US Economic Update – US GDP, 2013 Q3

- **US GDP rose by 2.8% (annualized rate) in the September quarter, continuing the improvement experienced over the course of the past year.**
- **However, the stronger growth largely reflected a pick-up in inventories. Business investment and consumption were weak, but housing is still growing strongly while net exports turned positive.**
- **We expect GDP will grow by 1.7% in 2013 (previously 1.6%) and 2.6% (previously 2.7%) in 2014. The revisions largely reflect a change in the timing of activity due to the stock-cycle.**

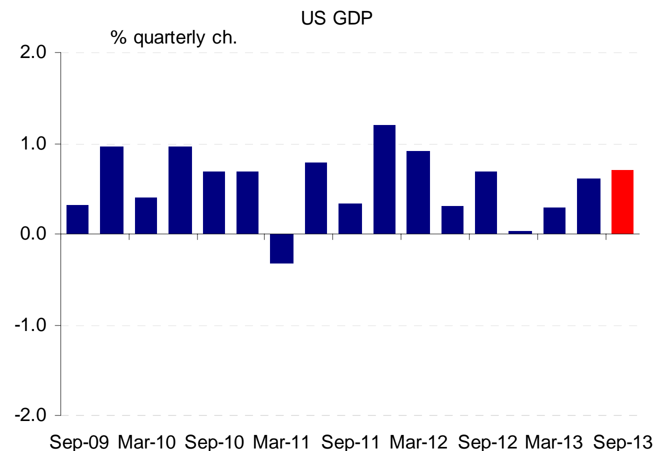
US GDP in the September quarter grew by 0.7% qoq or at an annualised rate of 2.8%. Since the almost zero growth in the December quarter 2012, GDP growth has strengthened in each quarter. However, this strengthening has not been as strong as it appears as it reflects a build up in inventories which are not a sustainable source of growth; final sales of domestic product (GDP ex inventories) grew by 0.5%, unchanged from the June quarter. That is not to say that the improvement in GDP is illusory; part of the inventory increase has been in the farm sector and reflects an improvement in conditions from the severe drought experienced last year.

Outside of the stock cycle, the details were mixed. Net exports strengthened and residential housing investment again grew strongly, but business investment was quite weak.

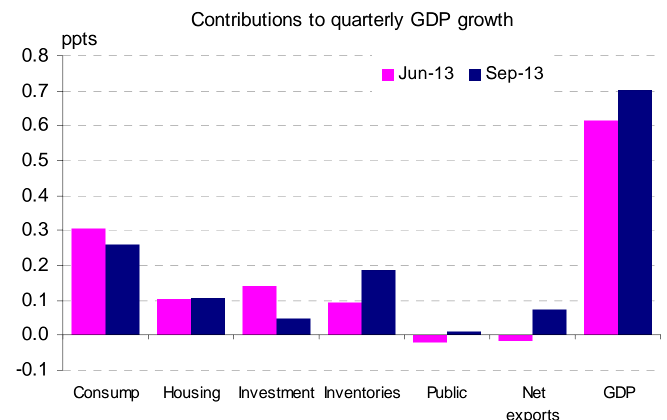
Consumption growth also softened to its lowest growth rate since the June quarter 2011, although the underlying details were more positive. Goods consumption growth strengthened so the poor result was entirely due to near flat services consumption. The latter was affected by a fall in the 'housing and utilities' component short-term variations in which are largely driven by power consumption reflecting weather conditions. Excluding this component, consumption growth has actually strengthened in each of the last two quarters, consistent with a fading impact from the start-of-year tax increases. Gasoline prices were, on average, higher in the quarter which would also have been a drag but they have been falling more recently.

Business fixed investment grew by 0.4% qoq, weaker than the previous quarter's 1.1% increase. This reflected a weakening in equipment investment. Investment in intellectual property products bounced back modestly after declining in the previous quarter while non residential structures investment was strong for the second quarter in a row. The overall weakness in business investment this year is broadly consistent with indicators from surveys on capex intentions; however, these indicators have been improving in recent months.

GDP growth has strengthened over 2013…



…but inventories a factor; underlying strength more modest



Q3 2013 GDP Details

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.4	0.26	1.8
Fixed investment	1.0	0.16	5.1
Structures	2.9	0.08	3.6
Equipment	-0.9	-0.06	2.4
Intellectual property	0.5	0.02	2.5
Residential	3.5	0.11	15.3
Ch. in inventories		0.19	
Public Demand	0.1	0.01	-2.8
Net exports		0.07	
Exports	1.1	0.14	3.0
Imports	0.5	-0.07	1.5
GDP	**0.7**	**0.7**	**1.6**

Source: US Bureau of Economic Analysis

In contrast to business fixed investment, inventory investment picked up in the September quarter, leading to another positive contribution to GDP growth. Farm inventories again increased, consistent with the overall easing in drought conditions in the United States. The level of inventories to sales does not appear to be out of line with the historical trend, so while we are expecting a more normal pace of inventory accumulation in the December quarter, we are not factoring in a major inventory correction.

Housing investment continues to grow strongly, with growth actually accelerating a little in the September quarter, contrary to the weakness in partial indicators, growing by 3.5% qoq to be over 15% higher than a year ago. Notwithstanding the continued strong growth, it is still off a low base and the level of activity remains low by historical standards.

Net exports made a positive contribution to growth for the first time in three quarters. Both import and export growth moderated in the quarter, but with the latter holding up better. Looking at annual growth rates, both export and import growth has been moving up since the March quarter, consistent with generally improving conditions in the world economy and in the United States.

Public demand rose for the first time in a year in the September quarter, albeit by a very modest 0.1% qoq , because of an increase in state and local government demand (for the second quarter in a row). In contrast, Federal government demand again fell, but the pace is moderating. Over the last two quarters federal government demand fell by 0.8% compared to a fall of 5.8% over the previous six month period. This reflects changes in defence spending which were not only affected by the automatic budget cuts under the 'sequester' but also by a winding down of overseas military operations. In contrast, Federal non-defence spending has fallen by 0.8 to 0.9% qoq in each of the last three quarters

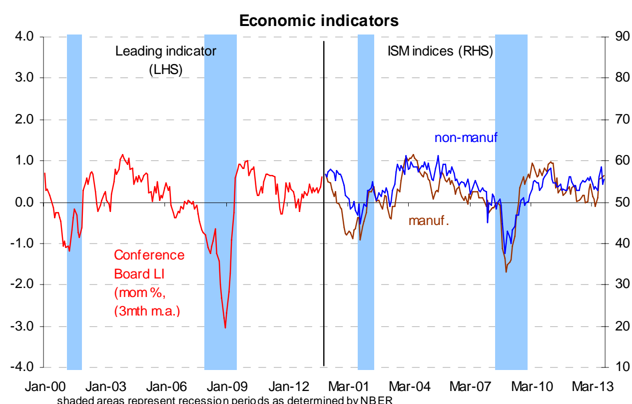
Inflation remains quite soft, although the quarterly growth rates for both the headline and core personal consumption expenditure (PCE) price index picked up from their very weak June quarter pace. The increase in headline inflation was boosted by a 2.8% qoq increase in energy prices in the quarter. Nevertheless, annual PCE inflation was only 1.1% (1.2% for the core measure), unchanged from the June quarter and well below the Fed's 2% longer-term goal.

Assessment

The September quarter accounts do not fundamentally change our view of the direction of the economy. While headline growth was stronger than we had expected this largely reflected higher than expected inventory accumulation. A concern is the weakness in business investment but the underlying factors that tend to support investment remain positive.

There is little hard data available on activity in the December quarter, but we expect a softening in growth in the quarter due to the government shutdown, a more normal level of inventory accumulation (which would mean inventories detract from growth in the quarter) and a slowdown in housing investment as suggested by recent partial indicators of housing activity. The direct impact of the partial Federal government shutdown is relatively small but the extent of indirect affects through confidence and other channels on business and consumer activity are unclear (as is their duration). Consumer confidence surveys suggest that confidence lost during the saga has only partially been restored and auto sales in October were below their September quarter average. On the other hand, measures of financial market stress such as the VIX index are back to pre-October levels and business surveys for the month are generally positive, particularly the ISM surveys, suggesting that business confidence has come through pretty unscathed. Similarly, share market prices also quickly recovered their losses and resumed their upwards trend.

Business and other indicators positive



Sources: ISM, Conference Board, NAB.

We still expect growth to strengthen in 2014 compared to 2013. The headwind from fiscal policy is expected to moderate as the pace of federal deficit reduction slows down. With household wealth continuing to trend up, employment growing, and banks gradually easing lending standards, consumption growth should strengthen. High and growing profits, coupled with banks continuing to ease their lending standards for business loans, will support business investment. Indicators of capital expenditure intentions are currently at their highest levels for a while suggesting business investment is set to pick-up. Exports should be also be supported by improving global economic conditions, although we expect further appreciation of the dollar to constrain net exports.

Various housing market indicators suggest that activity has slowed down recently likely due to the rise in mortgage rates between May and mid-September. However, there has been some moderation in rates more recently. More fundamentally, even at their recent peak mortgage rates were low by historical standards. This was also true of the level of home construction and new home inventories, and with signs that banks are slowly starting to ease lending standards – at least for 'prime' home loans - strong growth in the sector over the next few years is likely.

Developments in Washington continue to pose a risk to the outlook. Of immediate concern would be a repeat of last month's government shutdown and delay in increasing the debt limit. The October deal only funded the government through to mid-January and increased the debt limit to early February (although the real deadline for the debt limit is probably March given Treasury's access to its normal suite of 'extraordinary' measures). At this stage we are cautiously optimistic that things won't get as bad as in October, if only because the politicians who received a lot of heat last time around may not be ready for another round just yet.

With its stronger than expected headline but weak details, the September quarter GDP outcome is probably unlikely to

change the Fed's monetary policy view. The Fed has indicated that it is looking for a strengthening in the economy in order to provide comfort that the improvements in the labour market that have occurred since it started its current asset purchase program ('QE3') will be sustained. Stripping out the stock cycle the September quarter results do not indicate such a strengthening was underway before the Government shutdown/debt limit debate which itself will likely negatively impact some October data releases. Even November data may be affected – and so not provide clear a signal – to the extent that there is a rebound from any weakness in October. Given these considerations, as well as the looming budget debates early in 2013, we recently changed our call for when the Fed will start reducing the size of its asset purchases from December to March.

There has been some speculation recently that the Fed may also lower its unemployment threshold for when it will consider increasing the fed funds rate, from its current 6.5%. This has arisen because of a recent paper by senior Federal Reserve staff[1] suggesting that while a 6.5% threshold was a good policy, a lower threshold such as 5.5% would be a better one. While Fed meeting minutes indicate that the Fed has considered this option previously and decided not to act this is definitely a debate worth watching. When talk of tapering started earlier this year, it was also associated with markedly changed perceptions of when the fed funds rate might start to rise. The Fed sees QE and the fed funds rate as separate policy tools so it might try to use a lower threshold (perhaps at the same time they start to taper QE3) as a way of reinforcing this distinction, while also serving to keep bond yields down.

Overall, we expect that the drawn-out recovery will continue but with the pace of growth moving higher in 2014. We are forecasting GDP growth of 1.7% in 2013 (revised up from 1.6%) and 2.6% in 2014 (revised down from 2.7% in 2014). The small revisions in either direction largely reflect a pull-forward of activity due to the faster than expected inventory accumulation in the September quarter.

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[1] English W.B., Lopez-Salido J.D. Tetlow R.J., The Federal Reserve's Framework for Monetary Policy – Recent Changes and New Questions, November 2013

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	2.2	1.9	2.4	0.4	0.4	0.6	0.5	0.4	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Private fixed investment	6.2	8.3	4.6	7.9	0.7	2.8	-0.4	1.6	1.0	**2.0**	**2.1**	**2.1**	**2.1**	**2.0**
Government Spending	-3.2	-1.0	-2.1	-0.4	0.9	-1.7	-1.1	-0.1	0.1	**-0.7**	**0.2**	**-0.1**	**-0.1**	**0.0**
Inventories*	-0.2	0.2	0.0	0.0	0.1	-0.4	0.2	0.1	0.2	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Net Exports*	0.1	0.1	0.1	-0.1	0.0	0.2	-0.1	0.0	0.1	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.8**	**1.7**	**2.6**	**0.7**	**0.0**	**0.3**	**0.6**	**0.7**	**0.4**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline		(yoy%)												
Headline	2.6	1.7	1.0	1.6	0.4	0.4	0.3	0.0	0.5	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.8	1.7	1.2	1.7	0.4	0.3	0.3	0.16	0.35	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Unemployment Rate (%)	8.7	7.8	7.2	6.8	8.0	7.8	7.7	7.6	7.3	**7.2**	**7.0**	**6.9**	**6.9**	**6.8**
US Key Interest Rates (end of period)														
Fed Funds Rate	0.25	0.25	0.25	0.3	0.3	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	1.7	1.72	1.96	2.30	2.61	**2.50**	**3.00**	**2.75**	**2.75**	**2.90**

Source: NAB Group Economics

*Contribution to real GDP

** History are quarterly averages, projections are end quarter

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