United States Economic Update

National Australia Bank

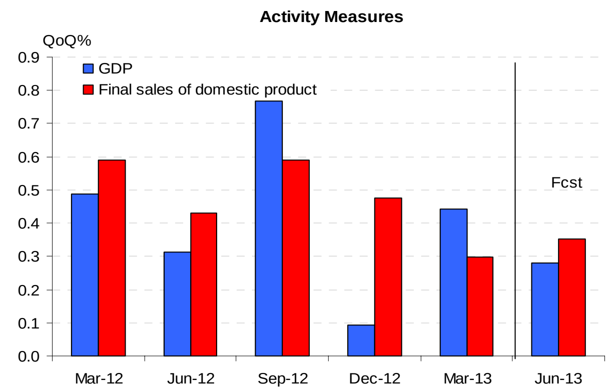
- **Overall, the US economy appears to be continuing to grow at a modest pace. While GDP growth is likely to slow in the June quarter, this is partly due to an expected inventory correction.**
- **We are forecasting GDP growth will strengthen in second half the year. As a result GDP is expected to grow by 1.8% in 2013 (previously 2.1%) and 2.7% (previously 2.9%) in 2014.**
- **Tapering of QE3 expected to be announced following the September FOMC meeting (but risk that it will be delayed to later in the year), with the end of QE not expected until the September quarter 2014. Fed fund rate rises are not expected until 2015.**

Overall, the US economy appears to be continuing to grow at a modest pace. While indicators suggest that GDP growth will slow in the June quarter from its March quarter level, this will partly reflect a temporary inventory correction. The underlying pace of growth is still expected to strengthen later in the year.

We have revised down our forecasts for June quarter GDP from 0.5% qoq to 0.3% qoq (or 1.1% on an annualised basis). This reflects a combination of factors including downward revisions to past consumption data by the BEA, weak non-residential construction and trade outcomes for May, and weak inventory data.

Inventory movements tend to have little impact over time on GDP growth. The 'final sales of domestic product' measure excludes inventories and can give a better underlying picture of demand for U.S. goods and services. On this basis, the June quarter is expected to be similar to the March quarter (perhaps a bit stronger).

Q2 GDP growth to slow but underlying activity similar to Q1

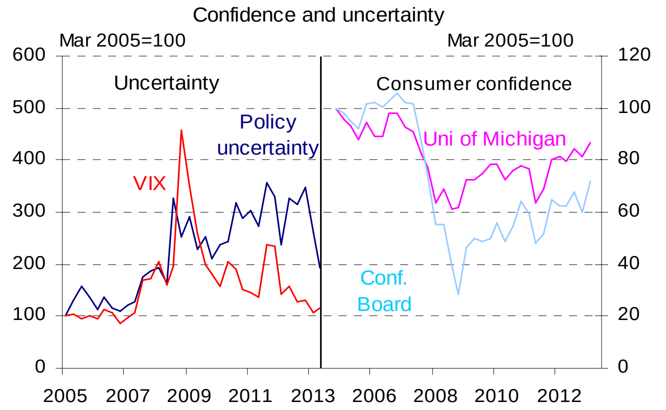


Sources: ISM, Conference Board

Beyond the current quarter, the impact of the tax cuts at the start of the year will begin to fade, and consumption will also be supported by the continued growth in household wealth and employment, still low interest rates and the gradual easing in lending standards by banks. This later factor will also aid business investment, which will also be supported by high corporate profits, notwithstanding a small decline at the start of 2013. The reversal of the expected June quarter inventory correction will also provide a one-off boost to GDP growth in the second half of 2013.

Another factor that should be a positive for consumption and investment is the improvement in confidence as well as reduced uncertainty. While bond markets have been getting excited by QE tapering, the VIX measure of volatility remains relatively subdued, while the Baker, Bloom, and Davis index[1] of policy uncertainty is at its lowest level in five years.

Consumer confidence improving & uncertainty is down



Source Thomson Reuters (Chicago Board Options Exchange), University of Michigan/ThomsonReuters, Conference Board

The rapid growth in housing construction is also expected to continue, underpinned by low inventory and continued employment growth which will support household formation.

In contrast, subdued economic conditions in the US' major trading partners, together with the rise in the USD (expected to continue) will constrain the export sector. As a result we have reduced our expectations for net exports over the rest of this year and into early 2014. Federal fiscal policy will also be a drag on growth for some time to come, although conditions at the state/local government level are improving.

In terms of monetary policy, we expect tapering of the QE program will probably be announced after the Fed's September FOMC meeting, but there is a chance it will be delayed until later in the year. Once tapering starts, if the economy turns out as we expect, QE will end by around the September 2014 quarter. An increase in the Fed Funds rate, however, is not in prospect until 2015.

[1] Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

In summary, we expect that the drawn-out recovery seen to-date will continue. While GDP growth will likely moderate in the current quarter it should strengthen in the second half of the year. GDP growth is forecast to be 1.8% in 2013 (previously 2.1%) and 2.7% (previously 2.9%) in 2014. The downward revision to GDP growth in 2013 reflects the -0.2 percentage point revision to March quarter growth and, to a lesser extent, our downward revision to the June quarter forecast as discussed above. This latter factor, plus our revised profile for net exports, explains the 2014 revision.

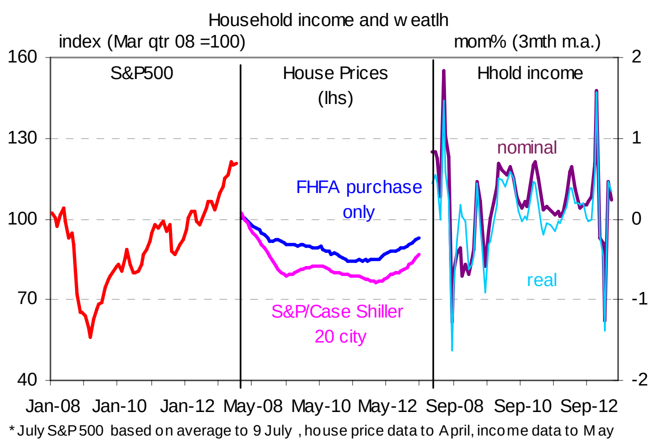
Consumption

Growth in household consumption has moderated in recent months, but was a still solid 0.2% mom in May. Moreover, new car sales rose by 4.2% mom in June possibly indicating some acceleration in consumption towards the end of the quarter. For the quarter as whole, however, consumption growth is likely to be lower than in the March quarter. This in part reflects the boost to the March quarter result from a weather related increase in energy consumption.

Recorded income growth was up and down in late 2012/early 2013 due to timing changes brought about by tax changes. However, growth has settled recently at a modest level and labour market data for June point to a possible strengthening, at least for private sector employees.

With income growth only modest, and taxes taking a large bite out at the start of the year, consumption has been supported by rising household wealth. As we noted last month, net household wealth rose 4.5% qoq in the March quarter, and strong growth likely occurred again in the June quarter. Equity prices rose 6.4% in the June quarter and house prices at the start of the quarter were continuing their upwards trend, and are 7-12% higher than a year ago. Importantly, consumer confidence rebounded in May and June to be at post-recession highs in the University of Michigan/ Thomson Reuters and Conference Board measures.

Rising wealth a support to consumption



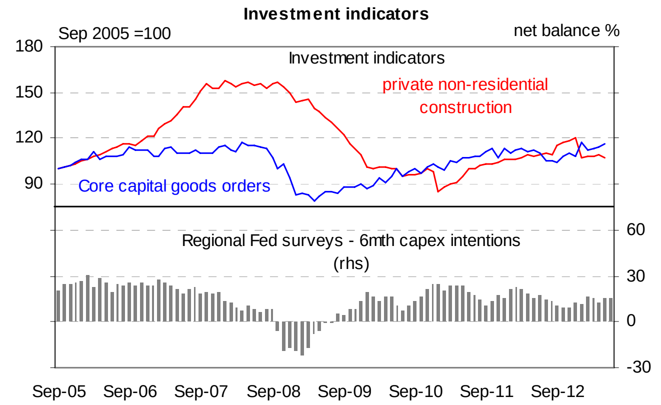
Sources: Bureau of Economic Analysis, S&P, Bureau of Labor Statistics, FHFA

Business investment

Indicators generally suggest that business fixed investment has been growing at a modest pace. The outlook is also generally positive as, notwithstanding a small decline in the March quarter, profits remain high and credit conditions are favourable. Inventory data for the current quarter has been weak and should subtract from June quarter GDP growth.

Both core capital goods shipments and orders (which exclude defence and aircraft) rose in May. After some big swings up and down earlier in the year, orders have now risen in the last three months and are above the level of shipments suggesting further growth can be expected for the latter. The decline in non-residential construction that occurred earlier in the year has been arrested, notwithstanding a small decline in non-residential construction in May. Lastly, capex intentions, as measured by the various Fed regional surveys, have stabilised recently at a level above that seen in the latter part of 2012.

Indicators suggest business investment growing modestly



Source: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves, NAB.

The spike in interest rates over the last couple of months represents a downside risk. However, we expect business investment growth will remain positive. Lending rates are still low by historical standards and lending standards have been easing, suggesting increased availability of credibility (even if at a higher price). Moreover, as we saw last year, when business investment actually declined in the September quarter, uncertainty and confidence about the future can also be important. With fiscal policy discussion relegated to background noise for now, policy uncertainty, as mentioned above, has fallen significantly. The VIX measure of financial market volatility, while up a little in recent months, is at relatively subdued levels. In addition, still high levels of corporate profits should continue to underpin business investment.

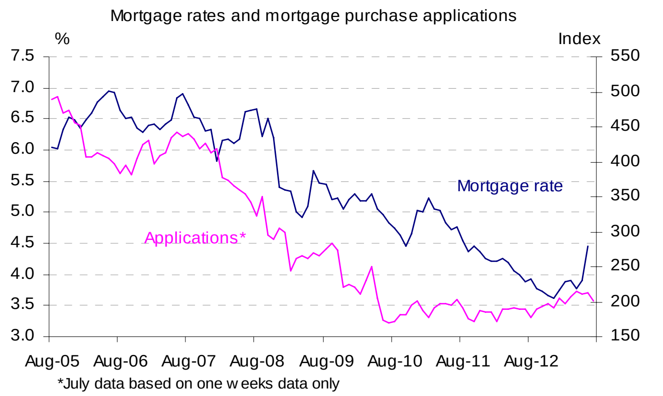
Inventory data available for the June quarter is looking weak. April inventories were revised down and there was a large fall in wholesale inventories in May. The inventory data is still fairly incomplete – retail inventories for May are not yet available – and are in nominal terms (so may reflect lower prices, e.g. for petrol). Nevertheless, we now expect inventories to detract from GDP growth, but this will be a temporary impact, likely to be reversed in the second half of 2013 (probably mainly in the September quarter).

Housing

While housing activity is still growing strongly, there are some mixed signals emerging on the strength of growth. After jumping upwards early in the year housing starts have retraced some of their gains, and monthly growth in private new residential construction expenditure in May of 0.7% mom was the slowest in around 1½ years. However, to put this in perspective, both series are still well above year ago levels (by around 30%) and the leading indicator of building activity – building permits – is still on a strong upwards trend.

Related to this is the issue of whether the recent increase in mortgage rates will slow down the sector. Mortgage rates have increased by around 0.9 percentage points since May. At this stage, the housing market appears to be taking the increase in its stride with mortgage applications for purchase holding up. We expect this to continue to be the case as, while interest rates can affect the market, they are not the sole determinant and they are still relatively low by historical standards. As can be seen in the chart below, the housing market was flat for a long time following the recession despite falling and record low interest rates. Other factors such as employment growth (which will support household formation), house price expectations (rising), household confidence in the economy (rising) and low inventories of new homes will continue to support strong growth in the housing sector for a while to come.

Mortgage purchase applications holding up

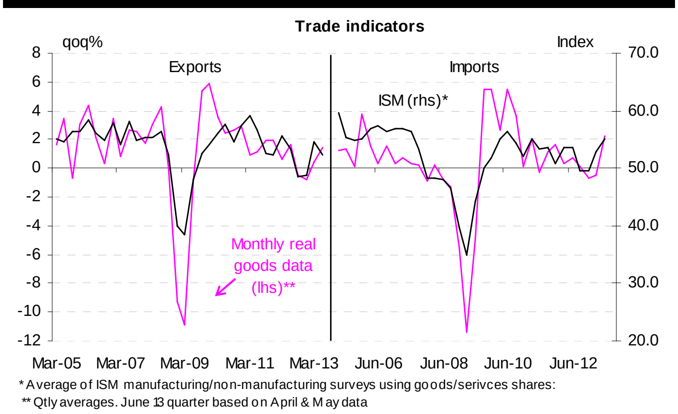


Sources: Mortgage Bankers Association of America

Trade

Both real goods exports and imports rose for the second consecutive month in May, although exports (0.1% mom) were far more subdued than imports (+3.1% mom). As a result trade flows have strengthened in the June quarter to-date. This has broadly matched the movement in the ISM trade indices. The ISM export indicators softened noticeably in May, but in June the manufacturing ISM export indicator recovered some lost ground, pointing to further export growth.

Rebound in trade



Sources: ISM, Census Bureau

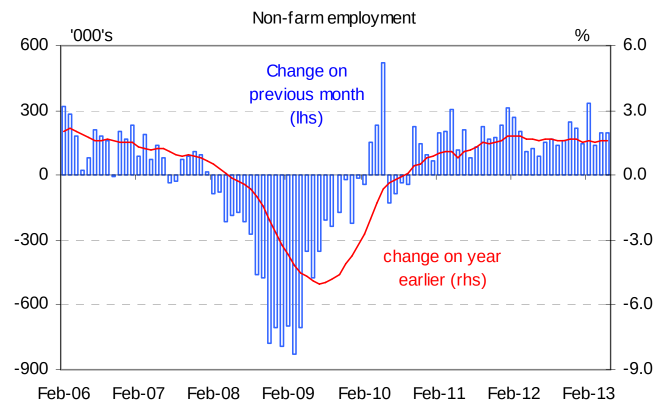
Exports are expected to come under continued pressure due to the continued weakness in the global economy and the recent appreciation of the USD (and which our currency team expects to continue). Given this, as well as the weak May net export results and downward revisions to our forecast of Chinese economic growth (one of the US' major trading partners), we have marked down our forecasts of net exports.

Labour market

The U.S. labour market continues its slow, but steady, improvement. Non-farm employment grew by 195,000, similar to the average over the last nine months. This pace of growth is in line with the threshold some Fed members have indicated in the past would be consistent with 'substantial' improvement in the labour market. Of course, the Fed's main labour market indicator is the unemployment rate, and while this was steady at 7.6%, this was because of the second consecutive monthly rise in the participation rate, so even this suggests some further improvement in labour market conditions.

As we have noted previously, non-farm employment growth has been remarkably steady with annual growth of around 1.5 to 1.8% since late 2011. The recent pace of job gains has been strong relative to GDP growth. While this can happen for a period of time, at some point either GDP growth will need to strengthen or employment growth slow down. We are forecasting the latter, but normally employment growth lags changes in GDP growth so some softening in payroll numbers would not surprise (but not enough to derail the downward trend in the unemployment rate).

Steady employment growth continues



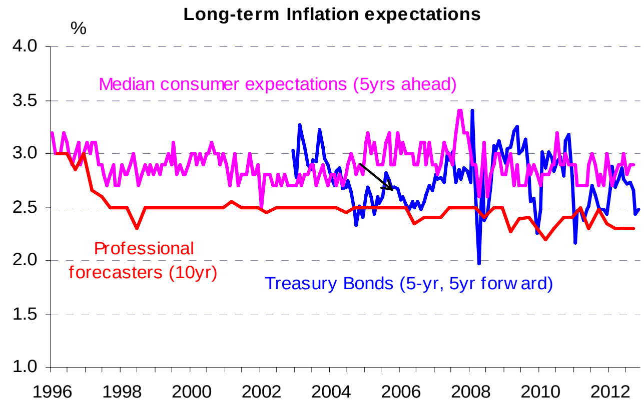
Source: Bureau of Labor Statistics

Inflation

Inflation continues to remain subdued with both headline and core (ex energy and food) personal consumption expenditure (PCE) prices increasing by 0.1% mom in May to be 1.0% and 1.1% higher respectively on the same time last year. However, since May gasoline prices have moved higher in seasonally adjusted terms, so the fall in headline inflation is over for now. However, we expect inflation to remain subdued, and below the Fed's 2% objective over this and next year, as the appreciation of the USD and the still large amounts of slack in the economy and weakness in the global economy constrain goods inflation.

In addition to the actual rate of inflation, the Fed closely monitors longer-term inflation expectations. While there have been some declines in some measures recently, they are still within their recent historical bounds.

Inflation expectations remain 'anchored'



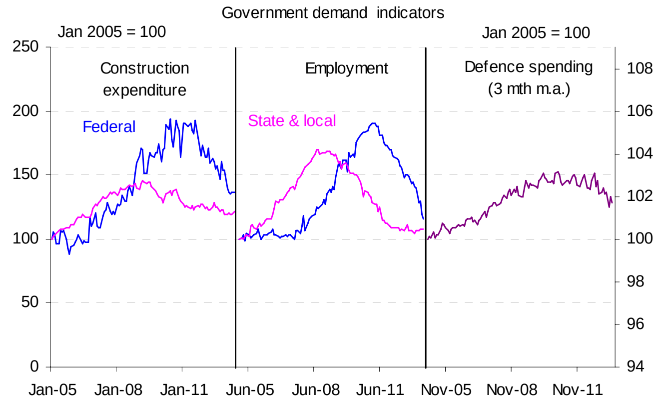
Sources: Federal Reserve (unofficial staff estimates), Philadelphia Federal Reserve, University of Michigan

Public demand

The focus on fiscal policy has been at the Federal level with the so-called sequestration – code for automatic budget cuts – kicking in at the start of March, as well as the tax rises at the start of the year. Partial indicators such as federal government construction & defence expenditure and employment have been moving down consistent with the tightening of federal fiscal policy.

However, state and local governments represent 60% of total government consumption and investment spending. At these levels of government, in aggregate, the end to cut-backs has been reached. Indeed, both construction expenditure (based on April and May data) and employment have increased in recent months. So while Federal fiscal policy is likely to be a continuing headwind for a while to come, some relief is coming from the state & local governments.

Federal spending decline but state/local has bottomed out



Source: Census Bureau, Bureau of Labor Statistics, U.S. Treasury

Monetary Policy

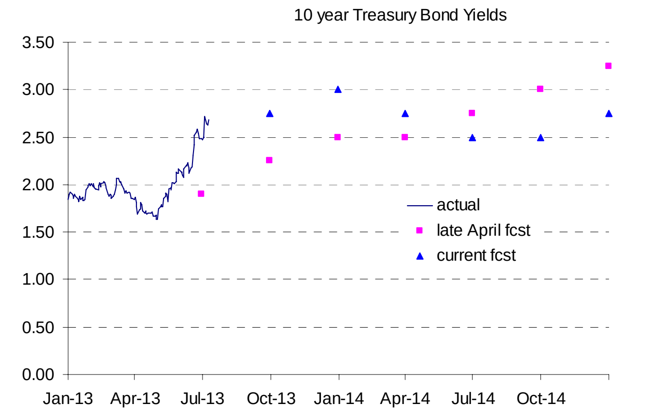
Discussion of U.S. monetary policy continues to focus on the prospect of the Federal Reserve 'tapering'. 'Tapering' in this context refers to reducing the size of its asset purchases (QE3) which are currently running at $85b a month.

Following the FOMC June meeting, the Fed Chairman indicated that, if the economy developed as they expected, that asset purchases were likely to be scaled back in 'measured steps' starting later this year, with the program to end in mid-2014 when unemployment would be around 7%. The timings are conditional on the data so we would expect the end to QE to be in the September quarter 2014 as we have forecasts which are a little bit weaker than the Fed.

Since the FOMC meeting, there has been another solid employment report (including upwards revisions to data in previous months). Given this we expect tapering of QE to start in September. A number of Fed members are looking not only for continued labour market improvement but also for signs that growth is strengthening and inflation has stopped decelerating and will start moving back towards the Fed's 2% objectives. This makes a July meeting start date for tapering extremely unlikely, but means there is a not insignificant chance that the start of tapering will be delayed to the final quarter as it make take a while for the data to provide clear direction on the employment, growth & inflation trifecta.

As expectations of 'tapering' starting in 2013 have increased, so have interest rates. The rise in interest rates is by itself a negative for our forecasts, and the impact on housing and interest sensitive sectors such as autos will need watching. . However, just as falls in already low interest rates last year were seen as having diminishing impact, the impact of their reversal to what are still low levels by historical standards should not be too significant. Moreover, we had been expecting a rise in rates over this year and into next, it has just happened more quickly. While our fixed interest team see yields moving higher over the rest of the year, consistent with historical experience they expect a downward correction in 2014.[2]

Interest rates expected to rise a further before correcting



Source: Thomson Reuters Datastream, Federal Reserve, Bloomberg

antony.kelly@nab.com.au

[2] See Aussie & Kiwi Fixed Income Strategy, 3 July 2013 for more details. www.wholesale.nabgroup.com/Research/Australia/Pages/Fixedinterest.aspx#

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	2.5	0.4	0.5	0.6	**0.4**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	6.6	8.7	6.9	8.8	0.2	3.3	0.7	**1.9**	**2.2**	**2.2**	**2.2**	**2.1**	**2.0**	**2.0**
Government Spending	-3.1	-1.7	-2.8	-0.7	1.0	-1.8	-1.2	**-0.6**	**-0.4**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Inventories*	-0.2	0.1	0.0	0.1	0.1	-0.3	0.2	**-0.1**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	0.1	0.0	-0.2	0.1	0.1	0.0	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.2**	**1.8**	**2.7**	**0.8**	**0.1**	**0.4**	**0.3**	**0.8**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline		(yoy%)												
Headline	2.5	1.6	0.9	1.7	0.4	0.4	0.2	**0.0**	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Core	1.7	1.5	1.1	1.9	0.3	0.3	0.3	**0.2**	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment Rate (%)	8.7	7.8	7.4	6.8	8.0	7.8	7.7	7.6	**7.5**	**7.4**	**7.2**	**7.1**	**7.0**	**6.8**
US Key Interest Rates (end of period)														
Fed Funds Rate	0.25	0.25	0.25	0.25	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	1.72	3.00	2.75	1.72	1.72	1.96	2.30	**2.75**	**3.00**	**2.75**	**2.50**	**2.50**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

** History are quarterly averages, projections are end quarter

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics

Rob Henderson
Chief Economist, Markets
+61 2 9237 1836

Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy

Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy

Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Ken Hanton
Senior Credit Analyst
+61 2 9237 1405

Equities

Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Mike Jones
Currency Strategist
+64 4 924 7652

Kymberly Martin
Strategist
+64 4 924 7654

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44 207 710 2993

Gavin Friend
Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207 710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

Alexandra Knight
Economist – Australia
+(61 3) 9208 8035

Vyanne Lai
Economist – Agribusiness
+61 3 8634 0198

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Property
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Gerard Burg
Economist – Industry Analysis
+(61 3) 8634 2778

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

James Glenn
Economist – Asia
+(61 3) 9208 8129

Tony Kelly
Economist – International
+(61 3) 9208 5049