8 April 2014

United States Economic Update

National Australia Bank

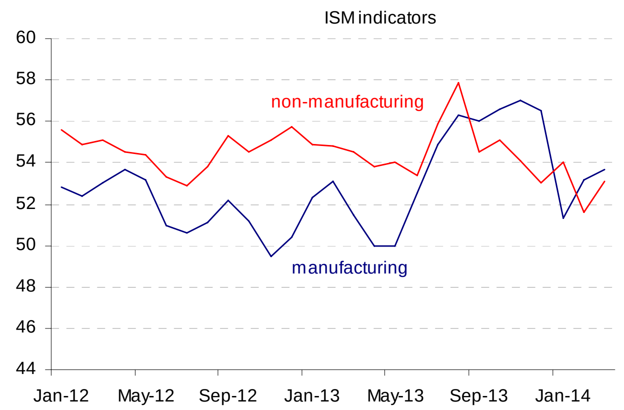
- **GDP growth is expected to decelerate in the March quarter, partly reflecting the temporary impact of a severe winter.**
- **The recovery should get back on a firmer footing over the rest of 2014. We are still expecting GDP growth of 2.6% in 2014 and 2.9% in 2015.**
- **Fed tapering of its QE program is likely to continue through 2014, with the program ending in the December quarter. No change in the fed funds rate is expected until around mid-2015.**

Economic Overview

Economic growth appears to have decelerated in the United States in the March quarter. Some of this is likely due to the harsh winter and cold start to spring, although other factors are likely to be in 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. We have revised down our forecast for the March quarter – to a 1.3% annualised growth rate (previously 1.9%) largely reflecting weak trade data for February, revisions to historical consumption data and mixed fixed investment data.

The softening in the economy can be seen in the ISM manufacturing and non-manufacturing surveys (shown below on a quarterly basis). However, consistent with the view that the slowdown reflects some temporary factors, the ISM indicators have started to strengthen in the last month or two. While they are still only at levels consistent with moderate growth, the weather was still being mentioned as a negative factor by some survey respondents in March, so there is scope for further improvement.

ISM indicators starting to move back up



Sources: ISM.

Consumption growth also strengthened in February and there was a surge in auto sales in March, consistent with activity strengthening heading into the June quarter. Labour market data have also improved over the last couple of months, with the weakness in non-farm employment growth reported in December and January short-lived.

Looking over the rest of 2014 and into 2015, our view of the factors that will drive the U.S. economy is 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 - the level of residential investment is still very low, as is the inventory of new homes available for sale, and there is considerable pent-up demand. Moreover, by historical standards mortgage rates are also still relatively low. Business investment 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 the overall improvement in 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 around mid-2015.

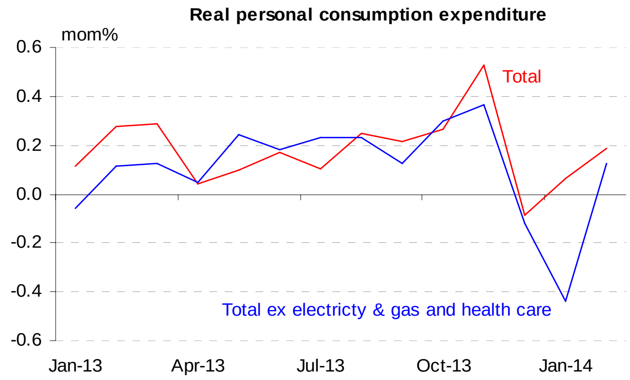
After growth of 1.9% in 2013 we expect GDP growth of 2.6% in 2014. This is unchanged from last month's estimate as the lower March quarter estimate is forecast by the upwards revision to the December quarter 2013 (2.4% to 2.6% annualised rate) and some modest expected bounce back in the June quarter. For 2015 we are expecting growth of 2.9%.

Consumption

In our update last month we noted that consumption grew strongly in January (0.3% mom); however, the BEA has now revised the estimate and now indicates that consumption was quite weak (0.06% mom) notwithstanding a strong boost from utility and health care consumption due to the poor weather and changes in health care laws respectively.

Excluding these spending categories, consumption fell in January, probably in part reflecting the impact of the extreme winter in parts of the country. February data, however, show some improvement and auto sales, after falling in December and January, and only recovering a little bit of lost ground in February, rebounded strongly in March (up by almost 7% mom).

Consumption weak recently but signs of recovery



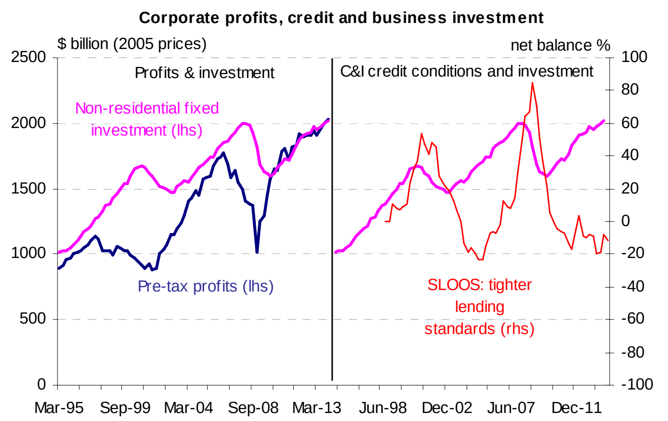
Source: Bureau of Economic Analysis, NAB

Over the rest of 2014 consumption is set to grow at a reasonable rate. Annual average wages growth remains modest but with subdued inflation real wages are rising. As the labour market recovery continues wage growth may also strengthen. Coupled with solid employment growth this is a positive for household budgets. Many households are also seeing stronger balance sheets on the back of increasing equity and house prices. As a percentage of household disposable income net worth has almost returned to its (relatively high) pre-recession levels. 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.

Business investment

February business investment partial indicators were mixed – capital goods shipments ex transport and defence (the 'core' measure) rose a little and orders fell and both are tracking around their December quarter average. On a more positive note, however, private non-residential construction expenditure – which might have been negatively impacted by the extreme weather - rose 1.2% mom and the recent trend has been quite solid. The average of Fed regional manufacturing survey capex indicators also strengthened a little in March. Apart from possible weather impacts, another temporary factor may be the end of investment related tax breaks at the end of 2013, which may have pulled some investment out of 2014 and into 2013, although it is difficult to discern this clearly in the aggregate data.

Rising profits & easing credit standards supporting investment



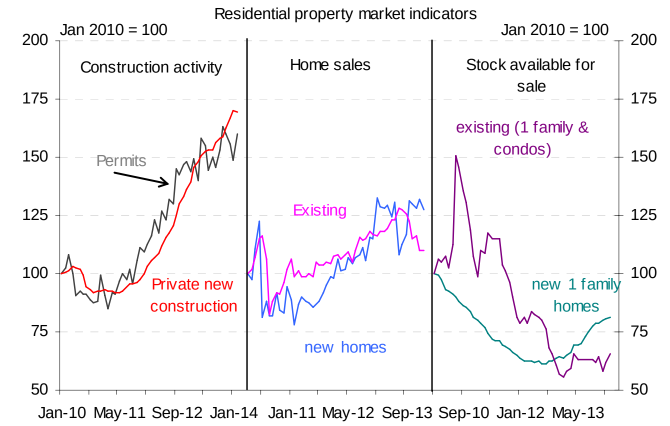
Sources: Bureau of Economic Analysis, Federal Reserve, NAB. SLOOS denotes Senior Loan Officer Opinion Survey and commercial and industrial loans lending standards data shown are for large/medium firms.

While partial indicators for the March quarter are pointing to a deceleration in business investment growth in the March quarter, looking beyond the short-term fluctuations in the data, continued growth in business investment is expected. Historically rising profits and easing lending standards are associated with increases in business investment. December quarter data show corporate profits continuing to rise – indeed the annual growth rate for pre-tax profits is now at its highest level in over a year. Moreover, some of the domestic political and policy uncertainty has fallen away (particularly fiscal policy) which should provide a more conducive environment.

Housing

The latest data show the pause in housing sector activity continuing through February. New building permits rose strongly but this came after several months of declines and it was driven entirely by the very volatile multi-family category. Behind the volatility in the numbers there still appears to a broad upwards trend in permits but it has definitely slowed down. Similarly the latest data for new residential construction expenditure fell slightly in February following several months of rapid growth.

Declining sales depressing residential investment



Sources: Census Bureau, NAB

At the same time, existing home sales continue to fall, although new home sales have held up better. Existing home inventories are very low so it may be not just an issue of subdued demand, but also one of weak supply. Continuing growth in house prices should eventually pull more supply onto the market.

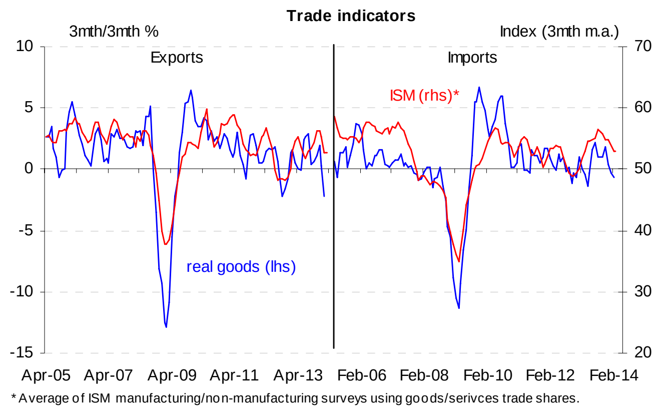
While the pause in activity started before the harsh winter and early spring weather in many parts of the United States, the weather likely had some impact. The increase in mortgage rates in mid-2013 may also still be being felt but this should fade over time, particularly given rates are still low by historical standards. As a result we expect to see a return to strong growth in residential investment as the level of construction activity remains low by historical standards, as is available inventory, and there is likely considerable pent-up demand. We are projecting this to become apparent in the June quarter but the risk is that it will be delayed.

Trade

Trade flows further weakened according to the February trade data, particularly for exports. Real goods exports fell by 1.6% mom and are also down on a three monthly basis, while the fall in real goods imports was a more modest 0.2% mom. The decline in exports is somewhat surprising given the improvement in the global economy through much of 2013. That said, the upwards momentum stalled in late 2013/early 2014 and as a result world economic growth appears to have flattened out. The ongoing, albeit modest, USD appreciation is also likely proving to be a headwind to exporters

It is also possibly just a correction to earlier strong data. Indeed the ISM export and import indicators which generally track the direction of the trade data pretty well, while showing some softening, are consistent with stronger trade flows. Nevertheless, because of the weakness in the export data, we now expect net exports to detract from March quarter 2014 GDP growth, although not by as much as the data to February alone would suggest as we think the recent weakness is exaggerated.

Weakness in trade flows looks exaggerated



Sources: Census Bureau, NAB

Labour market

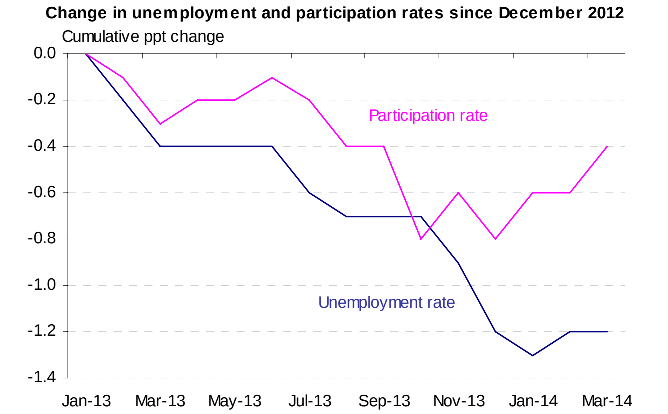
The slow recovery in the labour market remains on track despite recent hiccups. The latest employment report was again solid, with an increase in non-farm employment of 192,000 in March and upward revisions to prior months. Average monthly job gains in the March quarter were 178,000, only slightly down on the 185,000 average over the past six months.

The impact of the harsh winter on the labour market is also waning, even though the first month of spring was also much colder than normal. Average hours worked bounced back to equal its post-recession high, and the number of people with a job but not able to work was around its March average for the preceding ten years (in contrast to February where it was significantly elevated). However, there were still a greater than typical number of people working reduced hours because of the weather (although, again, less so than in February).

The unemployment rate was unchanged in February – indeed it is at the same level it was in December 2013 - 6.7%. However, this follows a very rapid, 0.8 percentage point, fall in the unemployment over the second half of 2013, so it is probably just as much a correction to earlier exaggerated moves as anything else.

Moreover, the underpinnings of the fall in unemployment look better. Following the December employment release, there was concern that the fall in the unemployment rate could be explained by a drop in the participation rate and that this might simply reflecting people giving up looking up for work (and so no longer counted as unemployed). However, the workforce participation rate has improved in recent months and a lot more of the decline in unemployment is now attributable to job gains.

Unemployment rate decline now looks built on more solid grounds

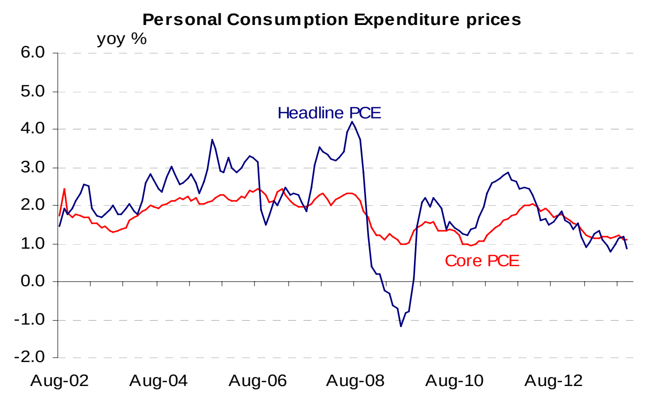


Source: Bureau of Labor Statistics, NAB

Inflation

Annual inflation remains subdued and well below the Fed's 2% longer-term objective. 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. With inflation expectations well 'anchored' (i.e. within historical norms) we expect inflation to gradually move back towards target over time as the amount of slack in the economy declines.

Inflation remains subdued



Source: Bureau of Economic Analysis, NAB

Monetary Policy

As we flagged in our last update, the Fed continued the process of reducing the size of its monthly asset purchases (QE "tapering") in its March meeting, as well as removing its numerical based forward guidance.

The monthly asset purchase program was again reduced by $10 billion taking it down to $55 billion per month. While the Fed continues to say that QE tapering is not on a preset course, Fed speakers have emphasised that it will take a major change in outlook to stop the process. As a result we expect the Fed to reduce to continue to scale down QE in $10 billion lots in future meetings. This would mean the program of purchases will end in the December quarter 2014.

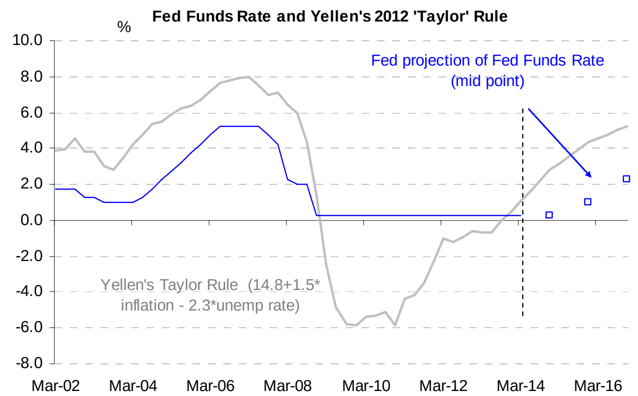
The Fed's monetary policy statement threshold based forward guidance has been removed. This guidance had stated that there would be no increase in the funds rate until the unemployment rate was 6.5% or lower, or projected inflation was above 2.5%, or inflation expectations were moving outside their normal bounds. With the unemployment rate close to the threshold, but the Fed still keen to indicate rates were on hold, it had increasingly become irrelevant.

Now the Fed is saying that in determining how long to keep the fed funds rate at its current level it will take into account progress towards its inflation and employment objectives, taking into account a wide variety of information including relating to the labour market, inflation pressures and expectations and financial developments. Indeed, by some counts the Fed Chair, in her post meeting press conference, mentioned over ten labour market statistics that she looks at in assessing the labour market.

This is of course a long way of saying the Fed will raise rates when it thinks it is appropriate to do so – no real surprise there. The Fed is also stating that it will likely keep the fed funds rate unchanged for a 'considerable time' after the QE purchase program ends. The Fed Chair, again in her post-meeting press conference, indicated that around six months probably constitutes 'considerable time' (subject to certain caveats). This caused some excitement because it meant that the fed funds rate could start rising by April next year which was earlier than market expectations. Also gaining some attention was the mid-point of individual member expectations of the appropriate fed funds rate at year-end – which rose from 0.75% at end 2015 to 1.0% and from 1.75% to 2.25% at end 2016.

Several Fed speakers seemed surprised by the markets focus on the Fed member projections, reasoning they were quite small and that they didn't fundamentally point to any major change in policy – rates are low and likely to remain low for some time. However, monetary policy is operating far away from normal rules, and Fed monetary statements now provide little guidance. In the chart below we have plotted a 'Taylor' interest rate policy rule used by the Fed Chair herself in a 2012 speech[1]. It suggests rates would normally already be rising given the current economic environment and that the end-2016 Fed projections are also well below what would normally be expected. Of course the Fed Chair does not consider circumstances are normal; in her speech she noted that for a while the rule called for rates below zero; as this was impossible it justified keeping future rates lower for longer.

Fed projecting low funds rate given economic projections



Sources: Federal Reserve, NAB

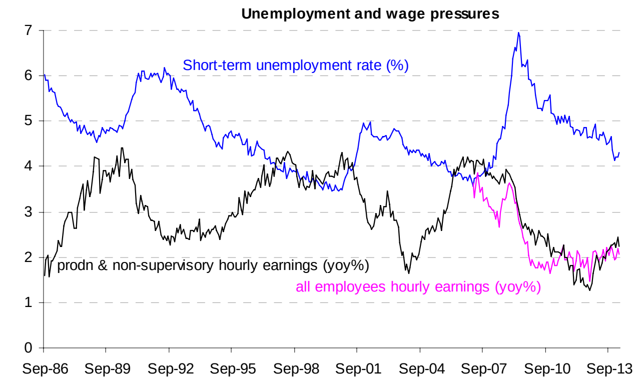
[1] Yellen J., Revolution and Evolution in Central Bank Communications, 13 November 2012.

However, this is not the justification that the Fed is using for its low rates projections. Rather, as it said in its March meeting statement:

> *… even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run. "*

However, this is not a promise or a commitment and when conditions are back to 'normal' it will be hard to justify low rates for this reason. So markets will be looking for signs that the Fed will tighten policy earlier and/or faster. This can be seen in a debate underway on the link between the short-term unemployment rate and wages. Historically the hourly earnings of production and non-supervisory employees start to rise rapidly as short-term unemployment rate falls to around the level it is currently around. However, while the growth rate of this measure has been picking up, the broader measure for all non-farm employees is showing little acceleration. Another wage cost measure (not shown in chart) is the employment cost index – it is true that this measure shows wage growth rising, but when total compensation is looked (i.e. including non-wage benefits) growth is low and flat. So no concern yet; in any event some increase in wage pressures would be welcomed as a sign that inflation will move back to target.

Mixed signs on whether wage pressures rising



Sources: Bureau of Labor Statistics, NAB. Hourly earnings data are for private non-farm employees. Employment costs index is for all private employees, all compensation.

Our expectation has been that QE will end in the December quarter this year, and that the first fed funds rate increase would be in September quarter 2015. We haven't changed our forecast in light of the March meeting as we don't see the Fed Chair's qualified 'six month' post QE timeframe pointing to a significantly different timing – it's around mid-2015 either way. The bigger uncertainty is whether the Fed delivers what it is projecting – low rates even when things appear to be returning to 'normal. Given, the loose commitment to not raising rates for a considerable time after the QE program ends, the main risk therefore is not that the Fed will start increasing rates significantly earlier but that when it starts it will be quicker than anyone expects.

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	2.4	2.6	0.5	0.8	**0.4**	**0.7**	**0.6**	**0.7**	**0.6**	**0.6**
Private fixed investment	4.5	6.1	7.8	1.4	0.7	**1.0**	**2.3**	**2.2**	**2.1**	**1.9**	**1.7**
Government spending	-2.2	-0.5	0.3	0.1	-1.3	**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	0.1	0.0	0.0	0.2	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.9**	**2.6**	**2.9**	**1.0**	**0.7**	**0.3**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)											
PCE deflator-headline											
Headline	1.0	1.3	1.7	0.5	0.3	**0.3**	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**
Core	1.2	1.4	1.8	0.3	0.3	**0.3**	**0.3**	**0.4**	**0.4**	**0.5**	**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	2.72	**2.8**	**3.0**	**3.0**	**3.3**	**3.5**

Source: NAB Group Economics

*Contribution to real GDP

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