16 January 2014

United States Economic Update

- **Recent partial indicators of economic activity have been positive. With inventories also tracking more strongly than expected, December quarter GDP growth is now estimated to be 0.7% qoq (3.0% annualised).**
- **We are forecasting GDP growth of 1.9% in 2013 (previously 1.7%) and 2.8% (previously 2.6%) in 2014. Growth in 2014 will be helped by the fading headwind from fiscal policy. Conditions remain conducive for business investment and for residential investment to grow strongly again in 2014.**
- **Fed tapering of its QE program is likely to continue through 2014, with the program ending around the December quarter. However, no change in the fed funds rate is expected until well into 2015.**

Recent partial indicators of economic activity for the United States have generally been positive with solid, if not strong, readings for total consumption, business investment, and exports. This is a positive for December quarter GDP, for which the advance estimate will be released at the end of the month. Moreover, while still not expected to match the very strong September quarter pace, inventory accumulation has been greater than we expected so far during the quarter. As a result we have revised up our forecast of December quarter GDP, and we now expect growth of 0.7% qoq (3.0% annualised rate). While this would be a slower growth rate than in the September quarter, if the contribution from inventories is excluded – which gives a better guide to the underlying strength of demand – such a result would indicate that the economy strengthened at the end of 2013.

To some extent this strength is expected to be temporary; December retail sales data suggest consumption growth moderated in December, and net exports are unlikely to be as strong in following quarters. Extreme weather may also lead to a temporary slowdown in some indicators. Our forecasts also now factor in a slower return to a more normal level of inventory accumulation, which means that stocks will detract from growth in 2014.

Nevertheless, annual average growth in 2014 is expected to be stronger than in 2013. One factor behind this is that the headwind from fiscal policy is becoming more muted and fiscal policy uncertainty has fallen (although the debt ceiling remains a risk).

With household wealth continuing to trend up, employment growing, and banks gradually easing lending standards, consumption growth should be solid, although it will be constrained by modest wages growth. High and growing profits, coupled with banks also easing lending standards for business loans, should lead to stronger business investment growth. There are signs that the slowdown in the housing recovery may have ended, and with the level of home construction and new home inventories low by historical standards, residential housing investment is expected to grow strongly over the next few years. Exports should be also be supported by improving global economic conditions, although we expect appreciation of the dollar to be a constraint.

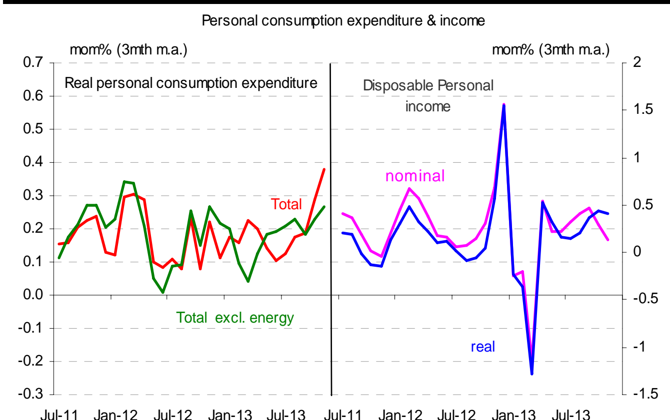
The Fed announced a slowing in its asset purchase (or QE) program at its December meeting and this process is likely to continue through much of 2014, with the program likely to end by the December quarter 2014 assuming that our economic projections hold-up. While the Fed's unemployment rate threshold is almost within touching distance after a large decline in the unemployment rate in December, any increases in the fed funds rate appears a long way off, as the Federal Reserve is downplaying the importance of the unemployment threshold. As a result, we are sticking with our call that the first increase in the Fed funds rate will not be until the September quarter 2015, although the risk is probably that it will happen sooner.

Overall, we are forecasting GDP growth of 1.9% in 2013 (previously 1.7%) and 2.8% (previously 2.6%) in 2014. The upwards revisions reflect the stronger recent partial indicators as well as the upwards revision to September quarter GDP.

Consumption

Consumption growth was strong in October and November, although retail sales growth moderated in December largely due to a decline in motor vehicle sales.

Strong consumption growth in recent months



Source: Bureau of Economic Analysis, NAB

Consumption expenditure in the December quarter – based solely on October and November - is already 0.9% higher than the September quarter. Even if unchanged after the December month data, this would represent the fastest quarterly growth rate in three years. Certainly it looks like consumption growth will slow in December as retail sales growth moderated, largely due to a decline in vehicle sales. A factor boosting November's consumption growth was energy

consumption; however, with colder than normal conditions in December and particularly early January's polar vortex, this factor may persist for a little while (although extreme weather can negatively affect other consumption categories).

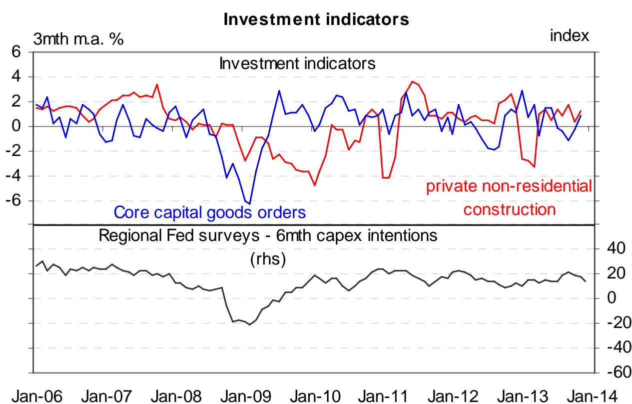
For 2014, while annual wages growth appears stuck at around the 2%, this represents a real increase in purchasing power given the current slow pace of inflation. Moreover, employment growth is boosting total household income. Wealth is also continuing to rise (driven by house price and stock market gains) which should provide support to consumption, particularly given the improvement in household balance sheets in recent years. Consistent with this, the savings ratio, which dropped in January 2013 due to tax increases and then was gradually rebuilt over much of 2013, fell over October and November.

Business investment

While partial indicators of business investment have been mixed for a while we have stuck with our call for stronger growth in business investment and in November there were signs that this is starting to occur.

Core capital goods orders and shipments both rose strongly in November more than reversing declines over the previous two months, while private non-residential construction expenditure is still trending up. Moreover, the level of core capital goods orders remains above that of shipments again consistent with further shipment growth ahead.

Investment indicators improving…but intentions softening?



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

Our view is that high (and growing) corporate profits and easing credit conditions are consistent with stronger business investment growth in 2014, particularly given that some of the uncertainties that might have sapped business confidence in the past, such as fiscal policy uncertainty, are receding. However, at least for the manufacturing sector, the regional federal reserve surveys of capex intentions, which have fallen back over the last couple of months, suggest that there is a risk that business investment will remain subdued. Moreover, business investment towards the end of 2013 may have been boosted (at the expense of growth early in 2014) by the end of a depreciation tax-break.

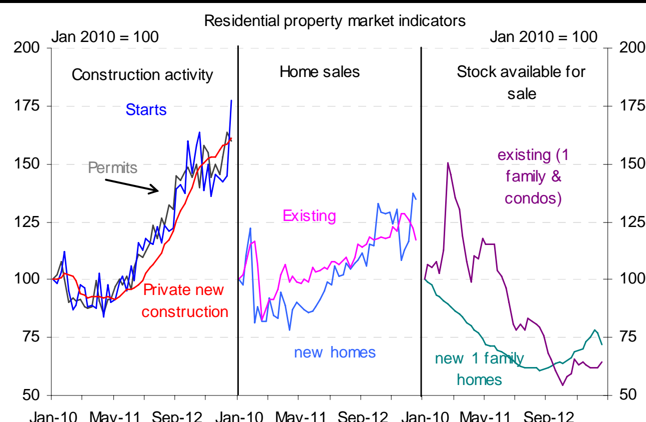
Housing

There are signs that the slowdown in housing construction activity has bottomed out, although extreme winter weather may cause some disruptions and home sales have recorded further declines.

While building permits fell 2% in November this was only a small correction to the 12% growth over the previous two months. More starkly, housing starts jumped almost 23% mom in November, more than reversing the decline that occurred between March and October. Private new construction expenditure again grew in November, and while the growth rate is still below the levels of earlier in the year, it has stabilised in recent months. There were cold snaps experienced in parts of the United States in early December, and even more so in early January 2014, which may delay construction, but this will be temporary (and lead to a rebound when weather conditions become more normal).

New home sales also held onto most of their October surge, and the improvement in the December National Association of Home Builders Housing Market index suggests that sales may rise even further. However, existing home sales recorded their third consecutive monthly decline in November, although the first increase in pending home sales in November in six months points to sales stabilising in early 2014. Nevertheless, the extent of the fall in existing home sales in the December quarter suggests that the rapid growth in residential investment recorded in the GDP accounts will, temporarily, be reversed in the December quarter.

Signs that housing construction growth may be picking up



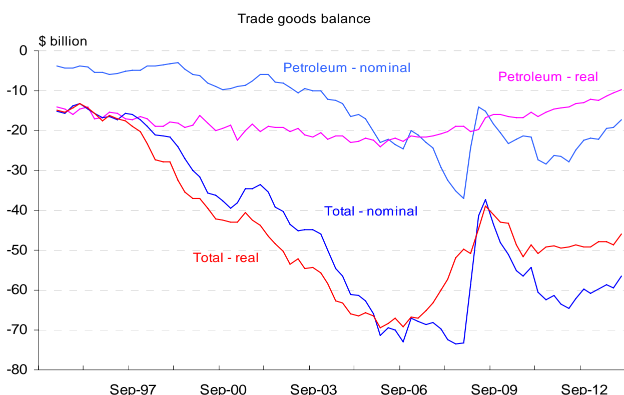
Sources: Census Bureau, NAB

Over 2014, however, we still expect strong growth, as the level of construction activity remains low by historical standards, as are available inventory. A downside risk is from the rise in interest rates in recent weeks (largely reversing the declines over September and October) and the possibility that this will keep buyers on the sidelines. However, rates are still low by historical standards and we don't expect any significant further increases this year, so this factor is unlikely to derail the housing market.

Trade

After strong growth in October, real goods exports rose again in October; so far the December quarter monthly average is up 3% on the previous quarter which (if maintained) would be the strongest quarterly growth rate since early 2010. At the same time real goods imports declined in both October and November, resulting in a large improvement in the trade balance. This raises the possibility of a substantial contribution to GDP growth from net exports in the December quarter, although the weakness in imports looks exaggerated relative to the ISM indicators, and given the underlying improvement in the U.S. economy and appreciation of the dollar.

Trade balance improvement driven by energy sector



Sources: Census Bureau, NAB

Nevertheless, while possibly over-stated, the resulting improvement in the trade balance is broadly consistent with the pattern since 2011/2012 both in real (2009 prices) and nominal terms. As the chart above shows, an important factor has been the energy boom in the U.S., with the improvement in the trade balance more than accounted for by an improvement in the petroleum trade balance.

Labour market

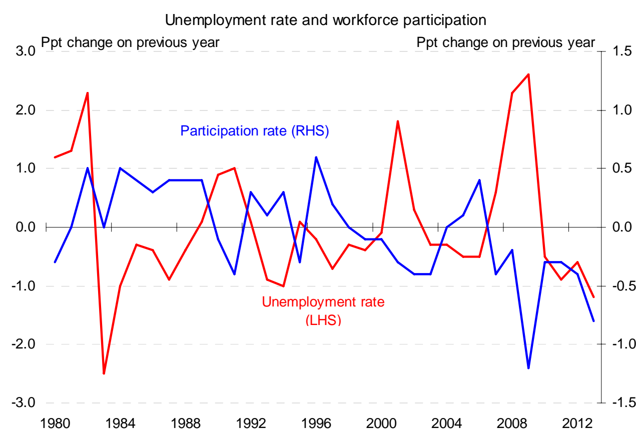
On the face of it the large decline in the unemployment rate of 0.3 percentage points to 6.7% in the December employment report should be a cause for celebration. However, with non-farm jobs growth of only 74,000 and a fall in the workforce participation rate driving the unemployment rate decline, it has been more widely regarded as a poor result. Indeed, the broader U-6 measure of unemployment (which includes discouraged workers and part-timers wanting a full-time job) was unchanged although it held onto its large November gain.

At least for the jobs data, the explanation is likely to be a combination of extreme winter weather (there was a large increase in the number of people who could not work for weather-related reasons) and the normal statistical volatility. Indeed the increase in non-farm jobs over the December quarter was a little higher than in the previous quarter.

The main issue continues to be the decline in the participation rate which fell 0.8 percentage points over 2013; the largest fall in a calendar year since the 1970s with the exception of 2009. The fall in 2009 was during a severe recession. Historically the unemployment rate and participation rate have tended to move in opposite directions, with a stronger economy encouraging not only more jobs but also workforce participation.

One factor that might change the relationship is demographics. Over the 1970s through the 1990s the workforce participation rate trended up but since then it has been trending down due to population ageing as well as other factors. The question then is whether these factors are strong enough to produce falls in the participation rate of the magnitude we have seen while the economy is growing. Studies that have made longer-term projections of workforce participation suggest not, as they project annual reductions in the participation rate of only 0.1 to 0.2 ppts.[1] One explanation is that baby boomers delayed retirement post the recession as they rebuilt their wealth. Another partial factor may be the ever present statistical volatility; the household survey civilian employment measure (used in the unemployment rate calculation) has only risen by 1.0% yoy to December compared to 1.6% for the non-farm employment report which is considered to be the more reliable indicator.

Size of workforce participation rate decline a surprise



Sources: Bureau of Labor Statistics, NAB.

Our forecasts have assumed that the participation rate would stabilise for a period of time as the recovery led to a return of discouraged workers which would offset the underlying downwards trend. Indeed, the employment report's measures of discouraged workers suggest that they have declined over the last twelve months (although there was an increase in December) so the decline in the participation rate has occurred despite this.

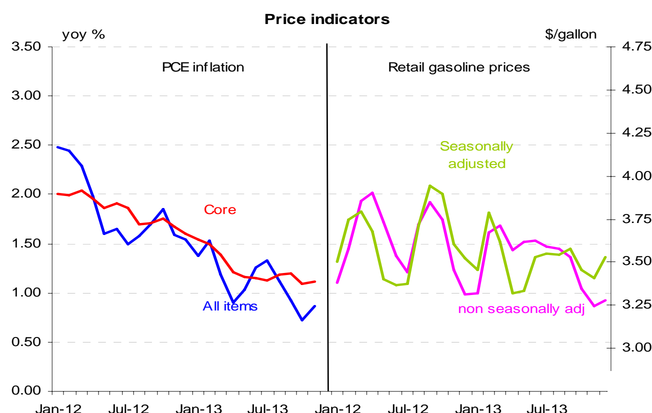
Given the magnitude of the recent decline in the participation rate we are still assuming that it will stabilise at least over the first half of 2014 before resuming a modest downward trend. However, as we are working from a lower base, the point at which the unemployment rate moves below the Fed's unemployment threshold has been brought forward to mid-2014. If the participation rate continues to decline in line with recent experience it could be even sooner. Moreover, at this stage it is still unclear whether extended (emergency) unemployment benefits – which formally expired at the end of 2013 – will be renewed by Congress. If these programs lapse this may lead to a further drop in the participation, and therefore the unemployment, rate.

Inflation

Annual inflation remains subdued, and while the core (ex energy and food) measure appears to have bottomed out, it is still below the 2% level the Fed would like to see. With wage increases tracking along at around 2% a year (as they have for several years now), excess capacity in the economy (but declining), and inflation expectations within historical bounds we expect core inflation will start to move back closer to target through 2014, but remain below the Fed's target until 2015. More immediately, headline inflation for the December month will likely spike-up due to a rise in gasoline prices. But this looks to be a one-off; as gasoline prices, if anything, moderated in early January (on a seasonally adjusted basis).

[1] See Toossi M., Projections of the labor force to 2050: a visual essay, Monthly Labor Review, October 2012 and Bureau of Labor Statistics, 2012—22 Employment Projections, http://www.bls.gov/emp/#publications

Core inflation appears to have bottomed-out

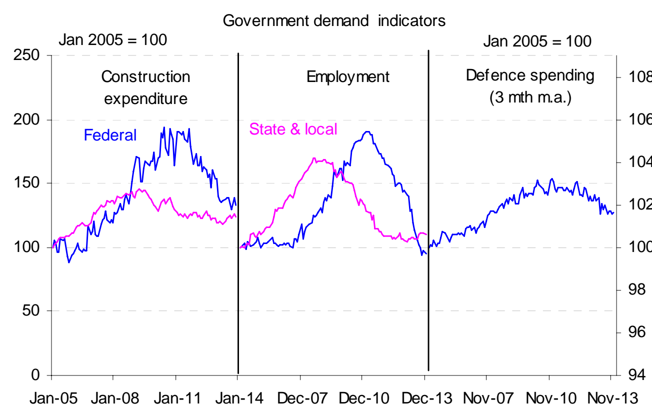


Source: Bureau of Economic Analysis, Energy Information Administration, NAB

Fiscal policy

The headwind from fiscal policy looks set to fade in 2014. At the federal level fiscal policy will remain contractionary – as the chart shows at the end of 2013 Federal employment and defence spending were still falling – although construction spending appears to have stabilised. There has also been talk of re-instating extended unemployment benefits which lapsed at the end of last year; it is hard to get a read on how likely this is to occur but if it were to eventuate it would probably represent a slight fiscal relaxation in 2014 as some of the 'savings' to pay for the extension may not take effect until well down the track. State and local government demand, after a long period of decline is also slowly expanding again.

Government demand – still weak but some improvement



Source: Census Bureau, Bureau of Labor Statistics, US Treasury

While the budget deal did not formally fund the government past its mid-January deadline, an omnibus appropriations bill to do so is expected to be passed shortly, with a short-term arrangement to keep the government going in the interim.

Looking more politically contentious is the debt limit. This will be formally reached on 7 February but the U.S. Treasury will be able to take measures to extend the practical deadline to sometime between March and early June 2014 (according to the CBO). While there may be a lot of noise in the lead up, we expect that it will be increased in-time.

Monetary Policy

The Fed announced after its December meeting that the size of its asset purchase program (known as quantitative easing or QE) will be reduced starting in January (so-called 'tapering'). The size of the QE program was reduced by $10 billion a month to $85 billion.

In his post-meeting press conference, the Fed Chairman intimated that future meetings would likely see reductions in the size of the asset purchases of a similar magnitude, assuming that the economy grows in-line with their forecast. If this were to eventuate, it would mean that the program would likely end around the December quarter 2014.

It is possible that the weak jobs growth number in the December employment report may lead the Fed to pause tapering at its January meeting. However, for reasons already discussed, the weak jobs number is more likely to be seen as an outlier and with the recent strength of partial indicators of activity a further reduction in the QE program is likely to be announced following the January meeting.

Future action on the Fed funds rate is conditional on various thresholds being met – in particular an unemployment rate of 6.5% or lower, inflation above 2.5% or inflation expectations moving outside their normal bounds. As we noted earlier, the unemployment threshold is likely to be reached this year; potentially very soon if the participation rate continues to fall but we think more likely around mid-year. Even when this threshold is breached immediate policy action is unlikely. Indeed in the December meeting statement the Fed added the following words:

> "The Committee now anticipates, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal."

While this is a very weak forward commitment at the very least it shows the Fed's current mindset, which is to down play the importance of the unemployment rate. There has been discussion of the possibility of the Fed moving its unemployment threshold downwards but Fed meeting minutes suggest this is unlikely right now. Apart from anything, the Fed would find it difficult to agree by how much to change the threshold given the uncertainty around how a good measure of the state of the labour market the unemployment rate is.

In this context, signs of inflation returning to 2% and higher, particularly if coupled with higher wages growth (which would suggest a tightening in labour market conditions) could trigger Fed action. There are no signs of this in the data yet, so at this stage we are leaving our call for the first tightening of the Fed funds rate to be in the September quarter 2015. But with 'forward guidance' not really providing much guidance now (and once the unemployment threshold is passed it will no longer be a bar to Fed tightening), and the economic recovery consolidating, the risk is probably weighted towards an earlier start to fed funds rate tightening.

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US Economic & Financial Forecasts

	Year Average Chng %					Quarterly Chng %							
						2013				2014			
	2011	2012	2013	2014	2015	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components													
Household Consumption	2.5	2.2	2.0	2.6	2.6	0.6	0.5	0.5	**0.9**	**0.6**	**0.6**	**0.6**	**0.7**
Private fixed investment	6.2	8.3	4.6	7.2	7.7	-0.4	1.6	1.4	**1.2**	**1.8**	**2.2**	**2.1**	**2.1**
Government Spending	-3.2	-1.0	-2.1	-0.5	0.3	-1.1	-0.1	0.1	**-0.7**	**0.2**	**-0.1**	**-0.1**	**0.0**
Inventories*	-0.2	0.2	0.1	-0.1	-0.1	0.2	0.1	0.4	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**
Net Exports*	0.1	0.1	0.1	0.1	0.0	-0.1	0.0	0.0	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.8**	**2.8**	**1.9**	**2.8**	**2.9**	**0.3**	**0.6**	**1.0**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)													
PCE deflator-headline		(yoy%)											
Headline	2.6	1.7	0.9	1.5	1.9	0.3	0.0	0.5	**0.2**	**0.3**	**0.3**	**0.4**	**0.4**
Core	1.8	1.7	1.1	1.6	2.0	0.3	0.2	0.3	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Unemployment Rate - qtly average (%)	8.6	7.8	7.0	6.3	5.8	7.7	7.5	7.2	7.0	**6.7**	**6.5**	**6.4**	**6.3**
US Key Interest Rates (end of period)													
Fed Funds Rate	0.25	0.25	0.25	0.25	1.00	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**
10-year Bond Rate	1.88	1.76	3.03	3.00	4.00	1.85	2.49	2.61	3.03	**3.00**	**2.75**	**2.75**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP

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