US ECONOMIC UPDATE FEBRUARY 2017

NAB Group Economics

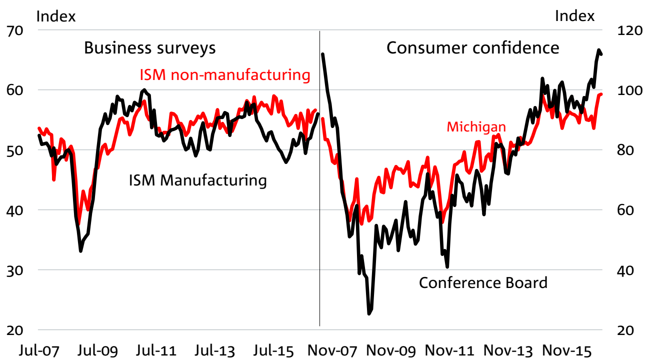
Moderate growth in the US is expected to continue, but with some strengthening later in the year if, as expected, the new Administration delivers a fiscal stimulus. The President has indicated details of his tax plans will be released in 2-3 weeks. However, the size of any stimulus is likely to be more limited than the President's election policies would suggest due to the underlying weak budget outlook.

Overview of economy

The US economy continues along the same moderate growth path it has experienced in its recovery from the Global Financial Crisis.

Growth slowed in the December 2016 quarter, following a particularly strong headline result in the September quarter. The underlying details were reasonable: consumption growth was solid, residential investment resumed growing again and business investment showed some further improvement. Temporary drags came from a fall in power consumption and the reversal of last quarter's spike in food exports, although they were partly offset by faster inventory accumulation.

Positive signs from businesses and households

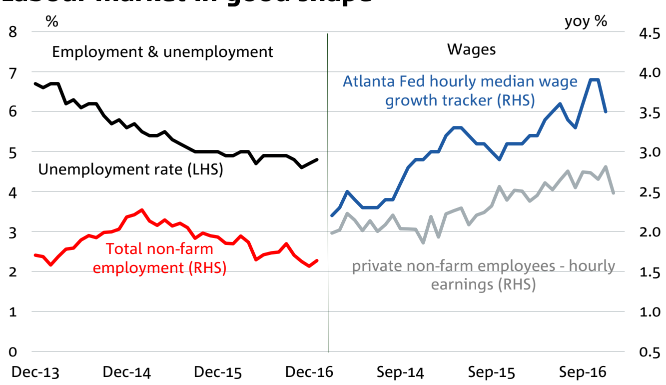


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

More positively, business sector readings for the US from the ISM have been trending up in recent months. In January, the manufacturing ISM moved to its highest level since late 2014 and, while the non-manufacturing ISM declined slightly, it remained at a robust level. Consumer sentiment has also received a post-election boost, and is back to pre-GFC levels.

The labour market is also in good shape, with strong growth in non-farm employment reported for January 2017. Nevertheless, there has been a trend slowing in employment growth as the US moves closer to full employment, although it remains strong enough to pull down unemployment over time. While the unemployment rate rose in January to 4.8%, reversing some recent gains, this was due to a rise in workforce participation. Further evidence of the strength of the labour market comes from initial jobless claims which are at historically low levels.

Labour market in good shape



Sources: BLS, Atlanta Federal Reserve, NAB.

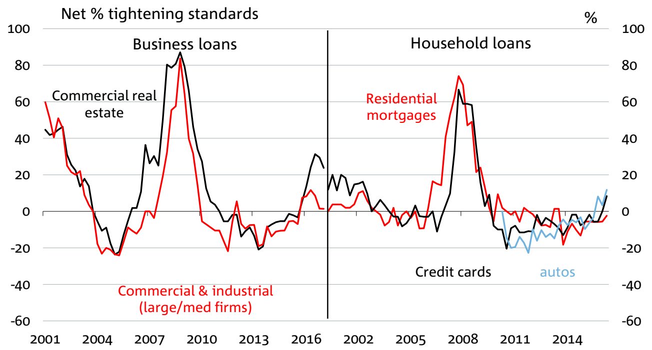
The January employment report also showed a slowdown in wages growth; however, the data are volatile and the trend still appears to be upwards.

Improved consumer and business sentiment since the election, as well as the rise in the stock market, and on-going strength in the labour market are positive signs for the growth outlook. Measures of future manufacturing capital expenditure intentions have also improved recently.

However one headwind is the appreciation of the US dollar since August which we think has a bit further to go notwithstanding some pull-back in recent weeks. That said, the manufacturing sector, which is particularly trade exposed, appears to be largely unaffected so far if the ISM survey is anything to go by. Along with a higher dollar, interest rates have increased which is likely to weigh on sectors such as consumer durables and housing.

Changes in credit conditions overall are threatening to turn into another headwind. Lending standards for business loans tightened somewhat last year, although the most recent Fed Senior Loan Officer Survey suggests that this process has paused for commercial and industrial loans. Moreover, credit conditions are starting to tighten for consumer loans. Balancing this, however, credit spreads (relevant for corporates accessing non-bank finance) have eased.

Gradual tightening in bank lending standards



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

Rising oil prices may also hold the economy in check as the US is a net importer of energy. That said, while a clear negative for household consumption, some businesses will benefit from higher oil prices – in particular the energy sector but also manufacturers and businesses that provide inputs to the sector.

Reflecting these various factors, we expect further moderate growth rates in coming quarters before some strengthening later in the year, assuming the President delivers a fiscal stimulus to the economy. For 2017 we are forecasting GDP growth of 2.1%, and 2.3% in 2018.

We have not made any allowance for the US imposing additional trade barriers or changes that will significantly reduce net immigration. These represent downside risks to the outlook.

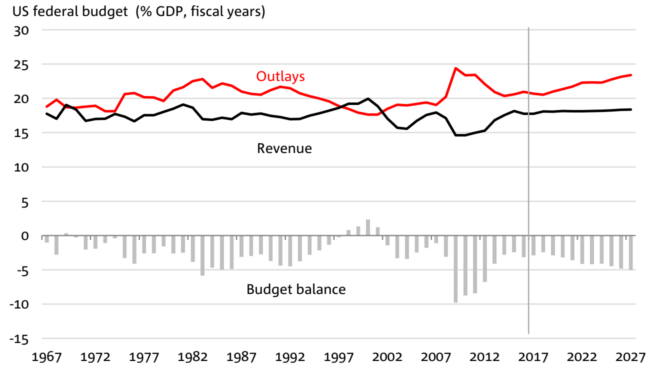
US Fiscal outlook – a poor starting point will constrain the new Administration

With considerable focus now on the fiscal policy of the Federal Government, one of the constraints on the new Administration will be the current state of the budget.

The Congressional Budget Office last month published updated projections of Federal finances. As normal, these are based on unchanged policy/current legislation. The estimates were completed before the new President took office so represent the starting point he faces in delivering his policies.

The budget deficit ballooned following the GFC as activity collapsed, affecting both revenue and expenses, and there was also a discretionary fiscal stimulus package put in place to aid economic recovery. However, starting in fiscal year (f.y.) 2010 the budget deficit declined year after year. This continued up until last year (f.y. 2016) when the budget deficit rose from 2.4% to 3.2% of GDP. While revenue was largely back to pre-GFC levels, spending remained higher (as a percentage of GDP).

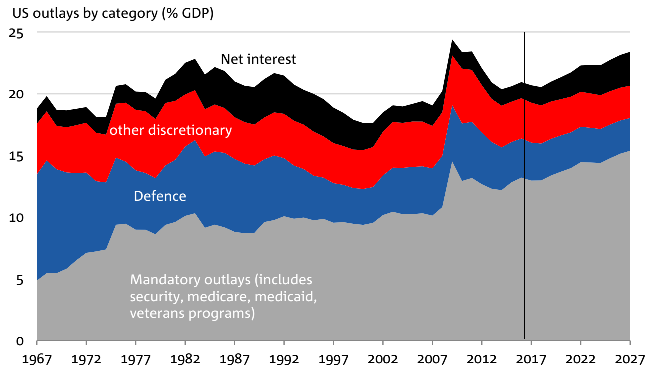
Long process of budget repair paused in f.y. 2016



Sources: CBO, NAB

Based on current legislation, the CBO expects some small improvement in the budget position in f.y. 2017 and 2018, before the budget begins to slowly deteriorate as spending drifts higher mainly due to growth in retirement and health care program spending, as well as a rising interest bill as debt accumulates. These programs are part of the 'mandatory' spending category which has grown in importance over time. At the same time, defence and other 'discretionary' spending (law enforcement, road grants to the States and other infrastructure spending etc) has been declining (as a % of GDP).

On-going shift in spending to transfer programs

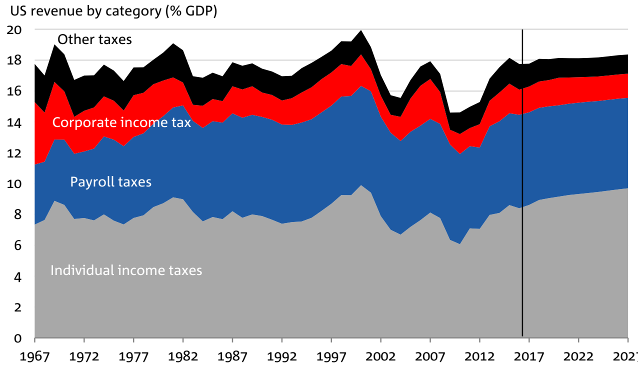


Sources: CBO, NAB

In contrast, during the election, and subsequently, the focus was on 'discretionary' spending – in particular infrastructure and defence. However, the President also indicated that he would not be seeking cuts to social security programs. Moreover, savings options identified – such as the '-penny plan' or the recently introduced hiring freeze – were targeted at discretionary spending.

The major election promises, in terms of budget cost, were around promises to cut taxes, particularly business and individual income taxes. The Committee for a Responsible Federal Budget (CFRB) estimated that the President's tax policies would reduce tax revenue by $4.5 trillion over a ten year period (over 2% of GDP). If enacted with no other offsetting measures this would represent a major shift down in the level of federal revenue, which has been reasonably steady (as a share of GDP) in recent decades outside of recessions.

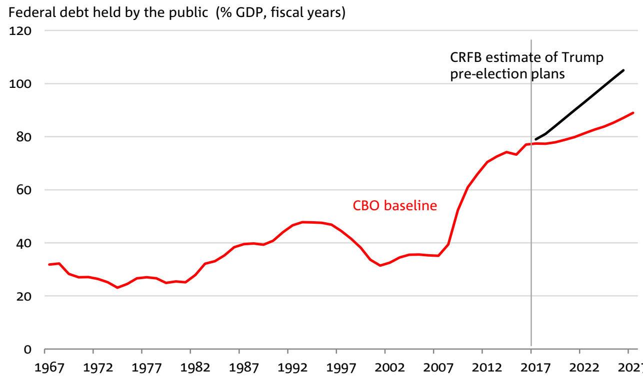
CBO estimates of revenue % of GDP – before any changes by the new President



Sources: CBO, NAB

The CFRB's pre-election estimate of the all up cost of the new Administration's policies was $5.3 trillion over ten years. Their figures did not include any allowance for infrastructure spending – despite all the focus on the President's infrastructure plans it is still unclear whether he plans to lift Federal spending, use private-public partnerships or provide tax incentives to facilitate private investment. Nevertheless, this suggests that the CFRB estimate is on the conservative side.

Debt already on upwards trajectory…pre-election policies would worsen the outlook



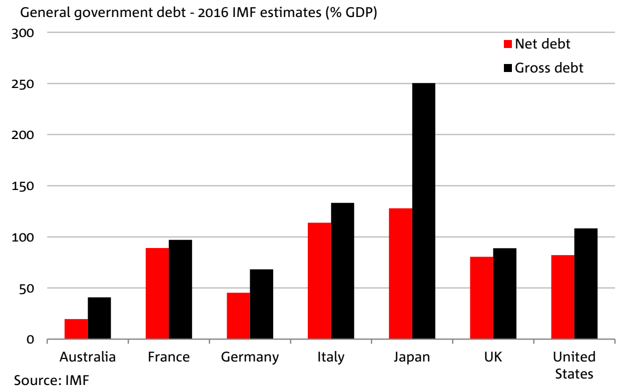
Sources: CBO, Committee for a Responsible Federal Budget, NAB

Even before any changes are made, however, the CBO projections show that debt is on a rising trend, from what is already a historically high level apart from World War II. The CBO considers that the factors driving debt higher would persist beyond its projection period and would "ultimately be unsustainable" without major legislative changes.

Implementation of the President's policies – without other changes – would certainly represent a major change but in the direction of taking the debt even higher.

This is not to say that this would cause a financial crisis any time soon. While elevated by its own standards, compared to major advanced economies US general government debt is mid-range. Higher debt levels can be expected to put upwards pressure on government bond yields, although Japanese experience with high debt shows (10 year yields are currently close to zero compared to over 2% in the US) government debt levels are not the only factor.

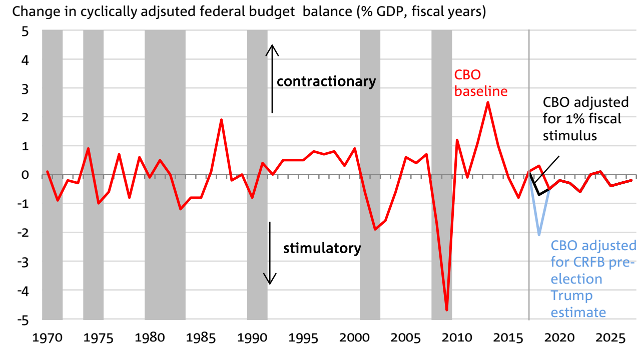
US government debt within range of peers



Source: IMF

Rather, the focus on fiscal policy is due to the possible implications for the US economy over the next few years. The CBO provides estimates of the cyclically adjusted budget balance; this effectively shows what the budget balance would be if the economy was running at its long-term potential level. Changes in this measure are a measure of discretionary fiscal stimulus/contraction.

Election commitments would make fiscal policy stimulatory



Sources: CBO, NAB estimates based on CRFB analysis, NBER business cycle dating committee. Grey areas represent recessionary periods .

The chart above shows that implementation of President Trump's pre-election plan, based on CRFB estimates (we have assumed implementation in f.y. 2018 for simplicity), would shift fiscal policy from being mildly contractionary to stimulatory.

However, given the sentiment of some in Congress to rein in the budget, the President's own statements that he would reduce in national debt, and the constraints imposed by the poor baseline outlook (as illustrated by the CBO's projections), we have only allowed for a smaller stimulus package of 1% of GDP in our projections. This could occur either through scaling back the President's promises or introducing other measures with a positive budget impact. Clearly, this represents a working assumption until the fiscal outlook becomes clearer.

In a meeting with airline executives on Thursday 9 February, Mr Trump signalled that his plans for taxation would be released in the next two to three weeks. More formally, the President's annual Budget request for the upcoming fiscal year (covering revenue and spending) is required to be delivered early in February, but this is often delayed for a new President. At this stage, it is unclear when the budget request will be made (if at all), although President Obama's first budget was delivered in late February (and in 2013 it did not occur until April).

While any budget request or plan for taxation are not in any way binding on Congress, they would provide a better idea of the new President's priorities and how he plans to reconcile his tax and other promises with a commitment to get national debt under control.

Even a fiscal package equal to 1% of GDP would be enough to turn fiscal policy stimulatory. While the magnitude may not be particularly large by historical experience what is unusual is to get fiscal stimulus at this stage of the cycle, with the economy at or around full employment (at least according to the Fed).

Hence, expectations of the positive impact of any stimulus on the economy are likely to be on the low side, and with the likelihood that the stimulus will add to inflationary pressures. In this environment, the Fed is likely to react to stimulus with higher interest rates than would otherwise be the case, unless its job is done for it by dollar appreciation producing an effective tightening in financial conditions.

Our current expectation is for two rate hikes in 2017, and three in 2018. However, based on recent Fed member commentary, there is upside risk to this. This will be heavily dependent on the size of any fiscal stimulus as well as how currency and other financial markets react, as well as developments in other policy areas such as trade.

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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	0.6	**0.6**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Private fixed investment	4.0	0.7	2.9	3.4	0.0	1.0	**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	0.2	0.0	0.1	0.2	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.1	-0.5	-0.3	0.2	-0.5	**-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*	*1.9*	*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	2.1	2.1	0.4	0.5	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**
Core	1.4	1.7	1.9	2.1	0.4	0.3	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.0	4.7	4.5	4.2	4.9	4.7	**4.7**	**4.6**	**4.6**	**4.5**	**4.5**	**4.4**	**4.3**	**4.2**
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**	**1.50**	**1.75**	**2.00**
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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