life for business investment. The third June quarter GDP estimate now indicates that business fixed investment rose on the previous quarter, rather than fell as the earlier estimates indicated.

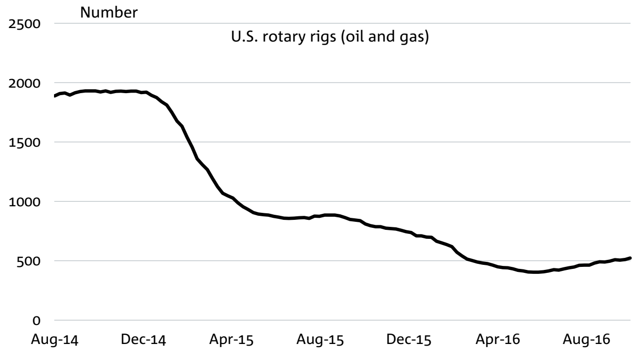
This is not unexpected as the negative pressures coming from past US dollar appreciation and low oil prices are fading. The dollar appreciated strongly between mid-2014 and early 2016 but has since declined (albeit only slightly). Similarly, oil prices bottomed out in January and have trended up since.

Consistent with this, partial indicators have turned more positive. While private non-residential construction expenditure had a small fall in August, this only partially reversed gains in previous months and the trend remains positive. This measure does not include energy sector construction, and the rig count has also turned around since early June 2016. Moreover, core (ex defence and aircraft) capital goods orders have risen in each of the last three months. Similarly, regional Federal Reserve surveys of manufacturing capex intentions have also shown recent improvement.

Some signs of life for business investment



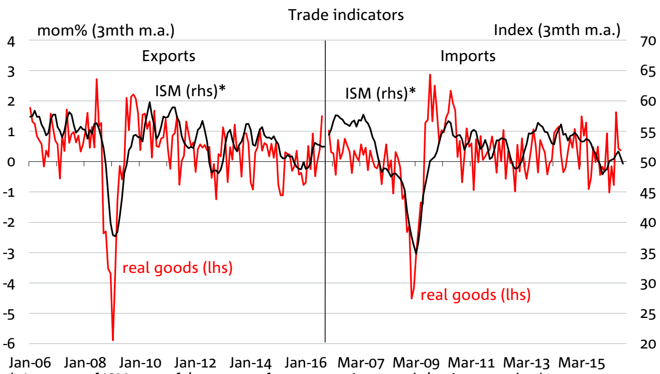
Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB



Sources: Baker Hughes Incorporated, Datastream

The significant appreciation of the US dollar from mid-2014 to early 2016 was also a negative for exporters, as has been the sub-trend growth in the global economy. However, with the dollar off its early 2016 highs, exports are starting to show some improvement, although recent strength may be being exaggerated by a surge in food exports. Real goods exports in July and August alone are tracking over 3% higher than in the June quarter. In contrast, real goods imports are only up 0.4%. Imports have likely been held down due to the fading boost from past US dollar appreciation as well as the extended inventory correction.

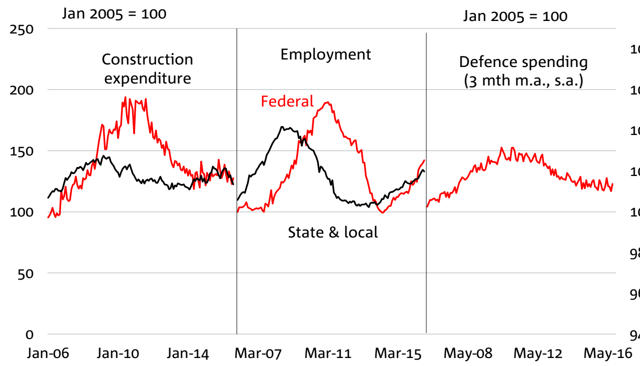
Exports have picked up; imports more subdued



* Average of ISM manuf./non-manuf. surveys using goods/serivces trade shares.

Partial indicators of government spending have been a bit mixed with construction spending softening recently while employment at both state and federal levels continues to trend up. Defence spending has been volatile but appears to have broadly stabilised.

Government spending indicators mixed



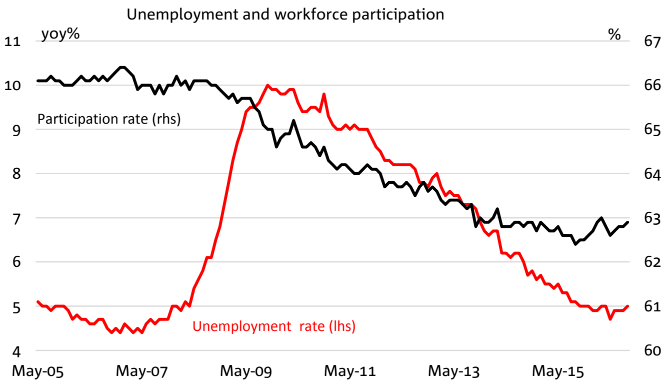
Sources: Census Bureau, BLS, Financial Management Service, NAB

August budget projections from the Congressional Budget Office suggest that, while federal fiscal policy may have been a mild tailwind in fiscal 2016, it would be close to neutral in fiscal 2017 (and 2018). CBO projections are based on existing law; the Congress and President agreed to a continuing resolution in late September, averting a possible government shutdown, to fund the Government until 9 December. This effectively delays the budget process for fiscal 2017 until after November's congressional and presidential elections.

Even though economic growth has been subdued over 2016, employment growth has been solid. Non-farm employment increased by 156,000 in September, leaving the annual employment growth rate unchanged at 1.7% yoy. However, the unemployment rate rose to 5.0% from 4.9% in August; it was at this level back in October 2015, so we have gone almost a whole year with no improvement.

The levelling out in the unemployment rate is due to an upturn in workforce participation. While longer-term demographic changes point to declining participation, the recent uptick reverses some of the decline that resulted from the 2007-2009 recession. The rise in participation is a further sign that the labour market is healing, something also suggested by initial jobless claims which have fallen to a new post-recession low. The September employment report also showed a small acceleration in annual non-farm average hourly earnings growth, adding to the evidence that wages are slowly picking up despite the headwind from low productivity growth.

Labour participation now also recovering



Source: BLS.

Inflation is also showing signs of edging back up. While personal consumption expenditure (PCE) price inflation was only 1.0% over the year to August 2016, the core measure, which excludes the volatile food and energy components, was 1.7% yoy. This is up from 1.6% in July and 1.3% in October last year.

Monetary policy

With the labour market still making solid progress and inflation (on a core basis) not that far from the Fed's 2% long-term target, we still expect the Fed to increase the federal funds rate target range by 25 basis points in its December meeting. The labour market is not running so hot that it will feel pressured to increase rates in its November meeting only days before the US presidential election. Any rate hike is dependent on the economy remaining broadly on track and no major shocks (either domestic or form abroad) which cause significant financial market volatility.

For 2017, if our forecasts of a further gradual increase in the inflation rate and a declining unemployment rate come to fruition, we expect two further rate hikes, in what is proving to be a very gradual tightening cycle.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					2016				2017			
	2014	2015	2016	2017	2018	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components													
Household consumption	2.9	3.2	2.6	2.3	1.9	0.4	1.1	**0.7**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.5	4.0	0.7	2.7	3.1	-0.2	-0.3	**0.1**	**0.7**	**0.9**	**0.8**	**0.8**	**0.8**
Government spending	-0.9	1.8	0.9	1.1	1.5	0.4	-0.4	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	-0.1	0.2	-0.4	0.1	0.0	-0.1	-0.3	**0.1**	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**
Net exports*	-0.1	-0.7	-0.1	-0.1	-0.1	0.0	0.0	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.4**	**2.6**	**1.5**	**2.1**	**1.9**	**0.2**	**0.4**	**0.6**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*0.8*	*1.4*	*2.5*	*2.1*	*2.3*	*2.2*	*2.0*	*2.0*
US Other Key Indicators (end of period)													
PCE deflator-headline													
Headline	1.2	0.4	1.4	1.9	2.1	0.1	0.5	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.6	1.4	1.8	1.9	2.1	0.5	0.4	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.9	4.5	4.5	4.9	4.9	4.9	**4.9**	**4.8**	**4.7**	**4.6**	**4.5**
US Key Interest Rates (end of period)													
Fed funds rate (top of target range)	0.25	0.50	0.75	1.25	2.00	0.50	0.50	0.50	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**
10-year bond rate	2.17	2.27	1.75	2.25	2.25	1.77	1.47	1.60	**1.75**	**1.75**	**2.00**	**2.00**	**2.25**

Source: NAB Group Economics

*Contribution to real GDP

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