US ECONOMIC UPDATE - JULY 2017

NAB Group Economics

After a slow start to the year, partial activity measures point to GDP growth rebounding in the June quarter. Business surveys, and our forecasts, point to a continuation of moderate above trend GDP growth.

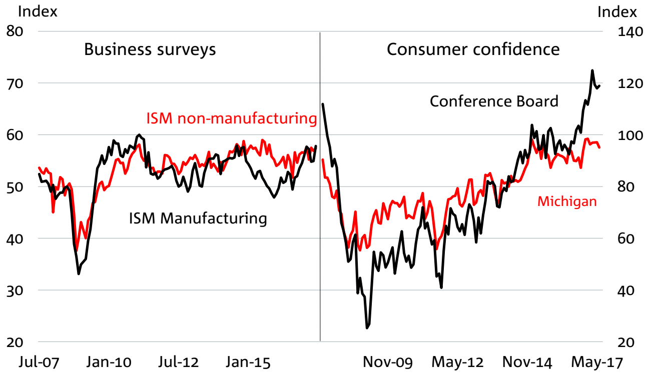
Overview

Following a slow start to the year, GDP growth looks to have accelerated in the June quarter. The key driver is stronger consumption growth, while business investment growth has slowed, but still remains in positive territory. Housing investment appears to have softened markedly while net exports likely detracted from growth.

GDP growth in the March quarter was again revised up in the statistician's third estimate to 1.4% qoq (annualised rate), double the original estimate of 0.7%. This still represents relatively modest growth.

Our current estimate for the June quarter is growth of 2.7% qoq. If this were to eventuate it would mean that the economy grew by around 2.0% (annualised) in the first half of the year. This would still represent growth above estimates of its longer-term trend.

Business surveys & consumer sentiment positive

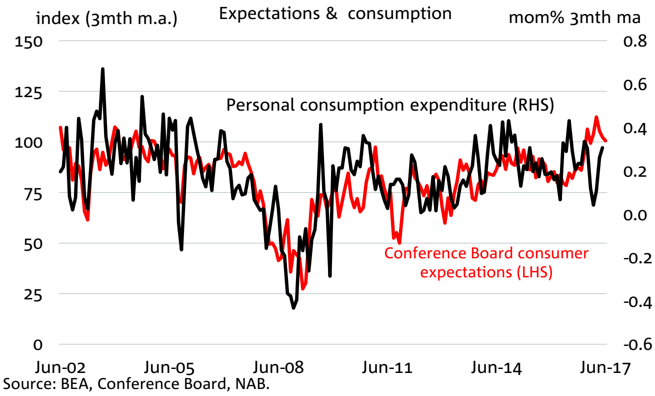


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

Business surveys have provided a more positive picture of the economy so far over 2017. They have also suggested there is some upwards momentum with both the manufacturing and non-manufacturing ISM surveys headline indicators rising in June. The manufacturing index reached its highest level since August 2014. Measures of consumer confidence are also at solid levels.

Solid levels of consumer sentiment are generally reflected in consumption growth. Consumption growth was weak early in 2017 but it has recovered in recent months. It should continue to be supported by a strong labour market and, reflecting the upwards trend in share and house prices, rising wealth.

Consumption growth has picked up recently

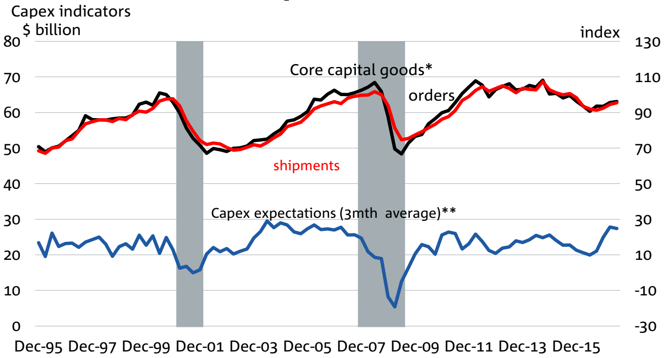


Source: BEA, Conference Board, NAB.

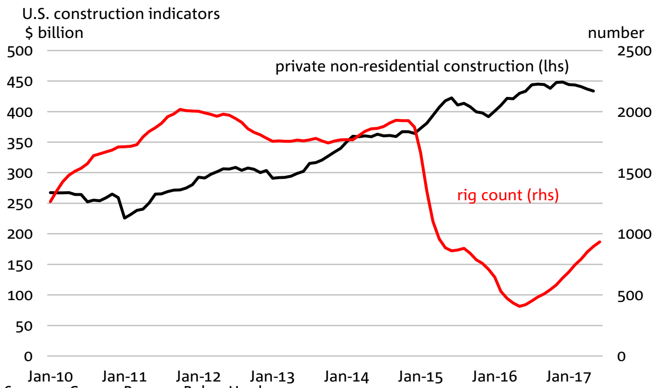
Business investment, after recording its strongest growth in five years in the March 2017 quarter, looks like it continued growing in the June quarter although at a slower pace. Capital goods orders and shipments are trending up and surveys of manufacturers point to solid investment intentions. In contrast, monthly nominal non-residential construction expenditure data have come down. However, these data do not include mining sector investment, which has been growing strongly.

Looking forward, business investment is expected to continue growing but at a moderate rate. Mining investment will likely remain a positive but the growth rate is likely to slow as we expect only a very gradual upwards trend in oil prices over the next year or so. Moreover, while still at decent levels, corporate profit margins have come off their post GFC peak, and may come under further pressure if the tightening labour market feeds through into stronger wage gains. Banks have also been tightening lending standards for commercial real estate. This suggests a modest outlook for overall business investment.

Investment indicators positive overall

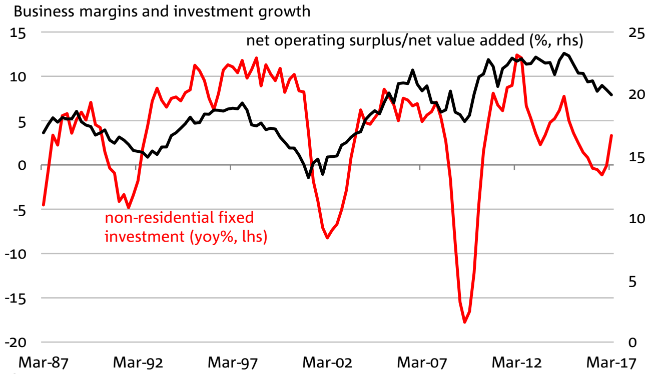


*Jun 17 qtr based on Apr & May data **Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys.



Sources: Census Bureau, Baker Hughes

But margin pressure suggests modest outlook



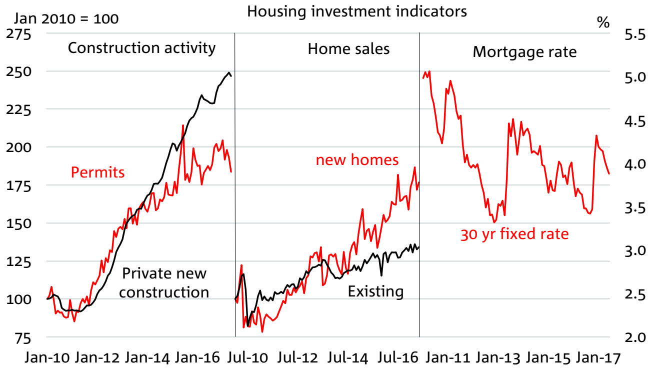
Sources: BEA, NAB

Similarly, housing investment growth, after a couple of robust quarters, appears to have slowed markedly in the June quarter, to the extent that negative growth would not be a surprise. Based on data for April and May, home sales in the June quarter are tracking below their March quarter level. New construction expenditure is modestly higher but fell in May making the trajectory unclear.

The slowdown may reflect a bring forward of activity earlier in the year due to mild winter weather, as well as the delayed impact of the run up in mortgage interest rates in late 2016.

Looking through the monthly volatility suggests that housing indicators are trending up. However, there are reasons to believe that over the next two years there will be a trend slowdown in housing investment growth.

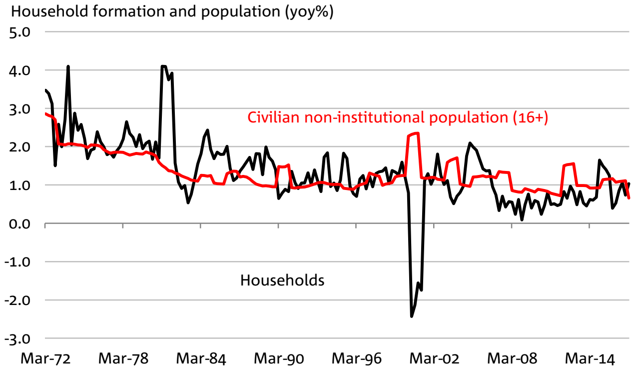
Housing investment trend still up



Sources: Census Bureau, Freddie Mac/Bloomberg,NAB

Over the last six years residential investment has grown at a strong over 8% annual growth rate. However, over the next two years mortgage rates are likely to resume rising as the Fed further tightens policy. Moreover, the boost to growth from pent-up demand is likely to diminish. This can be seen in the number of new households being started up, an important source of housing demand. While, since its GFC drop-off, growth in the number of households has been strengthening it was still generally below population growth. This is no longer the case as can be seen in the chart below.

Household growth no longer lagging population



Sources: Census Bureau, BLS

Overall, while we expect GDP growth to show a rebound in the June quarter, we look for a more moderate growth rate in the second half of the year, but still above the economy's longer-term trend. Our forecasts include a strengthening in growth in 2018; this reflects an allowance for fiscal policy stimulus. However, there is no guarantee this will eventuate as congressional Republicans are struggling to agree on a tax package and so there is downside risk to the forecast.

The above-trend growth in the economy is being reflected in continued strong jobs growth (which is well above population growth) and a declining unemployment rate. While the unemployment rate increased by 0.1 ppt in June to 4.4%, this followed a fall of 0.5 ppts between January and May and so the trend is still downwards. Non-farm wages growth was 2.5% yoy in June – the same as originally reported in May – and so there is still no clear sign of acceleration in wages growth, although other wage indicators are a bit more positive.

The ongoing strength in the labour market supports the Fed continuing to tighten policy. However, the recent downturn in inflation, as well as lack of clear upswing in wages growth, is a reason not to tighten. We expect that the Fed will start balance sheet 'normalisation' (running down its balance sheet) at the September meeting, consistent with the Fed Chair's comment in her congressional testimony this week that it would be "relatively soon".

We think it is unlikely that the Fed will raise rates and start balance sheet normalisation in the same meeting. So as a result, the next likely date for a fed funds rate hike is December, which gives the Fed plenty of time to see whether the recent weakness in inflation is an aberration or not.

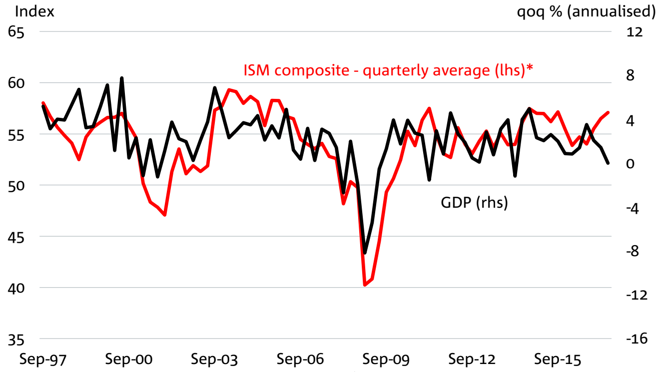
Growth and business surveys

As noted earlier, the ISM business surveys have provided a more positive reading on the U.S. economy than activity data.

While the ISM surveys are not reliable predictors of quarterly GDP growth, over time the two measures tend to move together, with the ISM somewhat more stable. This makes the ISM a useful measure of the underlying trend in the economy, and a good indicator to use to corroborate any marked shift in GDP growth; if GDP growth and the ISM both plunge you know you have a problem.

For the June quarter, the ISM indices were at levels that in the past have been associated with annual GDP growth of almost 4%. This can be seen either by lining up the two series on a chart or by running a simple regression of GDP growth against the ISM indicators (which suggests growth of 3.6% in the June quarter).

ISM points to almost 4% growth based on history

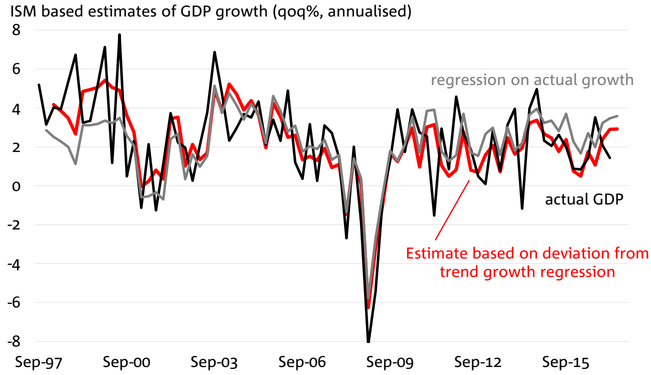


Sources: BEA, ISM, NAB. *weighted average of manuf/non-manuf. ISM surveys based on GDP shares.

However, simply taking the past link between the ISM and GDP and applying it today is potentially misleading. This is because of the clear slowdown in US trend growth – reflecting lower population growth, population aging and a slowdown in productivity growth. For example, one of the five indicators that combined to produce the headline reading is the net balance reporting increased employment. However, GDP growth is not just a matter of how many new people are added to the payrolls but how productive they, and existing employees, are. Similarly, a business survey will not pick up changes in the rate of new business start-ups.

One way to address this issue is to use the ISM to predict the deviation in growth from its 'potential' level. This estimated deviation from trend GDP growth is then added back to the potential growth rate to produce a GDP growth estimate. To do this we used the Congressional Budget Office's (CBO) estimate of potential growth. The result of this approach, as well as a more simple regression of actual GDP on the ISM, is shown below.

ISM and GDP growth – need to take account the economy's slower growth path



Sources: BEA, NAB.

GDP growth estimates based on the detrended growth approach indicate that the current level of the ISM indicators is consistent with GDP growth of around 2.9% (annualised) in the June quarter. This is well below the 3.6% estimate based on a simple ISM/GDP regression. GDP growth of 2.9% qoq is not significantly different to our estimate of June quarter GDP growth.

Even this more realistic way of translating what the ISM suggests is the underlying pace of GDP growth, is consistent with an economy growing at above trend rate. Indeed, the current CBO estimate of potential growth is only around 1.5/1.6% for the first half of 2017, although it sees this picking up to around 1¾% by the second half of 2018.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %									
						2016		2017				2018			
	2015	2016	2017	2018	2019	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	3.2	2.7	2.5	2.4	2.0	0.7	0.9	0.3	**0.7**	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**
Private fixed investment	4.0	0.7	4.4	3.4	2.6	0.0	0.7	2.6	**0.8**	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**	**0.7**
Government spending	1.8	0.8	0.0	1.2	1.6	0.2	0.0	-0.2	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.2	-0.4	0.0	0.1	0.0	0.1	0.3	-0.3	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.1	-0.3	-0.2	-0.1	0.2	-0.5	0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.6**	**1.6**	**2.1**	**2.3**	**2.0**	**0.9**	**0.5**	**0.4**	**0.7**	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)						*3.5*	*2.1*	*1.4*	*2.7*	*1.9*	*2.0*	*2.4*	*2.4*	*2.3*	*2.1*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	0.4	1.4	1.5	1.9	2.1	0.4	0.5	0.6	**0.0**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.4	1.7	1.5	1.8	2.0	0.4	0.3	0.5	**0.2**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.0	4.7	4.2	4.1	4.1	4.9	4.7	4.7	**4.4**	**4.3**	**4.2**	**4.2**	**4.1**	**4.1**	**4.1**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	0.50	0.75	1.50	2.25	2.50	0.50	0.75	1.00	1.25	**1.25**	**1.50**	**1.75**	**2.00**	**2.00**	**2.25**
10-year bond rate	2.27	2.45	2.75	3.00	3.00	1.6	2.4	2.4	2.3	**2.5**	**2.8**	**3.0**	**3.0**	**3.0**	**3.0**

Source: NAB Group Economics
*Contribution to real GDP

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