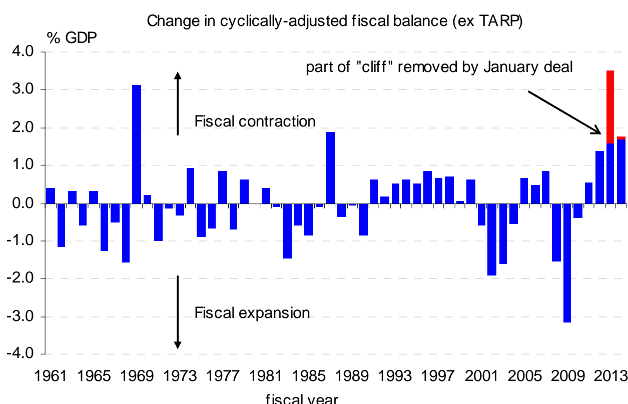
# United States Economic Update

- **The 'fiscal cliff' has been substantially scaled back. The fate of scheduled automatic budget cuts (delayed for only two months) is still subject to negotiation and an increase in the debt limit is also still to be agreed.**
- **The U.S. economy continues to track along at a moderate pace. December quarter GDP growth is likely to be weak due to reversal of transitory factors that boosted the September quarter.**
- **Risks include a loss of confidence from the on-going debate over both the sequester budget cuts and the debt limit as well as a bigger than expected impact on consumption payroll and other tax increases.**
- **Growth is expected to solidify over 2013 and 2014. Overall, we expect GDP growth of 2.3% in 2012, 2.4% in 2013 and 2.9% in 2014.**
- **An end to the current QE program by late 2013/early 2014 is likely (well before any tightening in the Fed funds rate).**

## Overview

As expected, the US Congress left it to the last moment to do something about the 'fiscal cliff'. The deal agreed removes a substantial part of the fiscal cliff (see chart). Moreover, it is possible the fiscal contraction may be further scaled back as the automatic 'sequester' budget cuts were pushed back two months and will be subject to further negotiations. At this stage our view that the level of fiscal contraction in 2013 will be similar to that in 2012 is looking close to the mark.

Fiscal cliff has been substantially scaled back




*Source: NAB Group Economics (Based on CBO and other estimates).*

Another issue still to be resolved is increasing the Federal government's debt limit which will be hit in late February/early March absent any action. Back in mid-2011 the machinations around increasing the limit (and worries of the US government defaulting) caused a large loss of confidence. This might occur again although markets are likely becoming more used to the last minute resolution of such issues under the current Congress.

Meanwhile, growth in the U.S. economy continues to track along at the moderate pace that has characterized the recovery from the recession. The estimate of GDP growth for the September quarter was again revised up late last month to 3.1% (annualised rate) from 2.7% in the 'second' estimate. While this represents the second strongest GDP quarterly growth rate in almost three years much of this was due to stronger inventory accumulation and a spike in public demand. As these factors unwind, we expect growth in the December quarter to look quite weak at around 0.3% qoq (1.4% annualised rate). However, just as the September quarter result overstates the underlying momentum in the economy this would understate it. The pace of job gains and the ISM surveys for manufacturing and non-manufacturing are consistent with moderate, around-trend growth in the economy.

Beyond the current quarter the outlook is boosted by some fading headwinds – state and local spending is no longer contracting, the pace of household balance sheet repair will likely slow down, and credit conditions are slowly improving. A return to more normal growing conditions would also see the farm sector add to, rather than detract, from growth. The recovery in housing construction is likely to continue given low stock levels and a faster pace of household formation. Moreover, the world economy is likely to improve over 2013 (which will support exports). Monetary policy is set to remain very stimulatory, with the Fed funds rate set to remain at its current level at least through 2014 and QE likely to run until late 2013/early March 2014.

Another positive is further signs of an end to the recent weakness in business investment. Core capital goods shipments and orders rose in both October and November and capital expenditure intentions rose for the second straight month in December. With the fiscal cliff largely resolved for now this should further boost business confidence unless the debt limit debate turns ugly. That said, the sequester cuts scheduled to begin in March remain a source of uncertainty in some industries (particularly defence). However, the fundamentals are supportive of further business investment growth.

Another risk is that the impact on household incomes from the end to the payroll tax holiday and other tax increases allowed to occur under the 'fiscal cliff' January deal will lead to a sharp cut back in household consumption spending. We are assuming households will smooth out any impact, particularly given recent declines in petrol prices, some recent improvement in income growth and the on-going improvement in wealth.

In summary, we expect that the drawn-out recovery will continue, although growth is expected to solidify over 2013 and into 2014. Overall, we expect GDP growth of 2.3% (previously 2.2%) in 2012, 2.4% in 2013 and 2.9% in 2014. The small upwards revision to our 2012 forecast is due to the upwards revision to the September quarter GDP estimate and an increase in our expectations of business investment in the December quarter.

## Consumption

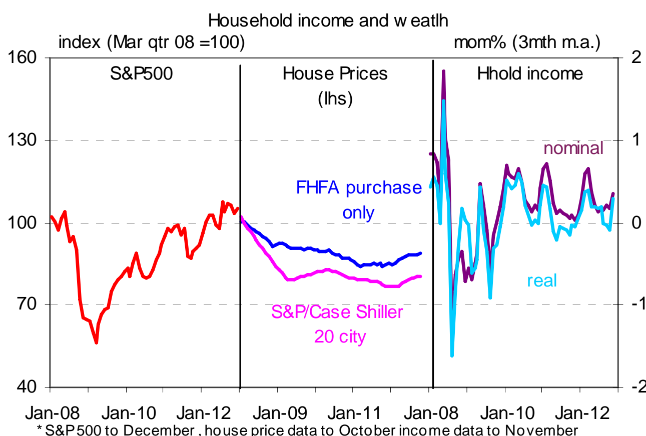
Private consumption grew by a strong 0.6% mom in November. This was partially a correction to the fall in October which likely reflected a combination of factors including Hurricane Sandy and

the (lagged) impact of a run-up in oil prices in August and September.

Any remaining Sandy bounce should be smaller in December. This can already be seen in auto sales, which fell by 1.1% in December after surging by 8.7% in November.

In contrast, petrol prices have declined considerably since September, which will support consumption activity. Consumption will also be supported by the recent strengthening in nominal household incomes (in part reflecting some strengthening in wage income) and the upwards trend in wealth.

Fiscal drag will hit households but other factors more supportive




*Sources: Bureau of Economic Analysis, S&P, Bureau of Labor Statistics, FHFA*

However, the parts of the 'fiscal cliff' that were not removed in the January deal are largely centred on households. The end of the temporary payroll tax cut and increases in marginal income tax and estate tax rates for high income earners, and increases in dividend and capital gains taxes will all affect household incomes. The payroll tax increase is the largest single component - worth over $100 billion or around 1% of household disposable income - and its impact on household budgets will be felt pretty much immediately.

Of added concern is that some measures of consumer confidence showed a notable drop in December, particularly in the forward looking expectations components. Now that a fiscal cliff deal, albeit incomplete, has been reached, it is possible, but by no means certain, that these measures may return to previous levels.

Our forecasts assume that households will smooth out any impact on consumption spending from the tax increases (and indeed such a process may well have started at the end of 2012 as the increases will come as a complete surprise to few people). The support to consumption from falling petrol prices and rising wealth will assist this smoothing process. The spike in disposable income in January 2011, when the payroll tax holiday began, did not bring with it clearly faster consumption growth (and, as now, petrol prices were working in the opposite direction). However, there is probably a (short-term) downside risk to our forecast, particularly if consumer confidence does not bounce back.

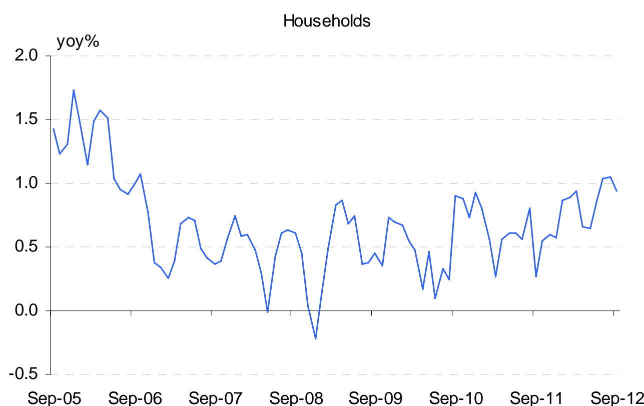
## Housing

The housing sector continued to be a shining light in the economy towards the end of 2012. While the level of construction activity remains low, there is no doubt it is on a strong upwards trajectory. Private new-residential construction rose by 1.2% mom in November. While starts declined by 3.0% in the same month, this was after growth of 22% over three previous months and with permits – a leading indicator of activity - resuming growth in November it is likely to be only a short-run correction.

The stock of homes available for sale remains low and, combined with rising sales, this will support further new construction and maintain the upwards pressure on existing home prices.

A key underlying driver for the housing market is household formation. Household formation slowed markedly ahead of the recession and remained low subsequently. However, over 2012 (data available to September) the annual growth rate has started to pick-up. This likely reflects the continuing recovery in the labour market which may encourage more people (and provide the means) to start their own household. Indeed, there is likely an element of pent-up demand in this regard, as those forced to return to their parents homes or share with others due to the recession, will ultimately move-out causing a period of above normal household growth at some point. As a result the strong growth in residential housing investment is likely to continue.

Housing sector benefiting from strengthening household formation



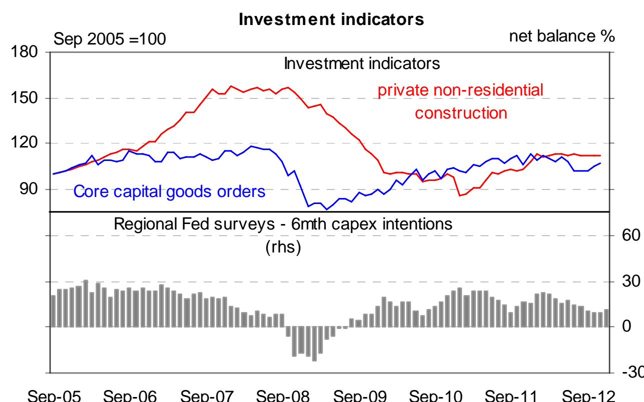

*Source: Census Bureau*

## Business investment

The turnaround in business investment indicators that emerged last month continued, for the most part, in the latest partial indicators.

Core capital goods shipments (which exclude defence and aircraft) and orders rose in both October and November. Orders have shown the most rapid rise – up 5.7% over this two month period (compared to 2.3% for shipments) – which is not surprising as the level of orders are still below that of shipments. Moreover, capital expenditure intentions – as measured by a simple average of Federal Reserve regional surveys rose for the second straight month. However, capex expectations are still relatively low and private non-residential construction remains flat.

Business investment starting to pick-up again




*Sources: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves*

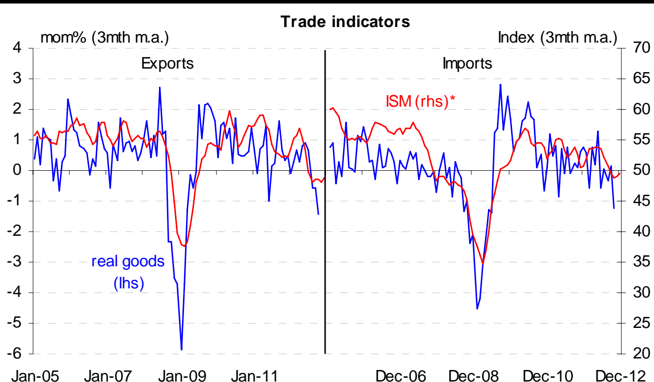
Our view had always been that the slowdown in business investment would prove to be temporary given solid fundamentals of a growing economy, high (and still growing) corporate profits and improving credit conditions. The timing of the turnaround is more of a surprise as it had been largely attributed to concerns over the fiscal cliff which became more prominent in the final quarter of 2012. It may be that other uncertainties – particularly concerns over the future of the euro-zone and more general uncertainty caused by the election – were more important than previously thought and these factors have moderated recently. Many businesses may also have put-off some capex as long as possible. In any event, in our forecasts we have brought forward the timing of the rebound in investment to reflect the latest data.

Partial data on inventories up to November show a reduction in the rate of inventory accumulation in the December quarter. This is broadly consistent with our view that the pace of inventory accumulation would show a slow-down in the December quarter, detracting from GDP growth. The increase in inventories in the September quarter was in the non-farm sector as farm inventories fell due to the drought. The detraction from the farm sector will probably moderate in the December quarter (and turn positive in 2013 if there is an improvement in conditions).

## Trade

There has been no new trade data since our December update. As we noted then, in October there were sharp falls in both real goods exports and imports which, overall, suggested that trade would continue to make a further positive contribution to GDP growth. However, monthly trade data are particularly volatile and even more than normal caution is required due to port disruptions in October from Hurricane Sandy. The ISM survey trade indicators are also weak but picked up in December both for imports and exports, also suggesting that the October trade data are overstating the weakness in trade flows.

**Trade remains weak but ISM survey measures stabilising**



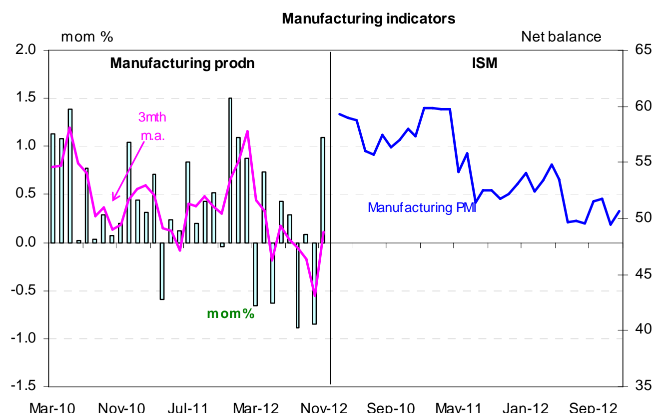

*Source: Census Bureau, Institute of Supply Managers, NAB*

## Industrial production

Industrial production rebounded in November from the disruptions caused by Hurricane Sandy in late October. Total industrial production rose by 1.1% mom (following a 0.7% fall the previous month) with the manufacturing, utility and mining sectors all recording growth.

Manufacturing production rose by 1.1% (NAICS basis) after declining by 0.9% mom in October. In addition to a reversal of Hurricane Sandy affects, auto sector production also rose strongly (4.5% mom). Taking the two months together, however, suggests manufacturing production is still weak, with the level of production broadly flat over much of 2012. This is also confirmed by the manufacturing ISM survey which continues to hover around the neutral 50 mark although it moved to be just on the positive side of this benchmark in December. Adding to this more positive picture, the December labour force data showed both solid manufacturing employment growth (0.2% mom) and an increase in average hours worked per employee.

**Manufacturing production still weak despite Sandy rebound**

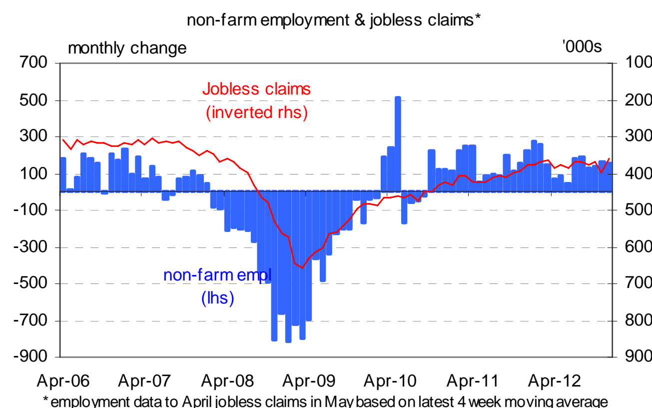



*Sources: Federal Reserve, ISM*

## Labour market

It was another solid employment report in November, with the payrolls data pointing to a net 155,000 non-farm jobs created, similar to the pace since mid-2012. Moreover, average weekly hours worked by private non-farm employees rose for the second month in a row (meaning the fall in October has been completely reversed). The unemployment rate was unchanged at 7.8% (the rate for October was revised up from 7.7% to 7.8%).

**Moderate employment growth continuing**




*Source: Bureau of Labor Statistics, Department of Labor*

The story continues to be one of moderate jobs growth, broadly in line with moderate economic growth. As we have been noting for a while, despite the swings in monthly employment numbers, the year-on-year growth rate for non-farm employment has been tracking in a fairly narrow band of between 1.3 to 1.5% (except in February where it was 1.6%) for over a year. Similarly, initial jobless claims data, after being distorted by Hurricane Sandy, have broadly returned to where they have been since around February 2012.

## Fiscal policy

As expected, the US Congress left it to the last moment to do something about the fiscal cliff, with the American Taxpayer Relief Act being passed in early 2013. The major elements of the deal were:

- Making permanent the so-called 'Bush tax cuts' (except for individuals and families with incomes at or above $400,000 and $450,000 respectively who will now face higher rates). There was also a permanent 'fix' to the Alternative Minimum Tax to stop 'middle-income' earners being caught. Estate (above a $5m threshold for individuals), capital gains and dividend tax rates will also rise.
- Some more temporary extensions such as for extended unemployment benefits, some corporate tax credits (such as those relating to research & development, 50% bonus or accelerated depreciation, and the exception under Subpart F for active financing income) and delaying a reduction in Medicare payment rates to doctors.
- Allowing the temporary payroll tax cut (or 'holiday') to lapse.
- Delaying the scheduled automatic spending cuts by two months (the 'sequester') [1].

All up, the Congressional Budget Office estimates that the measures adopted will increase the deficit by $329b in fiscal year 2013. This compares to an expected reduction in the budget deficit in fy2013 of $487b (August estimate). That is, the deal enacted in early January has removed the major part of the cliff. However, with no decision on how to address the spending cuts specified under the sequester the short-term path for fiscal policy is still not entirely clear. It is quite possible that the negotiations will result in some of the spending cuts being pushed-back (which would further reduce the fiscal drag in 2013) and/or the mix changed. Our forecasts have been based on the view that the fiscal drag in 2013 would be similar to that of 2012, and this remains a realistic assumption.

Apart from the sequester, there were two other aspects of fiscal policy not addressed. The first, and of most immediate concern, is that the U.S. government will run-up against the legislated debt limit in late February or early March, setting a possible re-run of the events of July/August 2011 and associated loss of confidence. However, markets may be becoming used to the last-minute nature of congressional deals so the impact may be more muted this time around (assuming an increase is eventually legislated).

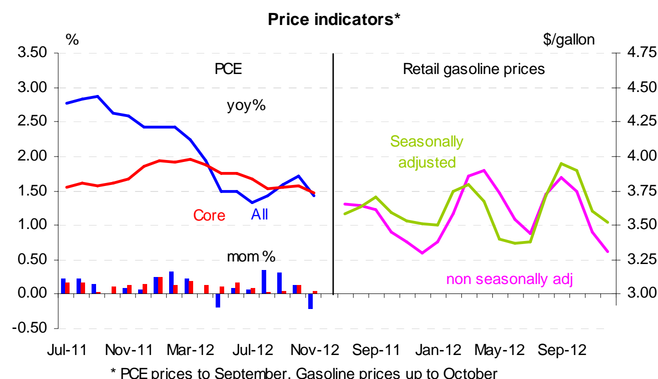
The other unfinished business is how to address the medium-to-long term fiscal problems facing the U.S. Based on the most recent CBO long-run projections available, the January deal (absent further policy changes) would essentially stabilise the Federal debt to GDP ratio at its current elevated level for the next ten years. Beyond this period the demographic changes underway in the US (as well as the rapid rise in health care costs) will start to place further upwards pressure on the deficit and therefore the level of public debt.

## Inflation

Consumer prices (measured by the personal consumption expenditure price index) fell in November largely due to falling energy costs, although core inflation (which excludes energy and food prices) was close to flat. Over the last year headline consumer prices have grown by 1.4%, while core inflation is tracking at 1.5%, well below the Fed's 2% long-term goal.

Retail gasoline prices declined further in December, although more modestly than in November. This will put further downward pressure on headline inflation, although food prices have started rising reflecting the impact of the drought. With considerable slack still in the economy inflation will continue to remain constrained. However, the downward pressure on inflation from imports (excl. energy) is abating due to the depreciation of the dollar since June.

**Inflation remains under control**




*Sources: Bureau of Economic Analysis, Energy Information Administration, Bureau of Labor Statistics, NAB Group Economics*

## Monetary Policy

At its December meeting the Fed replaced its calendar based forward guidance on the Fed funds rate with numerical thresholds. Specifically the Fed anticipates maintaining an exceptionally low Fed funds rate while the unemployment rate remains above 6.5%, one-to-two year ahead (forecast) inflation is below 2.5% and longer-term inflation expectations remain well anchored.

In the recently released minutes of the meeting, there was somewhat of a return to calendar guidance in respect to the Fed's ongoing QE program (purchases of Treasury securities and mortgage backed securities of $85b per month). The minutes indicate that the FOMC is evenly divided between those who though it would likely be appropriate to end QE in mid-2013 and those who thought a later date more appropriate (as well as some participants who did not want the Treasury purchases component of QE at all). In another part of the minutes, it noted that a few members thought asset purchases would be warranted until the end of 2013 (as well as a range of other views around this).

The FOMC's December meeting statement tied the QE program to a "substantial improvement" in labour market conditions. While this was not been defined, the Fed had indicated that QE would end ahead of any increase in the Fed funds rate. The central tendency of FOMC participant projections is for an unemployment rate of 7.4 to 7.7% at end 2013, and annual GDP growth of 2.5 to 3.0%. While the focus is on the unemployment rate the Fed would likely want to see confirmation in broader measures of activity so that it can be confident that any improvement in the unemployment rate will be sustained. Nevertheless, this suggests that the (unstated) threshold for the unemployment rate, in respect of QE, may not be that high. We are forecasting the unemployment rate to fall to around 7.5% by end 2013 and move lower in 2014 (and annual GDP growth will hit 2¾% yoy). This would suggest that an end to QE in late 2013/early 2014 is on the cards.

As the comments on QE in the minutes have lead to considerable speculation (and confusion) it would not surprise if the Fed moves to clarify its views on QE in up-coming meetings.

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[1] Automatic spending cuts triggered by the Budget Control Act of 2011 following the failure to enact legislation to achieve an estimated $1.2 trillion in deficit Reduction.

## US Economic & Financial Forecasts

| | Year Average Chng % | | | | Quarterly Chng % | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | 2012 | | 2013 | | | | 2014 | | | |
| | 2011 | 2012 | 2013 | 2014 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| **US GDP and Components** | | | | | | | | | | | | | | |
| Household Consumption | 2.5 | 1.9 | 2.0 | 2.6 | 0.4 | **0.5** | **0.4** | **0.5** | **0.6** | **0.7** | **0.7** | **0.7** | **0.7** | **0.7** |
| Private fixed investment | 6.6 | 8.3 | 7.0 | 8.9 | 0.2 | **1.6** | **1.8** | **2.3** | **2.2** | **2.3** | **2.2** | **2.1** | **2.0** | **1.9** |
| Government Spending | -3.1 | -1.4 | -0.4 | -0.5 | 1.0 | **-0.4** | **-0.2** | **-0.3** | **-0.2** | **-0.2** | **-0.1** | **-0.1** | **-0.1** | **-0.1** |
| Inventories* | -0.2 | 0.1 | 0.0 | 0.0 | 0.1 | **-0.2** | **0.1** | **0.1** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| Net Exports* | 0.09 | 0.05 | 0.09 | -0.07 | 0.09 | **0.04** | **0.00** | **0.00** | **0.00** | **-0.01** | **-0.02** | **-0.02** | **-0.02** | **-0.02** |
| **Real GDP** | **1.8** | **2.3** | **2.4** | **2.9** | **0.8** | **0.3** | **0.6** | **0.7** | **0.8** | **0.7** | **0.7** | **0.7** | **0.7** | **0.7** |
| **US Other Key Indicators (end of period)** | | | | | | | | | | | | | | |
| PCE deflator-headline | | (yoy%) | | | | | | | | | | | | |
| Headline | 2.5 | 1.5 | 2.0 | 2.1 | 0.4 | **0.3** | **0.4** | **0.5** | **0.5** | **0.5** | **0.5** | **0.5** | **0.5** | **0.6** |
| Core | 1.7 | 1.5 | 1.9 | 2.1 | 0.3 | **0.2** | **0.4** | **0.5** | **0.5** | **0.5** | **0.5** | **0.5** | **0.5** | **0.5** |
| Unemployment Rate (%) | 8.7 | 7.8 | 7.5 | 7.1 | 8.0 | **7.8** | **7.8** | **7.7** | **7.6** | **7.5** | **7.4** | **7.3** | **7.2** | **7.1** |
| **US Key Interest Rates (end of period)** | | | | | | | | | | | | | | |
| Fed Funds Rate | 0.25 | 0.25 | 0.25 | 0.3 | 0.25 | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** | **0.25** |
| 10-year Bond Rate | 1.98 | 1.65 | 2.25 | 2.60 | 1.72 | **1.65** | **1.90** | **2.10** | **2.20** | **2.25** | **2.25** | **2.40** | **2.40** | **2.60** |

**Source: NAB Group Economics**

***Contribution to real GDP**

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