US ECONOMIC UPDATE JANUARY 2017

Economic conditions remain solid as optimism rises

NAB Group Economics

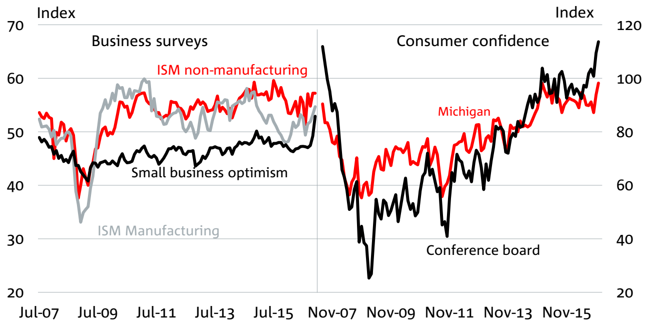
Surveys show business conditions are solid, while small business and consumer sentiment has strengthened post-election. However, increases in interest rates and the US dollar may act as a constraint on growth until the expected fiscal stimulus kicks in later in the year. Partial data point to moderate, over 2% annualised GDP growth, in the December quarter.

Overview of recent data

According to the most recent surveys, business conditions and household sentiment are solid, and on an upwards trend.

The manufacturing ISM survey rose for the fourth month in a row in December, to its highest level in two years. While the recent appreciation of the dollar is an emerging headwind for the sector, it is likely benefiting from the end to the recent inventory correction and improving conditions in the energy sector. At the same time the non-manufacturing survey has also been improving and is at an above average level. Small business optimism has surged following the Presidential election.

Business conditions and consumer sentiment rising



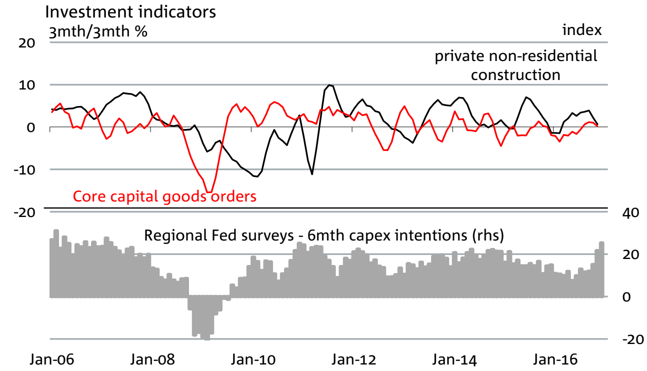
Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, NFIB (index divided by 2).

Post-election, consumer confidence has also shown improvement and has returned to pre-GFC levels. This is despite a rise in petrol prices, but may reflect increased optimism about the economy's future and the boost to the share market, which is increasing household wealth.

Improved consumer confidence should support household consumption. Consumption rose 0.1% mom in November, but as with the previous two months it was held down by a fall in electricity and gas utility consumption due to relatively mild weather. Excluding the later, consumption grew a solid 0.2% mom. Early signs are also positive for December; auto sales increased 3.1% mom and the number of 'heating days' was a little above average, signalling a likely boost to utility power consumption.

The improvement in sentiment is also evident in investment indicators. A simple average of regional Fed future capital expenditure indicators for manufacturers started to increase in September, but jumped noticeably higher in November and December to its highest level since early 2007.

Capital expenditure intentions up strongly

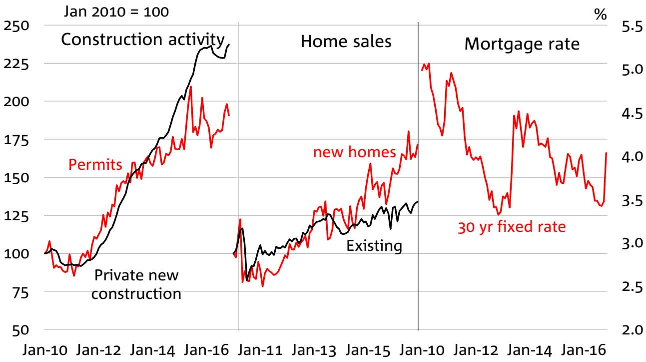


Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Core (ex defence and transport) capital goods orders are also showing improvement. Moreover, energy sector investment is turning around; the rig count increased by 14 and 23% in the September and December quarters respectively.

After declining in the June and September quarters, residential investment looks set to show growth again in the December quarter 2016. Monthly average private new residential construction expenditure and house sales for October and November are both higher than in the September quarter. However, mortgage rates have increased sharply in recent months so it is unclear how long this improvement will last; a spike in rates back in 2013 was followed by a slowdown in residential investment. Building permits are also tracking higher in the December quarter suggesting some short-term positive momentum for construction, but pending house sales have eased so the forward looking indicators are mixed.

Housing indicators up…but so are mortgage rates

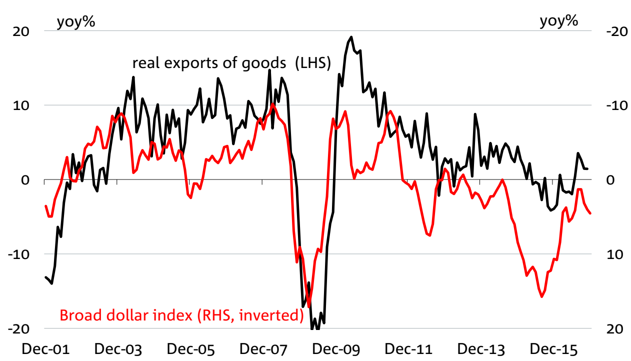


Sources: Census Bureau, Freddie Mac/Bloomberg,NAB

In contrast net exports are set to make a negative contribution in the December 2016 quarter. Across October and November, real goods imports are up 1.4% on their September quarter level, while real goods exports are down 2.3%. The fall in exports appears to largely reflect an unwinding of the September quarter surge in soybean exports.

This is in contrast to the trade indicators of the ISM surveys – which generally track the underlying trend with less volatility. The ISM surveys suggest export orders are at reasonable level, and trending up while imports are weak. That said, downwards pressure on exports and support for imports is likely to come from the recent appreciation of the dollar. The large appreciation of the dollar between mid-2014 to early 2016 led to a fall in goods exports. As this appreciation was partially reversed between February and October 2016 exports started to recover. However, between October and December the Broad Dollar Index moved up 3.8% and is tracking higher again in January 2017.

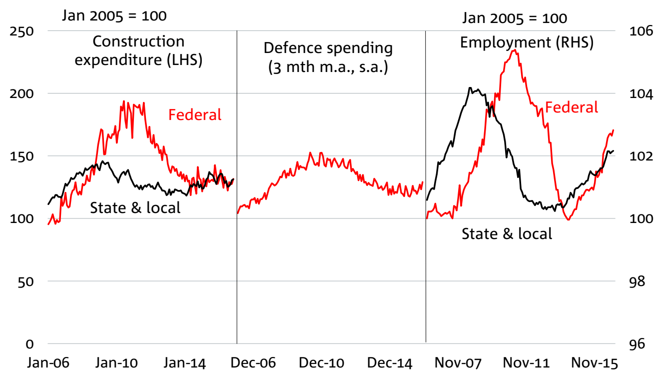
Recent dollar appreciation a negative for exports



Sources: Census Bureau, Federal Reserve. Dec qtr '14 dollar index equal to Oct. '14.

While the focus on fiscal policy is on what the new President and Congress might do, public demand appears to be increasing modestly. While construction spending appears to have levelled out, the impact of defence cutbacks appear to be over and government employment is increasing.

Public demand showing modest growth

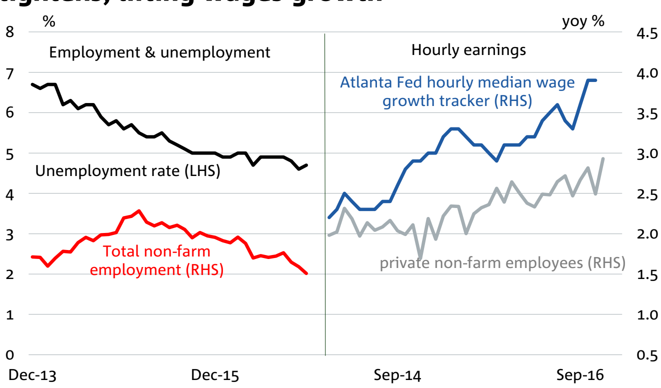


Sources: Census Bureau, BLS, Financial Management Service, NAB

Consistent with activity indicators, the labour market continues to show further tightening. Non-farm employment increased by 156,000 in December. Overall, the data are pointing to a slowdown in the rate of employment growth. The growth rate (on same month a year earlier) at 1.5% was the lowest it has been since 2013.

This is not surprising and will not be a concern to the Federal Reserve. The working age population is estimated to be growing at only 1.1% yoy, and, over time, workforce growth is likely to be lower, due to demographic changes. As a result, the unemployment rate continues to trend down. While the unemployment rate increased by 0.1 ppt to 4.7% in December 2016, it is still down 0.2 ppt since September 2016. The unemployment rate is not only lower than it was a year ago, but is also below the Fed member median estimate of its long-run level. Further evidence of a tight labour market comes from the increasingly clear upwards trajectory in wages growth.

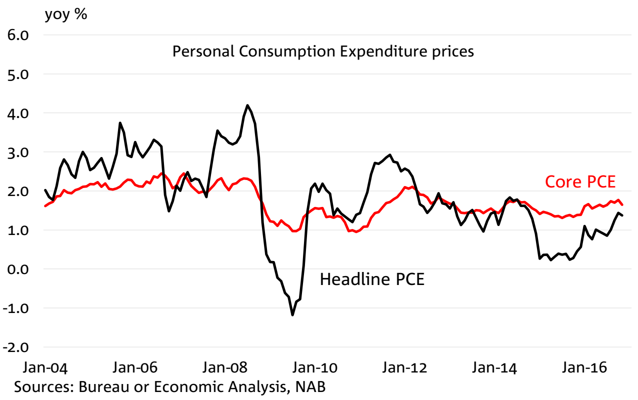
Employment growth slowing as labour market tightens, lifting wages growth



Sources: BLS, Atlanta Federal Reserve, NAB.

Inflation has also been trending up, but it took a pause in November. The headline personal consumption expenditures (PCE) price index grew by 1.4% yoy in November 2016, unchanged from October. Moreover, the core measure – which excludes food and energy prices – barely moved, resulting in a decline in the year-on-year growth rate to 1.6% from October's 1.8%.

Inflation trending up, even with November pause



Sources: Bureau or Economic Analysis, NAB

Since November, gasoline price growth has accelerated, and so the December data are likely to show a resumption of the upwards trend in inflation. The core measure should also continue to trend upwards over the next few years the amount of slack in the economy declines further, as dollar appreciation will likely slow this process in the first half of 2017.

Economic outlook and monetary policy

Our estimate for December quarter GDP growth, based on partial indicators released to date, is for annualised quarterly growth of a little over 2%. Consumption growth has remained solid, while investment has strengthened, but there is likely to be a significant negative contribution from net exports.

The recent rises in interest rates and the currency are a likely headwind, particularly in the first half of 2017. Rising oil prices may also impact on consumer spending, but are a positive to other parts of the economy. We also believe that the dollar is likely to appreciate further although it is unlikely to match the mid-2014 to early 2016 appreciation. That said, the increases in interest rates and the dollar are at least in part due to improved sentiment, which can itself act as a positive for the economy. This is reflected in higher equity prices and reduced risk spreads, offsetting some of the tightening in financial conditions.

Another likely positive factor is the prospect for a more stimulatory fiscal policy. However, the timing and magnitude of any stimulus is still highly uncertain. As we discussed in last month's US Economic Update, we have included in our forecasts an allowance for a fiscal stimulus of around 1% of GDP starting in the second half of 2017.

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.

As a result, we expect GDP growth will be modest for much of 2017 but then strengthen towards the end of the year and into 2018 as fiscal stimulus kicks in. As a result, we expect GDP growth will be higher in 2018 (2.3%) than 2017 (2.1%).

As expected, the Federal Reserve raised the target range for the fed funds rate by 25 basis points at its December 2016 meeting. The median Fed member projections looks for another three rate rises over 2017. Fed members, apart from tracking the most recent data, are clearly focussed on the possibility of a major fiscal stimulus. According to the December meeting minutes half of the members have already included an allowance for fiscal stimulus in their projections (but by how much and when is unclear).

We are currently projecting that there will be two further rate increases in 2017 and three in 2018. There is, however, the risk of a more aggressive tightening. With the unemployment rate already below the Fed's longer term level, it is possible that the Fed will react quickly to any fiscal stimulus once it announced, depending on how concerned it is about getting behind the curve.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %									
					2016		2017				2018			
	2015	2016	2017	2018	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	3.2	2.7	2.6	2.5	0.7	0.7	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.5
Private fixed investment	4.0	0.8	3.0	3.4	0.0	1.2	0.9	0.8	0.9	0.8	0.9	0.8	0.8	0.8
Government spending	1.8	0.9	1.0	2.0	0.2	0.3	0.3	0.3	0.4	0.5	0.5	0.6	0.6	0.6
Inventories*	0.2	-0.4	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.7	-0.1	-0.4	-0.3	0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
Real GDP	**2.6**	**1.6**	**2.1**	**2.3**	**0.9**	**0.5**	**0.5**	**0.4**	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**
Note: GDP (annualised rate)					*3.5*	*2.2*	*2.0*	*1.8*	*1.9*	*2.2*	*2.4*	*2.5*	*2.4*	*2.2*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	0.4	1.5	1.9	2.2	0.4	0.6	0.50	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Core	1.4	1.7	1.9	2.1	0.4	0.3	0.43	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	5.0	4.7	4.3	4.1	4.9	4.7	4.6	4.4	4.4	4.3	4.3	4.2	4.1	4.1
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	0.50	0.75	1.25	2.00	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25
10-year bond rate	2.27	2.45	2.50	2.75	1.60	2.45	2.40	2.50	2.50	2.50	2.50	2.75	2.75	2.75

Source: NAB Group Economics

*Contribution to real GDP

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