13 February 2014

United States Economic Update

- **Economy still on track despite fall in manufacturing ISM and another weak jobs report. Following GDP growth of 1.9% in 2013 we are forecasting GDP will grow by 2.8% in 2014 and 2.9% in 2015.**
- **Inflation remains well below Fed's 2% objective, but does not appear unusually low given the still large amount of spare capacity in the economy. Other factors are USD appreciation and subdued inflation in other countries which have contributed to declines in import prices and this has been reflected in domestic goods prices.**
- **Inflation should move back towards target over time, but it will likely be a slow process.**
- **Fed tapering of its QE program is likely to continue through 2014, with the program ending around the December quarter. No change in the fed funds rate is expected until well into 2015.**

Economic Overview

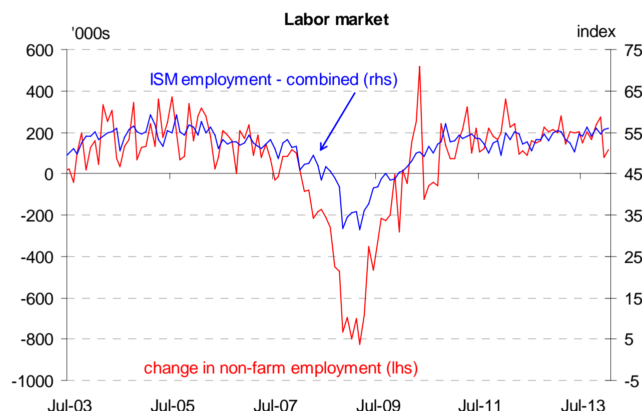
Towards the end of January, when the advance GDP estimate for the December quarter was released, the mood seemed to be one of general optimism. GDP grew at an annualised rate of 3.2% and growth over the second half of 2013 was the fastest half-yearly growth rate in almost two years. Even after excluding inventory accumulation, the picture was of an economy that strengthened over 2013.

However, since then some doubts have crept in. These have been driven by declines in U.S. equity prices and pressures on some emerging economies including confirmation that the Chinese economic growth was slowing down. There was also a big fall in the ISM manufacturing index, and the January jobs report was well below expectations.

The fall in the ISM was widely attributed (at least in part) to the poor weather in January (including a 'polar vortex' early in the month). However, historically the manufacturing ISM has been little affected by bad weather. More likely factors were issues with seasonal adjustment and a slowdown in manufacturing growth as manufacturers adjust inventory levels. The manufacturing ISM is still above 50 indicating the sector continues to grow. This is also the story shown by separate Markit manufacturing PMI. Moreover, the non-manufacturing ISM index, which covers more of the economy, recorded a small rise in January and our composite ISM measure (based on manufacturing/non-manufacturing share of GDP) is at a level consistent with moderate growth.

Weather conditions do not seem to be a factor in the second month of weak non-farm employment growth in January (although it probably was a factor in December). Non-farm employment increased by only 113,000 in January after 75,000 the previous month, but we think that the broader story of an improving labour market is still intact. The slowdown in employment is not matched by other indicators such as from business surveys (see chart below) or initial jobless claims.

Non-farm jobs weakness not matched by other indicators



Sources: Bureau of Labor Statistics, ISM, NAB. ISM manufacturing/non-manufacturing surveys weighted by six-monthly moving average of manufacturing/non-manufacturing employment shares.

We have been cautioning for a while not to place too much emphasis on the ups and downs of the employment data – the weakness in December and January follows two very strong months (average gains of 256,000 in October and November). The annual growth rate is still within the 1.5% to 1.9% range it has been for over two years. Moreover, the unemployment rate again fell in January (to 6.6%) and this time the fall was not due to a decline in the participation rate.

We expect GDP growth in the March quarter to show some further deceleration. This in large part reflects an expected slower pace of inventory accumulation which will likely be a drag on growth in 2014. Consumption growth is also expected to step back a bit from the strong level recorded in the December quarter. Motor vehicle sales for January were below their December quarter average (possibly partly weather related). Nevertheless, with household wealth trending up, employment growing, and banks gradually easing lending standards, the trend in consumption growth should be solid.

Signals for housing investment in the short-term are quite mixed and it is possible that severe weather conditions may delay construction. We are currently factoring in a resumption of residential investment growth in the March quarter, but still expect it to be down on the growth rates seen over recent years. However, mortgage rates, after rising rapidly between May and August, have since broadly stabilised. When households' adjustment to the higher level is complete we expect housing investment to resume its rapid growth. The level of residential investment is still very low as is the inventory of homes available for sale. Moreover, by historical standards mortgage rates are also still relatively low; although the most recent Senior Loan Officer Survey suggested that

the tentative easing in home loan lending standards has paused.

High and growing profits, coupled with banks also easing lending standards for business loans, should lead to stronger business investment growth. Regional Federal Reserve surveys of capex intentions were higher in the second half of last year than the first and picked up noticeably in January, which is a positive sign. A short-term risk is that the winding up of tax breaks may have boosted end 2013 investment and there may be a correction in early 2014.

Exports should be supported by improving global economic conditions, although we expect further appreciation of the dollar to constrain net export performance.

Federal fiscal policy will continue to be contractionary, but not to the same extent as in 2013. In the March quarter itself public demand should bounce back after being held back in the December quarter by the Government shutdown. Fiscal policy uncertainty has also reduced with spending bills passed for this financial year and the debt ceiling suspended until March 2015.

Taking all these factors into account, after growth of 1.9% in 2013 we expect GDP to grow by 2.8% in 2014 and 2.9% in 2015.

The Fed in its January meeting continued the process of reducing its asset purchase (QE) program and this is likely to continue through much of 2014, with the program expected to end by the December quarter 2014. The Fed's unemployment rate threshold is close to being reached after a large decline in the unemployment rate in December. This would mean that its forward guidance thresholds would no longer be a constraint on the Fed. However, any change in the fed funds rate appears a long way off, and we expect that the first increase in the Fed funds rate will be in the September quarter 2015.

Inflation outlook

The Fed, in its December 2013 meeting statement (when it started QE tapering) included the following addition to its forward guidance:

> *The Committee now anticipates… 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.*

With the unemployment rate threshold about to be breached, the focus will increasingly be on inflation, unless the recent weakness in non-farm employment turns out to be more persistent than expected. This is contrast to recent years. For example, the criteria for when the Fed might start winding back the 'QE' program was largely couched around the labour market (now tapering has started, inflation is also listed as a factor to be considered for future decisions).

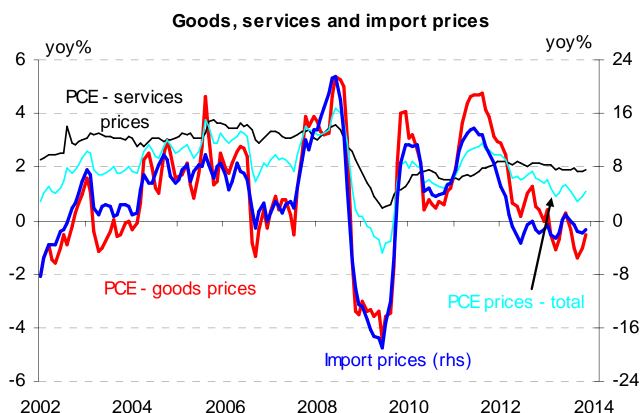
The reason for this is that while the labour market is heading towards the Fed's targets, inflation has moved away. Annual headline inflation (as measured by the Fed's preferred measure the personal consumption expenditure (PCE) price index) dropped as low as 0.9% in April 2013 and by December was only a little higher at 1.1%. Similarly core PCE inflation (which excludes energy and food prices) has been between 1.1% to 1.2% yoy since April. On any measure, therefore, inflation is well below the Fed's long-run goal of 2% annual inflation.

Moreover, the decline in inflation was unexpected. Back in December 2012, the Fed members' forecasts (based on the 'central tendency' which excludes the three highest and lowest projections) were 2.3% to 3.0% for GDP over 2013 and 7.4% to 7.7% for the unemployment rate and 1.3 to 2.0% by the end of the same year. Therefore the Fed got it right for GDP (which was 2.7% yoy in the December quarter) and under-predicted the fall in the unemployment rate. With the economy growing as expected and the labour market tightening more quickly than projected this should have meant higher than expected inflation not lower as it has turned out to be.

This has prompted the head of the St Louis Federal Reserve to state that "There is no generally accepted explanation for the low inflation readings."[1] Ironically, the concern about persistent low inflation is happening at the same time as research papers are still being written about why inflation stayed so high following the great recession.[2]

One reason for the current low inflation is downwards pressure from import prices. As the chart below shows, while services inflation has declined a little since mid-2012, the decline in PCE inflation has been driven by trends in goods prices. Partly this is an energy story, with energy goods prices falling over the last year. But other goods prices have also declined; over the last year non-energy goods prices grew by 1.1%, around half the rate of two years ago. The slowdown in goods inflation has mirrored a similar slowdown in imported inflation. The latter reflects several factors. The exchange rate has appreciated by around 9% (trade weighted basis) since mid-2011. Further, inflation in many other countries has decelerated.

Domestic goods prices and import prices have similar trends



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

As we will discuss further below, one common explanation of inflation is that it is influenced by the amount of slack in the economy. If there is full employment and all capacity is being utilised then inflation is likely to be high. In contrast if there is high unemployment and idle equipment then price (including wage) inflation will be subdued. For goods prices compared to

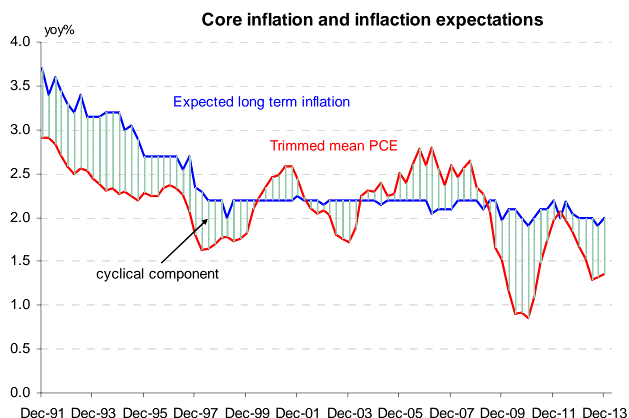
[1] Bullard J., Ghosts of Forecasts Past and Future, Indiana Bankers Association Economic Outlook Forum Luncheon, 10 January 2014

[2] See Coibon, O., Gorodnichenko Y., Is the Phillips Curve Alive and Well After All? Inflation Expectations and the Missing Disinflation, September 2013; and Watson M., Inflation Persistence, the NAIRU, and the Great Recession, January 2014 (http://www.princeton.edu/~mwatson/wp.html)

service prices, as they are more heavily traded, the relevant measure of slack will have a greater international component. Of course, the transmission of tradeable goods prices to the US economy is in part determined by movements in the USD, which is affected both by factors at home and abroad, including monetary policy settings. So it is too simple to say that the slowdown in US inflation is just an externally driven (import price) story, although this appears likely to be part of it.

An interesting way of analysing inflation was presented by the Dallas Federal Reserve in an Economic Letter in 2012.[3] Their approach was based on the idea that not only does economic slack influence inflation but that inflation expectations pay a central role in the level of inflation over time. This leads to the core inflation rate fluctuating around long-run expectations of inflation. This can be seen in the chart below which compares their preferred core inflation measure – trimmed PCE inflation which excludes goods and services with the highest and lowest price increases – against the 10 year inflation expectations of professional forecasters as reported in the Philadelphia Fed's quarterly survey.[4]

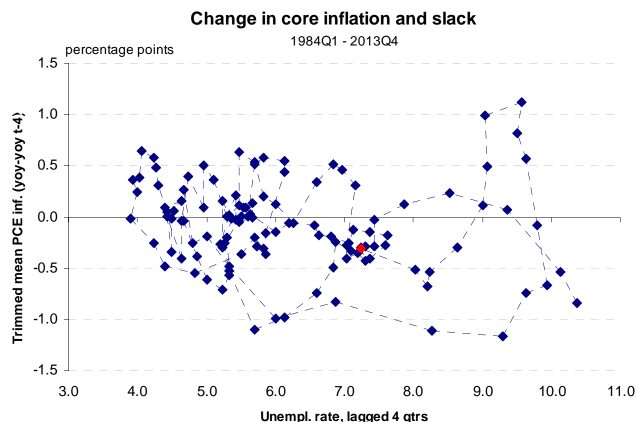
Core inflation fluctuates around inflation expectations



Sources: Dallas Federal Reserve, Philadelphia Federal Reserve, Bureau of Labor Statistics, NAB

Accepting that longer-run inflation is set by inflation expectations (which need to be matched by an appropriate monetary policy over time as well) then you would not expect to see a clear relationship between inflation and slack. Nor are changes in the inflation rate clearly linked to slack. Plotting the change in trimmed mean inflation against the unemployment rate does not show a clear relationship. This is also true of what the Dallas Fed calls 'transitory' inflation – which are those items excluded in estimating the trimmed mean (and which would often include energy prices which tend to be volatile).

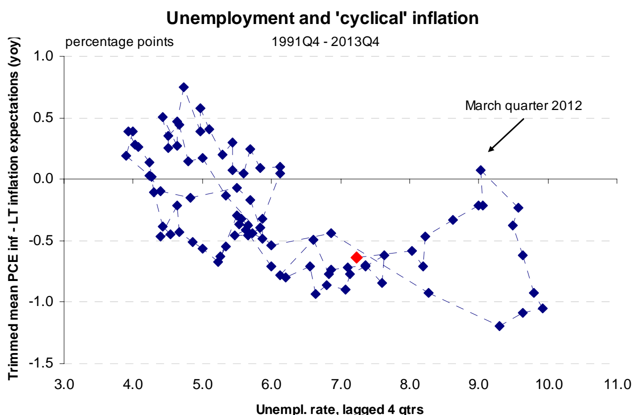
No clear link between inflation change and economic slack



Sources: Dallas Federal Reserve, Bureau of Labor Statistics, NAB

However, there is a clearer relationship between slack in the economy and deviations in core (trimmed mean) inflation from its long-run trend, what the Dallas Fed calls the 'cyclical' component of inflation. As the chart below shows, there appears to be a negative relationship between slack and 'cyclical' inflation. That is, the greater is unemployment (or slack) the lower cyclical inflation is likely to be. The red dot in the chart is the latest observation (December quarter 2013), and it does not appear to be out of line with past experience. Rather the clear outlier is the March 2012 observation which sits above the x-axis even though (lagged) unemployment is very high. Therefore, it is not so much that inflation now is unusually low, it is more that inflation was unusually strong in late 2011 and much of 2012 given the large amount of spare capacity at the time.

'Cyclical' inflation does not appear unusually low



Sources: Dallas Federal Reserve, Philadelphia Federal Reserve, Bureau of Labor Statistics, NAB

This analysis suggests that as the economy continues its recovery from the recession, and the output gap shrinks further, then we would expect that inflation will start to rise back towards the Fed's longer-term target of 2% annual inflation. Reinforcing this, the global economy is expected to grow more strongly this year which should put some pressure on international goods prices.

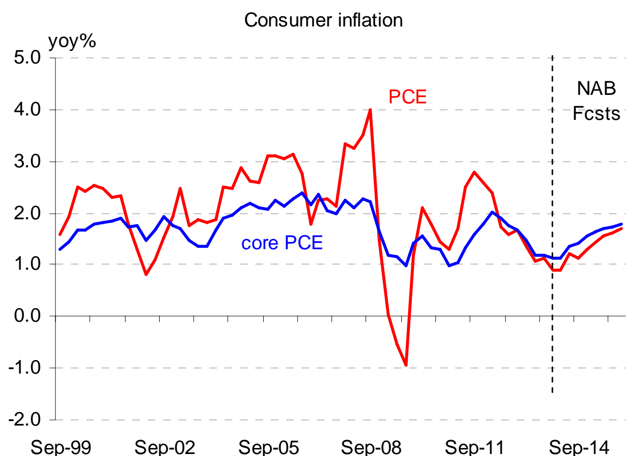
With a forecasting model based on a framework similar to that outlined above (which includes inflation expectations, an output gap measure, import, oil and food prices as explanatory variables) we expect this to occur, albeit slowly. This is partly due to our expectation for continued USD

[3] Atkinson T., Koenig E., High Unemployment points to below-target (but still stable) inflation, Vol.7, No. 12, October 2012

[4] A long history of 10 year expectations is only available for CPI inflation. As CPI tends to grow faster than PCE prices, we have deducted 0.3ppts from the Survey responses, consistent with the Dallas Fed approach.

appreciation as QE tapering proceeds, the economy establishes itself on a firmer footing and as the prospect of a rise in the fed funds rate comes into sight. Moreover, we also expect oil prices to decline from current levels over time.

Inflation to move back to target…slowly

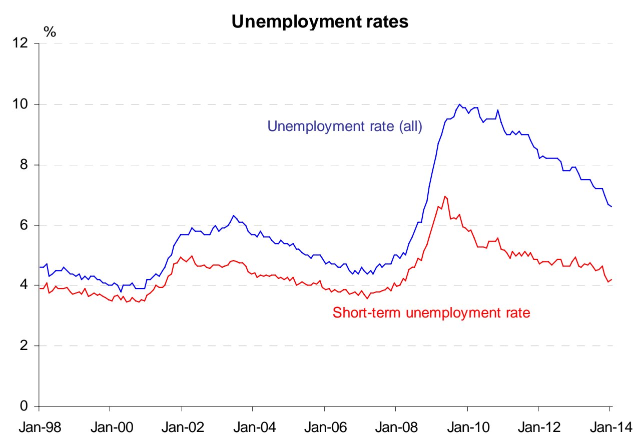


Sources: Bureau of Economic Analysis, NAB. Data are on a quarterly basis.

There are risks around these forecasts, however, both upside and downside. On the downside, signs of a strengthening in inflation are yet to emerge, and exactly by how much inflation expectations will anchor inflation is subject to uncertainty. This is particularly so in an environment where inflation has been below target for an extended period. This also raises the risk that inflation expectations will move down.

Another factor that has been getting some attention is what is the most relevant measure of 'slack' in the labour market. One theory is that short-term unemployment (those unemployed for less than 26 weeks as a share of the workforce) is a more important driver of wage costs. The idea is that the long-term unemployed are so removed from the labour force (and employers reluctant to hire them) that they exert little downward pressure on wages. While the unemployment rate remains well above its pre-recession levels, it is notable that the recovery in the short-term unemployment rate is more advanced and, according to at least some estimates, is at the point where, if it were to decline further, would put upwards pressure on inflation.

Is the labour market tighter than we think?



Sources: Bureau of Labor Statistics, NAB

With the unemployment rate trending down, the Fed and others will be keeping a close eye on signs of labour market tightness and stronger wage increases. At first, signs of these pressures emerging will be seen as a positive development necessary to take inflation back to target. However, over time it could cause unease. The Fed's approach of holding interest rates lower for longer than would normally be the case, would normally lead to above target inflation and the Fed will be keen to make sure inflation and inflation expectations remain under control.

This suggests that there is some risk that the Fed will start increasing the Fed fund's rate earlier than we think (September quarter 2015). However, if this is the case, it is unlikely to be much earlier. The Fed appears comfortable with a slow winding down of its QE program, and at the current pace this won't happen until towards the end of 2014 (and a delay – e.g. if the employment report is again weak in February – seems more likely than a bring forward of this timing). The Fed in its monetary policy statements has indicated that "…a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens". What is meant by a 'considerable time' is unclear, however, it does suggest that a tightening of the fed funds rate until well into 2015 is unlikely.

If you have any queries or comments on this report please contact: antony.kelly@nab.com.au

US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %							
					2013		2014				2015	
	2012	2013	2014	2015	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components												
Household consumption	2.2	2.0	2.6	2.6	0.5	0.8	**0.7**	**0.6**	**0.6**	**0.7**	**0.6**	**0.7**
Private fixed investment	8.3	4.3	6.2	7.6	1.4	0.2	**1.6**	**2.1**	**2.1**	**2.1**	**1.8**	**1.7**
Government spending	-1.0	-2.2	-0.4	0.3	0.1	-1.3	**0.6**	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**
Inventories*	0.2	0.2	-0.1	-0.1	0.4	0.1	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	0.1	0.1	0.3	0.0	0.0	0.3	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.8**	**1.9**	**2.8**	**2.9**	**1.0**	0.8	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)												
PCE deflator-headline	(yoy%)											
Headline	1.7	0.9	1.3	1.7	0.5	0.2	**0.3**	**0.3**	**0.4**	**0.3**	**0.4**	**0.4**
Core	1.7	1.1	1.5	1.8	0.3	0.3	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Unemployment rate - qtly average (%)	7.8	7.0	6.3	5.8	7.2	7.0	**6.6**	**6.4**	**6.3**	**6.3**	**6.2**	**6.1**
US Key Interest Rates (end of period)												
Fed funds rate	0.25	0.25	0.25	0.75	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
10-year bond rate	1.76	3.03	3.00	4.00	2.61	3.03	**2.9**	**2.8**	**2.8**	**3.0**	**3.3**	**3.5**

Source: NAB Group Economics

*Contribution to real GDP

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