US ECONOMIC UPDATE - AUGUST 2017

NAB Group Economics

After a sluggish start to the year, GDP growth rebounded in the June quarter and the labour market continues to tighten. The large fall in the non-manufacturing ISM indicator in July is probably exaggerated and, together with the rebound in GDP growth, points to a re-alignment of the 'hard' activity data with the 'soft' business survey measures. Growth is expected to remain modestly above the economy's longer term trend; in the near-term it will be supported by the easing in financial conditions that has occurred despite Fed rate hikes.

Q2 GDP growth rebounds

As expected, after a sluggish start to the year, there was a rebound in GDP growth in the June quarter. On an annualised basis, quarterly growth was 2.6%, up from 1.2% in the March quarter. Growth over the year to the June quarter was 2.1%, the highest annual growth rate since the September quarter 2015, but still only around the average growth rate recorded since the GFC.

The acceleration in June quarter growth was led by private consumption, as well as the absence of a significant inventory drag. Government spending also turned modestly positive. The contribution to growth from business investment and net exports moderated, while residential investment turned down in the quarter.

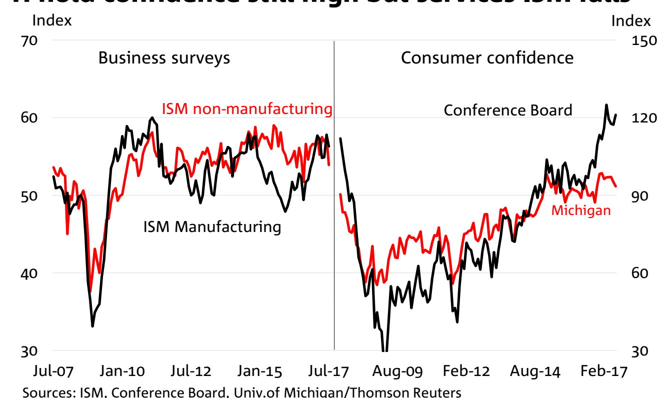
Large fall in non-manufacturing ISM

As to what happens next, there is very little data that will feed directly into the September quarter GDP report available at this stage. The main indication of how the economy is tracking in the current quarter comes from business surveys.

From mid-to-late last year through to the middle of this year, the ISM business survey readings – both manufacturing and non-manufacturing – showed improvement. Moreover, they were at levels that are generally associated with a higher level of GDP growth than was actually being reported. This gap – between the 'soft' survey data and the 'hard' GDP data – narrowed in the June quarter with the rebound in GDP growth.

Moreover, there was a large fall in the non-manufacturing ISM from 57.4 to 53.9 in July. Attempts to use the ISM to predict GDP growth find that not only is the level of the ISM useful, but the change in the level also provides useful information. Indeed, if the July readings were to hold for the rest of the quarter, our ISM based model would predict an annualised GDP growth rate for the September quarter not much higher than 1%.

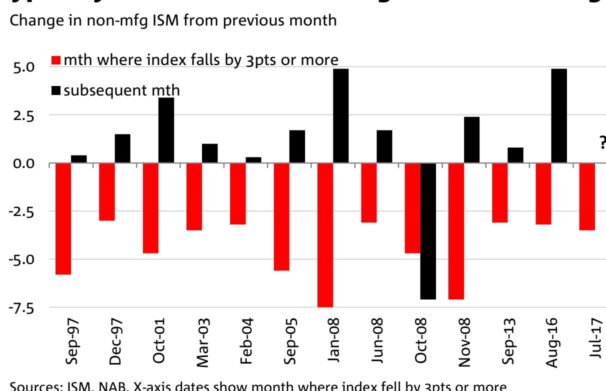
H'hold confidence still high but services ISM falls



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

Typically a rebound after a large fall in non-mfg ISM

Change in non-mfg ISM from previous month



Sources: ISM, NAB. X-axis dates show month where index fell by 3pts or more

However, assuming that the ISMs – particularly the non-manufacturing measure – remain unchanged for the rest of the quarter is a big assumption. Since the non-manufacturing survey started in 1997, there have only been twelve other instances of a fall of 3 or more index points. Only in once instance – at the

height of the GFC – did a 3 point fall in the index not get at least partially reversed.

Typically, the subsequent rebound was smaller than the initial fall, so the overall result over a two month period was still a decline. So it is likely that the non-manufacturing ISM has moved downwards, although the July fall probably exaggerates the extent. Rather than extrapolating the July reading forward, taking the average reading for last two or three months and putting it through our GDP/ISM model points to annualised growth of between 2 to 2¼% – a little bit above what was experienced in the first half of 2017.

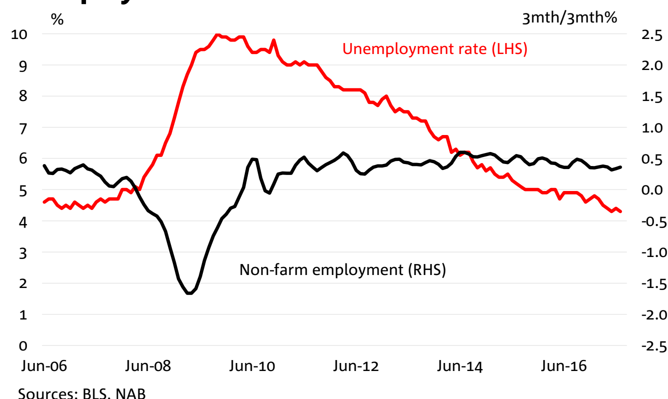
It is also worth noting that while the ISM surveys provide a good guide to the economy over time, they are not a particularly reliable tool for forecasting quarterly GDP. Again looking at the past times where the non-manufacturing survey has fallen by 3 points or more, only in around half of those instances, has the GDP growth rate in the quarter where it occurred been lower than the previous quarter.

In summary, the weakening in the non-manufacturing ISM is probably overstated in July. Together with the stronger GDP growth recorded in the June quarter, it most likely simply represents a re-alignment of the previously divergent 'hard' and 'soft' measures of activity.

Labour market still strong

The latest employment report again pointed to a tightening labour market. The gain in non-farm employment in July was 209,000 and the unemployment rate fell back to 4.3% reversing the previous month rise. Looking at the trend over time suggests that while employment growth has been slowing, it is more than sufficient to reduce the unemployment rate, given underlying population growth. This has been despite some recovery in the workforce participation rate since late 2015.

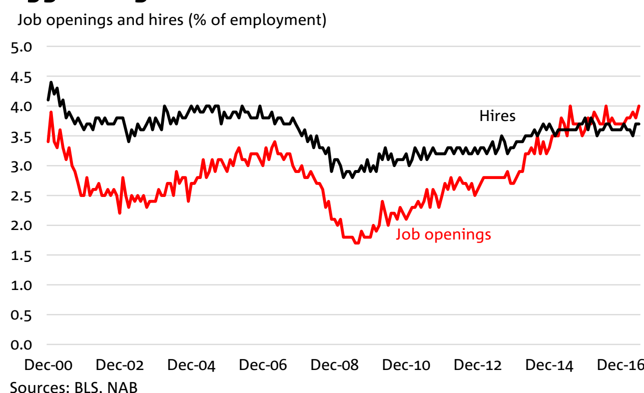
Employment growth still strong enough to reduce unemployment



Sources: BLS, NAB

The employment report provides data on net changes in employment. The 'JOLTS' report shows the gross movements in the labour market. The job openings rate in June was at its equal highest level since the series started (late 2000). The improvement in the job openings rate has been stronger over time than actual new hires – pointing to increasing difficulties for employers in filling jobs.

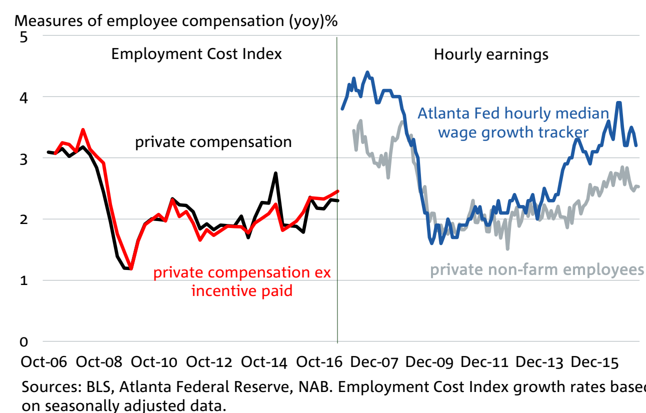
Job openings increasing faster than hires – also suggests tight labour market



Sources: BLS, NAB

However, the tighter labour market is not translating into a clear ongoing lift in wages growth. Growth in non-farm average hourly earnings did rise from early 2015 to end-2016, but then slowed, although it has stabilised recently. The Atlanta Fed's wage tracker has a similar profile. Only the quarterly Employment Cost Index appears to be rising, but only slowly.

No clear on-going acceleration in wage growth



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

Financial conditions

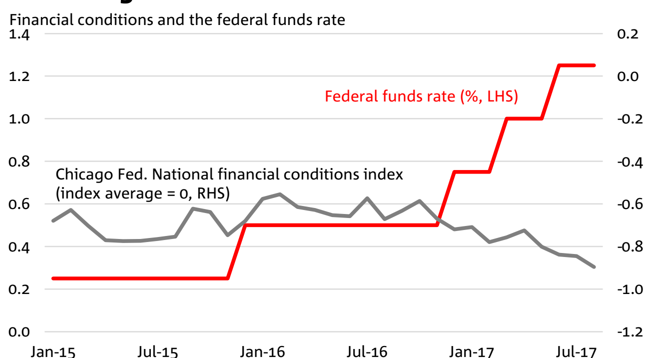
The Federal Reserve (Fed) has raised the federal funds rate target range three times – by 75bp in total – since late 2016. It is also clearly signalling that it will start 'balance sheet 'normalisation' (i.e. a reduction in the Fed's balance sheet through not reinvesting all repayments of its holdings of Treasury and Mortgage Backed securities) 'relatively soon'. This has been widely interpreted to mean at its September meeting.

However, the tightening in monetary policy settings has not translated into an across the board tightening in financial conditions. For example, credit spreads have narrowed, equity markets have risen and the dollar has fallen.

This can be seen in summary measures of financial conditions. For example, the Chicago Federal Reserve's National Financial Conditions Index (NFCI), constructed using "105 indicators of risk, credit, and

leverage in the financial system", shows conditions have eased since late 2016.

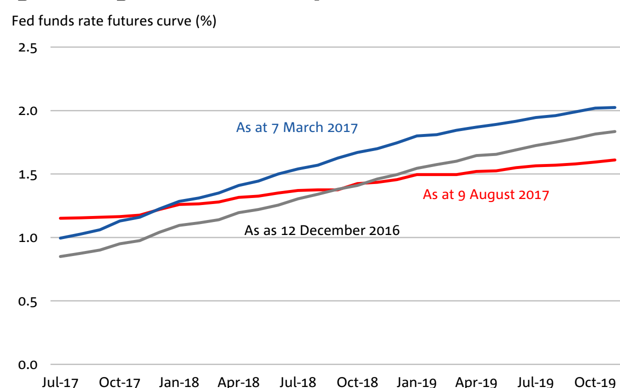
Fed has tightened but financial conditions looser



Source: Federal Reserve, Chicago Federal Reserve. A NFCI above (below) zero idicates tighter (looser) than historical average conditions. Fed funds rate shows top of target band.

One possible explanation for this is that expectations of future fed funds rate increases have come down. And certainly, the fed futures curve has moved down relative to where it was in March, reflecting recent lower inflation readings as well as growing doubts about the prospect of significant legislative changes being made by the Congress. That said, up until around Q3 2018, the current fed futures curve sits above where it was prior to the December 2016 Fed meeting – this is because actual Fed tightening to-date has exceeded what was expected late last year.

Rate tightening expectations down, despite Fed tightening faster than expected since late 2016



This suggests that if, as we expect, the recent weakness in inflation proves to be transitory and the Congress passes a (at least partly) deficit financed tax package, then there is the potential for expectations of Fed policy to move rapidly upwards, triggering tighter financial conditions. Indeed, these considerations are part of our expectation of future US dollar appreciation and rising yields.

Outlook

Nevertheless, for now the easing in financial conditions so far this year supports our forecast that growth will continue to be modestly above the economy's longer-term growth trend. We are forecasting GDP growth of 2.0% in 2017 and 2.3% in 2018.

The forecast strengthening in growth in 2018 reflects an allowance for fiscal policy stimulus. However, there is no guarantee this will eventuate, and so represents a downside risk to the 2018 forecast.

The above trend growth in economic activity is being reflected in a declining unemployment rate. This is a factor that would support the Fed raising rates again once more this year, with December the most likely date. However, this is largely dependent on inflation moving out of its recent soft patch and starting to move back towards the Fed's two per cent target in coming months. As noted previously, the Fed is likely to start the process of balance sheet 'normalisation' at its September meeting.

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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	3.6	2.7	2.5	2.3	2.0	0.7	0.7	0.5	0.7	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**
Private fixed investment	3.9	0.7	3.6	3.3	2.6	0.4	0.4	2.0	0.5	**0.8**	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**
Government spending	1.4	0.8	0.2	1.2	1.5	0.1	0.0	-0.2	0.2	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.2	-0.4	-0.2	0.1	0.0	0.0	0.3	-0.4	0.0	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.2	-0.2	-0.1	-0.1	0.1	-0.4	0.1	0.0	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**1.5**	**2.0**	**2.3**	**2.0**	**0.7**	**0.4**	**0.3**	**0.6**	**0.5**	**0.6**	**0.5**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)						*2.8*	*1.8*	*1.2*	*2.6*	*2.1*	*2.2*	*2.2*	*2.4*	*2.3*	*2.1*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	0.4	1.6	1.4	1.8	2.1	0.4	0.5	0.6	0.1	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Core	1.3	1.9	1.5	1.8	2.0	0.5	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	4.0	4.0	4.9	4.7	4.7	**4.4**	**4.3**	**4.2**	**4.2**	**4.1**	**4.1**	**4.0**
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 growth

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