US ECONOMIC UPDATE DECEMBER 2016

With economy on track, Fed to deliver on 'gradual' tightening this month

NAB Group Economics

The US economy remains on a solid footing, although growth is likely to moderate in the December quarter. After the large fall in the unemployment rate in November, the Fed looks set to raise the feds fund rate this month. We have incorporated an allowance for fiscal stimulus starting in the second half of 2017, leading to an increase in our 2018 GDP growth forecast.

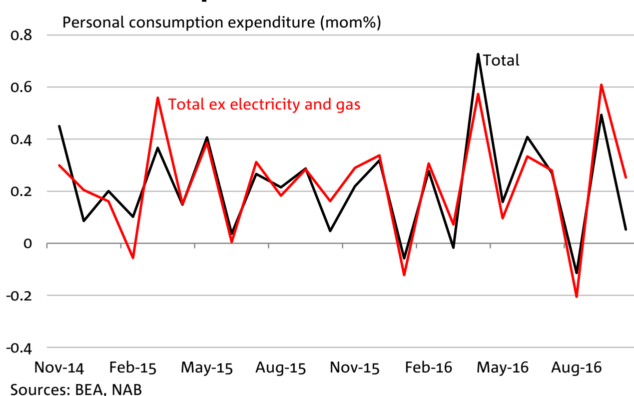
Overview of recent data

After a strong third quarter, the US economy remains on a solid footing based on the most recent partial indicators.

The Bureau of Economic Analysis revised up its estimate of Q3 GDP growth from 2.9% qoq (annualised) to 3.2%. This was the strongest growth rate in two years, although it came after several weak quarters. Partial indicators for 2016 Q4 are currently pointing to a more modest, but still reasonable, growth rate in the December quarter.

Real consumption expenditure growth of 0.05% mom in October was not as soft as it appears, as excluding electricity and gas utilities consumption growth remained solid. Monthly swings in electricity and gas utilities consumption are largely driven by weather, and October was unseasonably warm.

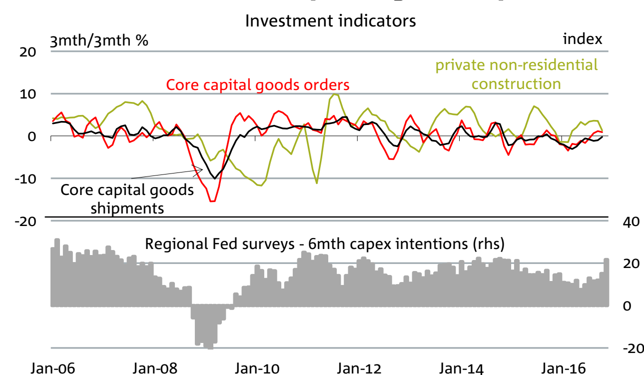
October consumption not as soft as it looks

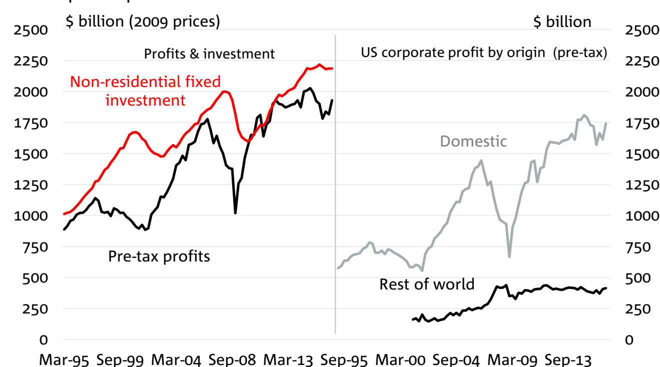


On the investment side, trends have generally been positive as well.

Total construction expenditure rose 0.5% mom in October, due to increases in residential and public expenditure. While the private non-residential investment component declined, it does not include energy sector construction and the rig count in Q4 (to date) is running over 18% higher than in Q3. Further, core (ex defence and aircraft) orders and shipments have shown improvement. Regional Federal Reserve surveys of manufacturers point to this turnaround continuing, with a simple average of these surveys' capex intentions indicator reaching its highest level in around two years in November.

Investment indicators improving as are profits





A further positive sign for future investment is the recovery in corporate profits so far this year. After falling in each quarter in 2015, pre-tax corporate

profits in 2016 Q3 are almost 10% higher than their end 2015 level. This is likely in large part driven by the partial recovery in oil prices and stabilisation of the USD after a period of rapid appreciation.

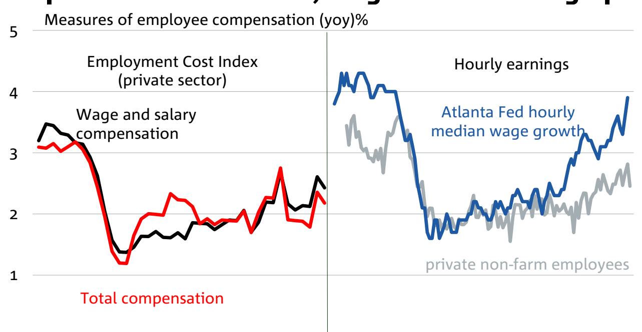
After two quarters of negative growth, residential investment looks to have turned the corner. October data for housing starts, housing permits, sales and private new residential construction expenditure are well up on their September quarter average.

In contrast, after a large September quarter contribution to GDP growth, net exports are set to make a negative contribution in this quarter. Real goods imports rose 1.4% mom in October while exports declined -2.9% mom. The fall in exports followed very strong growth in the September quarter which in part reflected a surge in soybean exports. The volume of food, feeds & beverages exports increased by 38% between June and August, but by October 75% of these gains had been given up. In contrast, the ISM surveys – which give a better idea of the underlying trends – show export orders are at their strongest level since late 2014, although recent US dollar strength is an emerging negative.

While GDP growth has not been rapid by historical standards, it has been sufficient to generate solid employment growth and a falling unemployment rate. This reflects the combination of weak productivity growth as well as demographic factors which have slowed workforce growth.

In November, non-farm employment growth was again solid – increasing by 178,000 – and coupled with a fall in the participation rate was enough to lead to a sizeable reduction in the unemployment rate to 4.6% (from 4.9% in October). The unemployment rate was around 5% over the period from late 2015 through to September 2016 due to an increase in the workforce participation rate; however, this has been partly reversed in the last two months.

Despite October reversal, wages still trending up



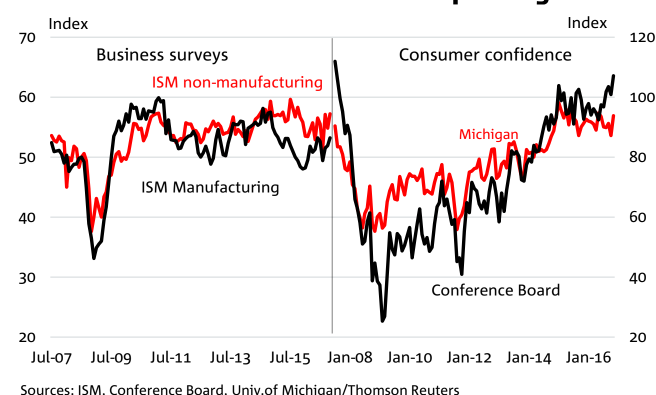
Sources: BLS, Atlanta Federal Reserve, NAB. Employment Cost Index growth rates based on seasonally adjusted data.

Despite the further tightening in the labour market indicated by the fall in the unemployment rate, private non-farm hourly earnings declined. However, the data are volatile and in recent years, declines in monthly earnings have tended to be quickly unwound. Taking this into consideration, as well as other wage indicators, there still appears to be a trend strengthening in wages growth.

Economic outlook and monetary policy

Business and consumer surveys are sending positive short-term signals about the state of the economy. The Conference Board's measure of consumer confidence reached its highest level since mid-2007 in November. Meanwhile the ISM business surveys improved in November, continuing the trend of recent months.

Business & consumer sentiment improving



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

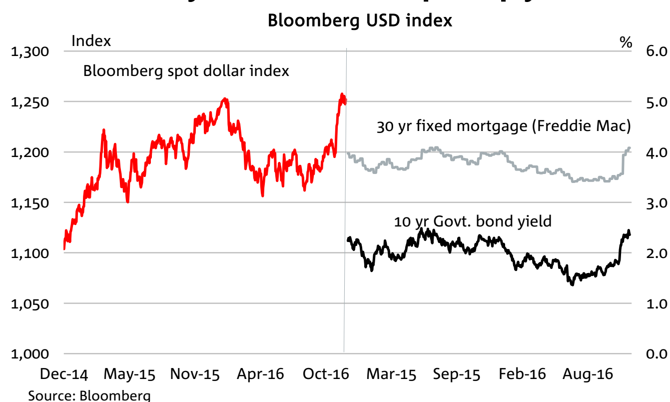
Getting more focus is the possibility that, with the election of Mr Trump, fiscal policy will become more expansionary. However, as he does not assume office till January next year, and he will need to negotiate what could be a sizable and complicated package through Congress (who also have their own plans), the general expectation is that any stimulus will not be seen until the second half of 2017.

Costings of the President elect's election policies suggested a stimulus of around 2% of GDP, although how much gets implemented and whether it is offset by revenue/cost cutting measures remains to be seen.

While concerns over the size of the Government's budget deficit mean that the stimulus is unlikely to be as high as 2% of GDP, some stimulus appears likely. Markets have not waited for the details, and the potential flow on effects of a fiscal stimulus and higher government debt are already being reflected in higher yields and a stronger dollar. Since the election 10 year government bond yields have increased around 0.5ppts and the Bloomberg spot dollar index has risen by around 4%. The rise in yields is not limited to government bonds – already there has been a significant increase in mortgage rates.

The combination of rising market interest rates and an appreciating dollar are, by themselves, factors that could constrain growth. Of course, they have risen on the basis of a more optimistic outlook, but any stimulus is uncertain and unlikely to come through for a while, while the impact from higher rates/stronger currency may start to emerge sooner.

Post-election: yields and dollar up sharply



Source: Bloomberg

While the extent of any change in fiscal policy is uncertain, the direction is clear. Therefore we have included in our forecasts an allowance for a fiscal stimulus of around 1% of GDP starting in the second half of 2017. It is likely to be mainly in the form of tax cuts although there may also be higher infrastructure spending. This is clearly a tentative estimate which we will have to monitor as the new administration's plans become clearer. We have not included any allowance for the US imposing additional trade barriers or changes that will significantly reduce net immigration; these remain as downside risks.

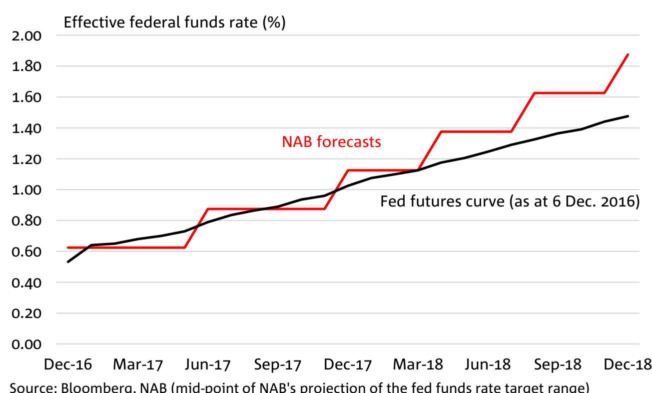
The other factor affecting our growth forecasts is the recent appreciation of the US dollar – which we expect to have further to go – and rising interest rates yields. These developments will potentially affect areas such as housing activity, durable goods consumption and exports.

As a result our forecast for 2017 GDP growth is unchanged at 2.1% - with the rates/dollar affects holding down growth earlier in the year and also offsetting some of the initial impacts of the fiscal stimulus. However, we now expect 2018 GDP growth of 2.3% (1.9% previously). The low impact of the stimulus (less than 1 for 1) reflects the stage of the economic cycle – unemployment is low and so the capacity for rapid growth is limited. With inflation nearing the Fed's target, if the US dollar doesn't rise in response as we expect, then the Fed would likely undertake a faster pace of rate tightening to ensure inflation remains under control; one way or another financial conditions will moderate the impact of any fiscal stimulus.

More generally how the Fed responds to any fiscal stimulus will be important: does it maintain its current stance of having a gradual tightening cycle or does it respond more aggressively in anticipation of inflationary pressures down the track?

At this stage we have not made any changes to our fed funds rate track. Our rate track is above the futures market rates but is still consistent with only gradual tightening. Risks of a more aggressive tightening if the new President delivers a fiscal stimulus are more concentrated in the second half of 2017/2018. US dollar appreciation will put downwards pressure on inflation over 2017 and nor is the Fed likely to do anything until it sees actual concrete fiscal measures.

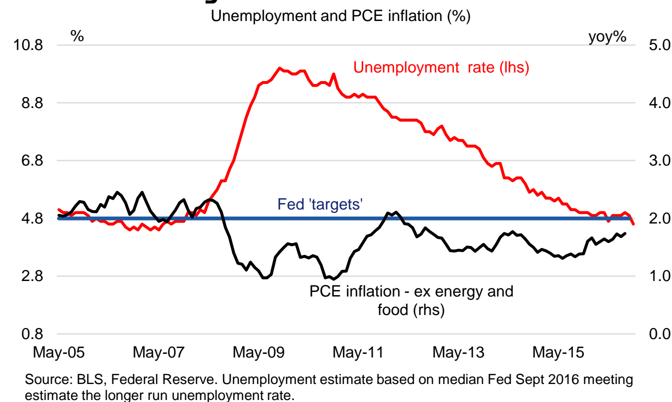
Gradual rate rises still expected



Source: Bloomberg, NAB (mid-point of NAB's projection of the fed funds rate target range)

In contrast, the immediate outlook for monetary policy appears clear. Markets are fully pricing in an increase in the federal funds rate at this month's Fed meeting. Inflation has been gradually trending up including the core personal consumption expenditure (PCE) measure – which excludes food and energy. At 1.7% yoy in October, core PCE inflation is not far off the Fed's 2% longer-term inflation goal.

Fed close to target = rate rise in December



Source: BLS, Federal Reserve. Unemployment estimate based on median Fed Sept 2016 meeting estimate the longer run unemployment rate.

In its October meeting statement the Fed said it wanted to see further evidence of progress towards its objectives. The drop in the unemployment rate to 4.6% certainly delivered on this requirement; the unemployment rate is now below most Fed member's estimate of its longer-run level. Essentially the Fed has met its targets, and with the low unemployment rate signalling future inflationary pressures, and the prospect of a potentially significant fiscal stimulus package looming, it will feel it is time to actually deliver on its much talked about 'gradual' tightening.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly 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	2.4	2.4	0.4	1.1	0.7	0.6	0.5	0.5	0.6	0.6
Private fixed investment	5.5	4.0	0.6	2.7	3.4	-0.2	-0.3	-0.2	0.9	0.9	0.9	0.9	0.8
Government spending	-0.9	1.8	0.8	1.0	2.0	0.4	-0.4	0.1	0.3	0.3	0.4	0.4	0.5
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	0.0	-0.2	-0.3	0.0	0.0	0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Real GDP	**2.4**	**2.6**	**1.6**	**2.1**	**2.3**	**0.2**	**0.4**	**0.8**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*0.8*	*1.4*	*3.2*	*2.0*	*2.0*	*1.8*	*1.9*	*2.2*
US Other Key Indicators (end of period)													
PCE deflator-headline	Change on year earlier %												
Headline	1.2	0.4	1.5	1.9	2.1	0.1	0.5	0.4	0.6	0.5	0.4	0.5	0.5
Core	1.6	1.4	1.8	1.9	2.1	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	5.7	5.0	4.8	4.3	4.1	4.9	4.9	4.9	4.8	4.6	4.5	4.4	4.3
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	2.30	2.50	2.75	1.77	1.47	1.60	2.30	2.40	2.50	2.50	2.50

Source: NAB Group Economics

*Contribution to real GDP

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