United States Economic Update

National Australia Bank

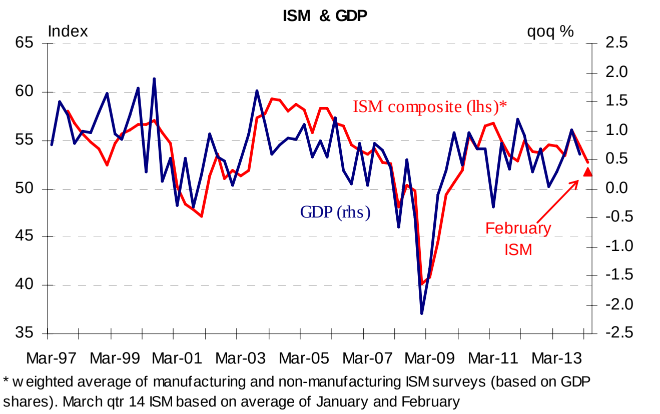
- **GDP growth is expected to decelerate modestly in the March quarter, partly reflecting the temporary impact of a severe winter.**
- **Following GDP growth of 1.9% in 2013 we are forecasting GDP will grow by 2.6% in 2014 (previously 2.8%) and 2.9% in 2015. The change to 2014 forecast primarily reflects the impact of revisions to historical data.**
- **Fed tapering of its QE program is likely to continue through 2014, with the program ending in the December quarter. No change in the fed funds rate is expected until well into 2015.**

Economic Overview

Tracking the strength of the U.S. economy has been complicated by the severe winter that has been experienced. Quite a few indicators have weakened, and while it is easy to say that is weather related, it is not possible to be sure or to quantify the extent. It is also likely that other factors are at play – we had been expecting some slowdown from the strong growth of the second half of 2013 which had been in part driven by inventory accumulation.

The softening in the data can be seen in our composite of the ISM manufacturing and non-manufacturing surveys (shown below on a quarterly basis). After a large fall in January, the manufacturing survey recovered some ground in February, however, the non-manufacturing indicator fell to its lowest level in four years and while it is still above 50 (indicating continuing growth) the net result is that the ISM composite measure is at its lowest level in quite a while.

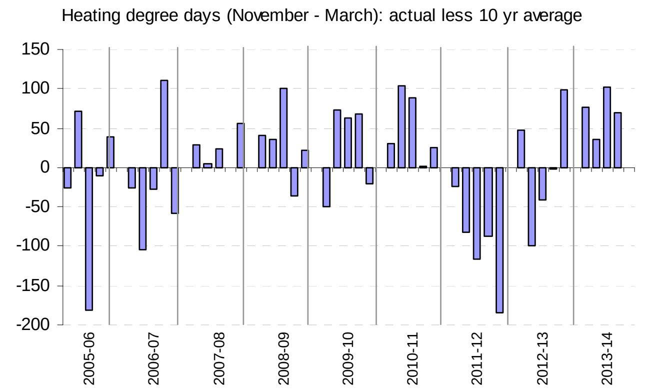
General softness in recent data reflected in ISM surveys



Sources: NAB, ISM.

The ISM is regarded as a measure which is not overly affected by weather conditions. However, comments by at least some respondents indicated that it was a factor. A feature of this winter has not been just that it has at times been severe, but that the conditions have been persistent, which may have compounded supply disruptions. This can be seen in the chart below showing heating degree days in the U.S. relative to their average over the preceding 10 years. The number of heating degree days has been well above their historical average since November. Indeed, the first week in March was also above average.

A cold and persistent winter period



Sources: United States National Weather Service, NAB

Not all partial indicators have weakened – initial jobless claims have been relatively flat on a trend basis, business investment has held up, and even housing construction continued to grow through January. Consumption growth also got off to a strong start in January; partly due to the impact of new health care arrangements but also because the cold weather boosted electricity and gas usage, a factor which tends to smooth the impact of cold weather conditions. These measures provide support for the view that the underlying strength of economic growth is still reasonable.

Nevertheless, we expect GDP growth in the March quarter to show a modest deceleration. To some extent our forecasts had already anticipated this, but the data has been softer than expected, so we have reduced our March quarter forecast to around a 2.0% annualised rate. More normal weather conditions in subsequent quarters should see some rebound in affected sectors of the economy.

Putting aside transient factors such as the weather, our view of the short-to-medium term factors that will drive the U.S. economy are largely unchanged. Household consumption will be supported by continuing employment growth as well as improved balance sheets. As the labour market recovery progresses, the modest wage growth of recent times may also start to pick-up.

Housing investment will eventually resume its strong growth of much of 2013, as 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. Looking at business investment, it will continue to be supported by strong profit levels and easing credit conditions, as well as the removal, for the time being, of some of the uncertainties that sapped business confidence in the past, such as fiscal policy uncertainty. Exports should be supported by improving global economic conditions, although an appreciating dollar will constrain net export performance.

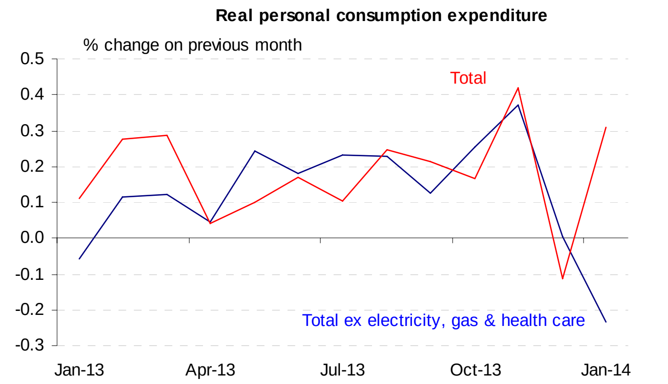
Federal fiscal policy will continue to provide a headwind, but not to the same extent as in 2013. On the monetary policy front, the current pace of QE tapering is likely to continue through 2014 (meaning an end to QE in the December quarter 2014). However, the fed funds rate is likely to be on hold until well into 2015 (we are forecasting September quarter 2015 for the first rate hike).

Taking all these factors into account, after growth of 1.9% in 2013 we expect GDP to grow by 2.6% in 2014 (revised down from 2.8%) and 2.9% in 2015. The 2014 forecast has been revised down largely due to the BEA's revision to December quarter GDP (from an annualised growth of 3.2% to 2.4%), with the small revision to the March quarter estimate noted above largely offset by stronger growth in following quarters.

Consumption

While consumption grew strongly in January (0.3% mom) this was distorted by a surge in electricity and gas consumption as well as an increase in health care consumption due to changes in health care laws ('Obama care').

Consumption boosted by power usage and health care in Jan.

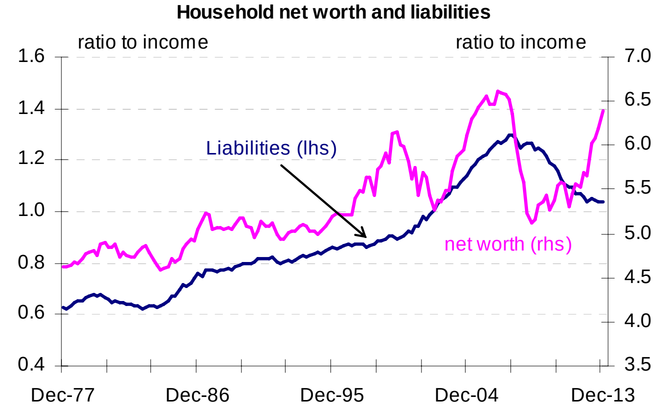


Source: Bureau of Economic Analysis, NAB

Excluding these spending categories consumption fell in January. However, this does not necessarily provide a clear insight into the underlying trend as the poor weather, while boosting power usage, would have negatively affected other consumption – it appears to have been one factor behind a decline in motor vehicle sales in December and January.

Over the rest of 2014 consumption is set to grow at a reasonable rate. While annual average wages growth remains modest it is sufficient to generate a real increase in purchasing power given the current slow pace of inflation. Employment growth will also support household budgets and as the labour market recovery progresses wages may start to strengthen. Another positive is that wealth is also continuing to rise (driven by house price and stock market gains). Indeed, as a percentage of household disposable income, net worth has almost returned to its pre-recession levels. Just looking at the liabilities side, household de-leveraging has not just stopped in absolute dollar terms, but when looked at in terms of liabilities as a proportion of income the bottom has, or is near to, being reached. While wealth may not have the same impact on consumption as it did pre-recession due to greater consumer and bank caution it is still likely to have some affect.

Net worth rising; household de-leveraging largely over

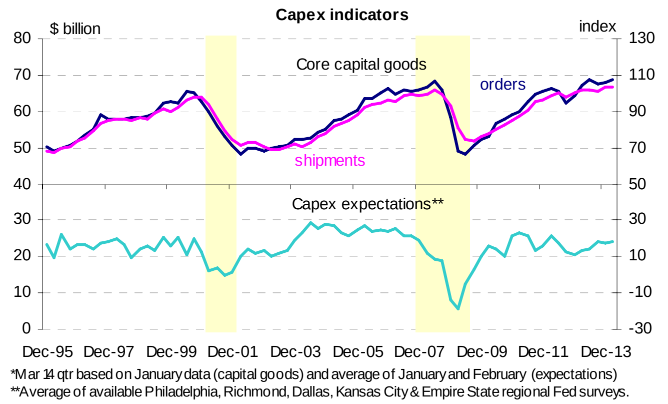


Source: Federal Reserve, NAB. Income refers to household disposable income

Business investment

Business investment appears to be growing at a steady rate. A short-term risk we have noted previously is that 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. While capital goods shipments ex transport and defence (the 'core' measure) declined a little in January, orders picked-up and both are tracking above their December quarter average. Given the volatility in these data, it is difficult to draw firm conclusions but this suggests that the impact may not be all that great. Private non-residential construction expenditure investment also recorded a small fall in January, but this followed a period of solid growth and given likely weather disruptions was not a bad result.

Investment indicators holding up



Sources: Source: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York federal reserves, NAB. Yellow bars in chart indicate recessions.

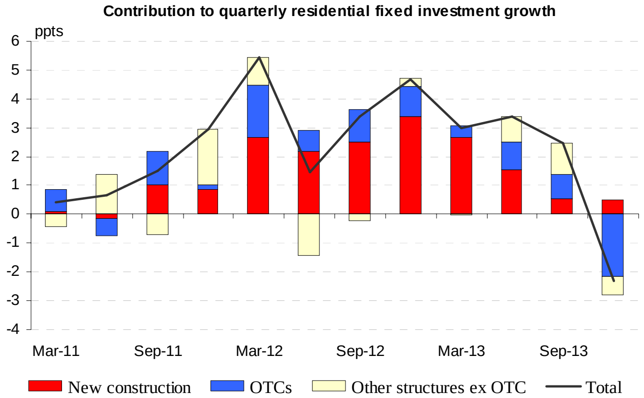
Capital goods orders in particular appear to have recovered from last year's September quarter slowdown. With the level of orders above shipments this is likely to provide some impetus to the latter (which is the measure directly relevant to GDP). However, the data do not suggest any acceleration in business investment growth from recent levels. This is also the message from the regional Federal Reserve surveys of capex intentions which improved over 2013 but have stabilised recently. That said even maintaining the December quarter growth rate of 1.8% qoq in business fixed investment would be an improvement compared to 2013 as a whole (average quarterly growth of 0.7%).

Our forecasts are based around business investment growing at around its December quarter 2013 pace over 2014. This is consistent with high corporate profits and easing credit conditions, as well as the removal, for the time being, of some of the uncertainties that might have sapped business confidence in the past, such as fiscal policy uncertainty.

Housing

Unsurprisingly the pause in the housing sector's recovery continued through the relatively extreme winter. The residential investment component of GDP in the December quarter recorded its first decline since 2010. Investment in new dwellings continued to grow (albeit more slowly) with the big change coming from a downturn in home sales – brokers commissions and other ownership transfer costs make-up around one-quarter of residential investment and existing home sales have been on a downward trend since August.

Declining sales depressing residential investment



Sources: Bureau of Economic Analysis, NAB. New construction is the 'permanent site' category'; OTCs are 'brokers' commissions and other ownership transfer costs', Other structures includes manufactured homes, dormitories and improvements. 'Residual' category is not shown in the chart.

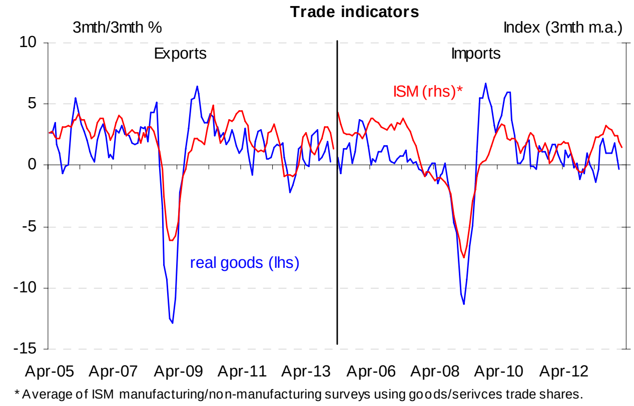
Partial indicators for the March quarter are generally only available for January. At this stage they show a similar trend – new residential construction is growing (in fact at a stronger rate than the second half of 2013) but sales are declining. It is likely that the underlying level of activity is stronger given the relatively severe winter, although other factors are also at play such as lingering effects from the mid-2013 rise in mortgage interest rates. Builders have also identified supply constraints as an issue, which is consistent with continuing growth in house prices. Looking at existing property sales, reports suggest that distressed property sales have been declining. Investors were big buyers of these properties and it is likely that the market is transitioning away from distressed to non-distressed sales. This is actually a positive as it signals the return to more normal conditions.

Over 2014 we expect strong growth in residential investment as the level of construction activity remains low by historical standards as is available inventory. Mortgage rates are still low by historical standards and as the impact of last year's rate increases fades the housing sector should strengthen.

Trade

The large decline in December real goods exports (-3.6% mom) was only partially recovered in January (+0.8% mom). At the same time, real goods imports remained subdued; while they saw their first positive growth in four months it was only +0.1% mom. On a three monthly basis, however, both imports and exports have softened. The trade data can be very volatile making it difficult to discern trends; our composite measures of the ISM surveys' export and import indicators also suggest that trade flows have moderated recently, although not to the extent indicated by the trade data.

Trade flows have moderated in recent months



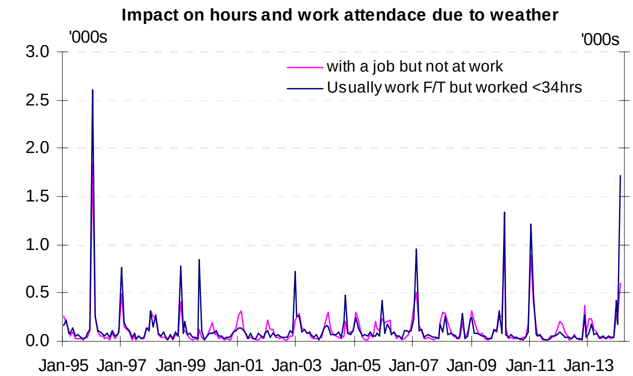
Sources: Census Bureau, NAB

These partial indicators suggest that the solid contribution to GDP growth in the December quarter from net exports is unlikely to be repeated in the current quarter. This is not unexpected given the underlying improvement in the U.S. economy over the last year and the appreciation of the dollar; but nor should net exports become a major negative – we expect an improvement in the world economy this year will assist U.S. exporters.

Labour market

After a couple of soft months, non-farm employment grew by 175,000 in February, despite another month of severe weather conditions. The weak December and January readings were also revised up a little. The severe winter weather is still probably having some affect on employment growth, although it is difficult to say by how much. The weak December/January results followed two months of strong job gains; as a result the increase in non-farm employment over the last five months is little different to the preceding five months. The bottom line is that the on-going recovery in the labour market is on-track.

Severity of winter clear in labour market indicators



Source: Bureau of Labor Statistics

The impact of the weather is easier to see in other labour market indicators. The number of people with a job who did not work due to bad weather, as well as the number of full-time employees who worked 34 hours or less due to bad weather are shown in the chart above. The data are not seasonally adjusted so both measures tend to increase in the winter months but this year has been worse than normal; indeed the measure showing the number working reduced hours is at its highest level since January 1996.

Reflecting the large number of full-time workers working reduced hours, average weekly hours worked by private non-farm workers declined further in February and is now at its lowest level in around three years. It suggests total hours worked fell in February (and the March quarter so far).

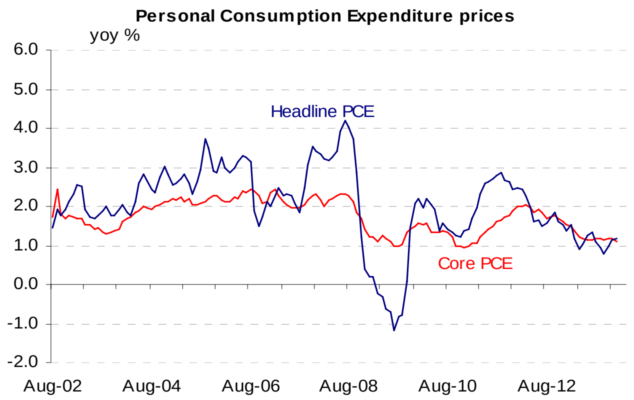
While the unemployment rate increased by 0.1 percentage point to 6.7%, given it declined by 0.6 ppts between October 2013 and January 2014 this is probably more a correction to an exaggerated decline than a sign of any major change. Moreover, the broader U-6 measure of unemployment (which includes discouraged workers and part-timers wanting a full-time job) declined. Broader measures of labour market conditions have been getting increasing attention as the Fed tries to work out how much slack there is in the economy.

This focus on alternative measures of slack has been driven by the downward trend in the labour force participation rate which raised concerns that the fall in the unemployment rate was overstating labour market improvement (as when a person stops looking for work they are no longer counted as unemployed). However, the participation rate has stabilised so far this year (and is a bit off its end 2013 lows). This is despite the expiration of extended (emergency) unemployment benefits at the end of 2013 which was expected to place downwards pressure on the participation rate.

Inflation

Annual inflation remains subdued. While the inflation rate appears to have bottomed out it is still well below the 2% level the Fed would like to see. The level of inflation is not unusually low given the still large amount of spare capacity in the economy, as well as USD appreciation and subdued inflation in other countries which have contributed to declines in import prices. We still expect inflation to gradually move back towards target over time as the amount of slack in the economy declines and given inflation expectations are still well 'anchored' (i.e. within historical norms).

Inflation remains subdued



Source: Bureau of Economic Analysis, NAB

Monetary Policy

The better than expected February employment report has dampened speculation that the Fed might pause its winding down ("tapering") of its asset purchase program ("QE"). Even before the report, several Fed speakers had made it clear that there was a high barrier for altering the current tapering. In each of the December and January meetings the Fed announced $10 billion reductions in the size of the monthly purchases (taking them down to $65 billion) and we expect similar reductions to be announced in future Fed monetary policy meetings which would mean the program will end in the December quarter 2014.

As QE comes to an end the focus will increasingly turn to the traditional tool of monetary policy –the fed funds rate. Currently the Fed's monetary policy statement includes some threshold based forward guidance: specifically that there will be no increase in the funds rate until the unemployment rate is 6.5% or lower, or projected inflation above 2.5%, or inflation expectations moving outside their normal bounds. Despite the unemployment rate threshold being close to being reached an increase in the fed funds rate in the near term is unlikely. Indeed since its December meeting statement the Fed has also stated that the current federal funds rate target will still be appropriate well past the 6.5% unemployment threshold being reached, especially if projected inflation continues to be below the Fed's 2% longer-run goal.

The Fed monetary policy statement also indicates 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". With QE not likely to end until towards the end of 2014 this suggests that a tightening of the fed funds rate until well into 2015 is unlikely (we are expecting the September quarter 2015).

As a result, the threshold based forward guidance has lost a lot of its importance. Several Fed speakers have signalled that it will be replaced by a more 'qualitative' (read more descriptive and less specific) form of forward guidance. However, the bottom line is unlikely to change – i.e. the Fed will still signal that the fed funds rate will stay at its current very low level for a while to come, but without fully committing or promising to do so.

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

US Economic & Financial Forecasts

				Quarterly Chng %							
				2013		2014				2015	
	2013	2014	2015	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components											
Household consumption	2.0	2.3	2.6	0.5	0.6	**0.5**	**0.7**	**0.6**	**0.7**	**0.6**	**0.6**
Private fixed investment	4.5	6.7	7.8	1.4	0.9	**1.3**	**2.3**	**2.2**	**2.1**	**1.9**	**1.7**
Government spending	-2.3	-0.5	0.3	0.1	-1.4	**0.6**	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**
Inventories*	0.2	-0.1	-0.1	0.4	0.0	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	0.1	0.2	0.0	0.0	0.2	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.9**	**2.6**	**2.9**	**1.0**	**0.6**	**0.5**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)											
PCE deflator-headline											
Headline	1.0	1.4	1.7	0.5	0.3	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.2	1.5	1.8	0.3	0.3	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Unemployment rate - qtly average (%)	7.0	6.3	5.8	7.2	7.0	**6.7**	**6.5**	**6.4**	**6.3**	**6.2**	**6.1**
US Key Interest Rates (end of period)											
Fed funds rate	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	3.03	3.00	4.00	2.61	3.03	**2.9**	**2.8**	**3.0**	**3.0**	**3.3**	**3.5**

Source: NAB Group Economics

*Contribution to real GDP

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics

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

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

Raiko Shareef
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

James Glenn
Senior Economist – Australia & Commodities
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+61 3 8634 0198

Karla Bulauan
Economist – Australia & Commodities
+(61 3) 8641 4028

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

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

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

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2778

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

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

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