13 May 2014

United States Economic Update

- **GDP growth paused in the March quarter, but indicators point to a bounce back in the June quarter.**
- **The labour market continues to improve highlighted by a large fall in the unemployment rate in April. Other labour market indicators are also improving but more slowly, and wages growth remains muted.**
- **QE tapering to continue through 2014 with the asset purchase program to end in the December quarter. No change in the fed funds rate is expected until around mid-2015. The main risk is that when tightening starts it will be quicker than expected.**

Economic Overview

Growth in the U.S. economy paused in early 2014. According to the advance estimate for the March quarter, GDP growth was only 0.1% qoq (annualised rate). Data released since the advance estimate suggests that, when the second estimate is released later this month, activity is likely to be revised downwards and show negative growth.

Several factors appear to be behind the sharp slowdown. These include a correction to strong growth in the second half of the year as inventory accumulation slowed and the strong December quarter net export performance was unwound. Equipment investment also declined after spiking towards the end of 2013. A harsh winter also likely had an impact although it is difficult to quantify.

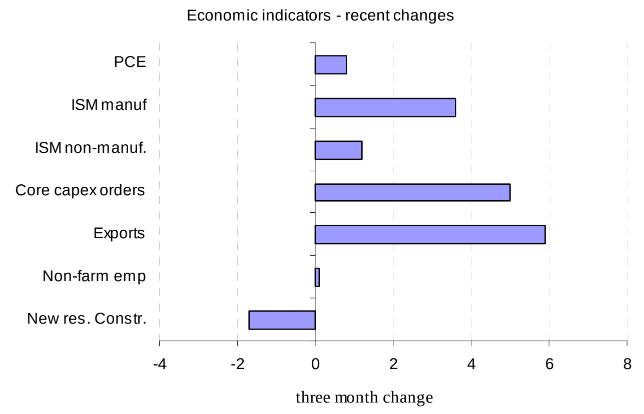
Private consumption growth did hold up in the March quarter. However, most categories of consumption were weak and the strong overall result was largely due to high rates of power (due to the cold weather) and health care (due to the impact of changes in health care laws) consumption growth. In contrast, business fixed investment declined and residential investment went backwards for the second consecutive quarter. More details on the advance GDP estimate can be found in our report on the release.

A deceleration in growth was not a surprise as the harsh winter and slower inventory accumulation were expected to take a toll. While the extent of the slowdown was a surprise, the bigger issue is whether the data over the course the quarter and into the June quarter are consistent with the view that it is a one-off result and that the broader recovery is on track.

At this stage, the indicators are consistent with this view and point to a bounce back in economic growth in the current (June) quarter. Partial indicators of consumption, business investment, exports and employment have strengthened over the recent months, with housing the main area still showing weakness.

We have illustrated this in the chart below which shows the change in growth rates over the last three months for a range of indicators. For example, personal consumption expenditure growth was -0.1% mom in December but by March was 0.7% mom, while the ISM manufacturing index increased from 51.3 to 54.9 over the three months to April. The non-manufacturing ISM has also risen and together the ISM indicators are at a level which is historically consistent with growth of just under 3% (annualised). The gain in the non-farm employment growth rate may look small but actually represents a pick-up in employment gains from 144,000 in January to 288,000 in April.

Indicators point to a bounce back in growth in June quarter



Sources: Bureau of Economic Analysis, ISM, Census Bureau, Bureau of Labor Statistics, NAB. Chart shows latest monthly growth rate less growth rate 3 months ago for personal consumption expenditure (PCE), real goods exports, non-defence (ex transports) capital goods orders, non-farm employment and private new residential construction expenditure and latest index less index three months ago for ISM manufacturing and non-manufacturing survey headline indicators. Data are to March except for ISM and employment which are to April.

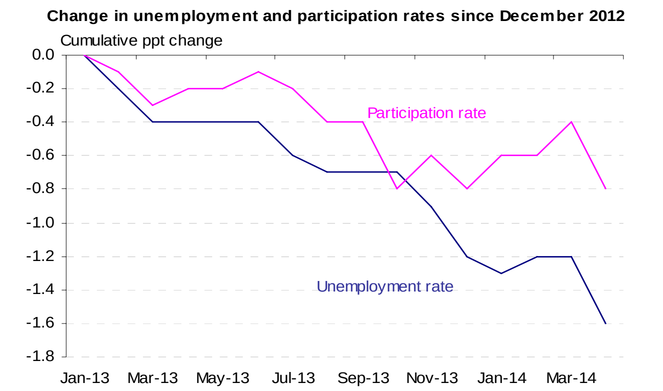
Labour market

As noted above there was strong growth in non-farm employment in April. As we cautioned at the time that low jobs growth was being recorded in December/January not too much should be made of individual job reports. Over the last year, non-farm employment has grown by 1.7%yoy, within the narrow 1.6-1.9%yoy range that has been experienced since late 2011.

At the same time there was a large fall in the unemployment rate from 6.7% to 6.3%. Technically this was entirely attributable to a fall in the participation rate which gave up all the gains made earlier in the year. The civilian employment measure used in constructing the unemployment rate actually fell by around 70,000. However, this employment measure is very volatile and the non-farm measure is considered to provide a more reliable picture of the jobs market. So in reality the continuing decline in the unemployment rate also reflects employment growth.

We have updated the chart we included in last month's report. Despite the fall in the participation rate in April, it is clear that it is not the only driver of the unemployment rate with job gains making a solid contribution as well. Indeed, the participation rate has been broadly flat since October last year. The long-term trend, mainly due to demographics, is for participation to fall over time, but the issue in the short-term is how many discouraged and other workers move into the workforce as the labour market continues to recover.

Decline in unemployment not just about participation



Source: Bureau of Labor Statistics, NAB

While the unemployment rate is central to the Federal Reserve's mandate and has been prominent in its forward guidance at times, it is not the only labour market measure that it considers. Indeed, the Fed Chair in her post March FOMC meeting press conference mentioned over ten labour market statistics that she looks at in assessing the labour market. Some of these measures are shown in the charts opposite which we have categorised in three ways – direct measures of slack, wages (indirect measure of slack), and inner workings of the labour market (gross flows data).

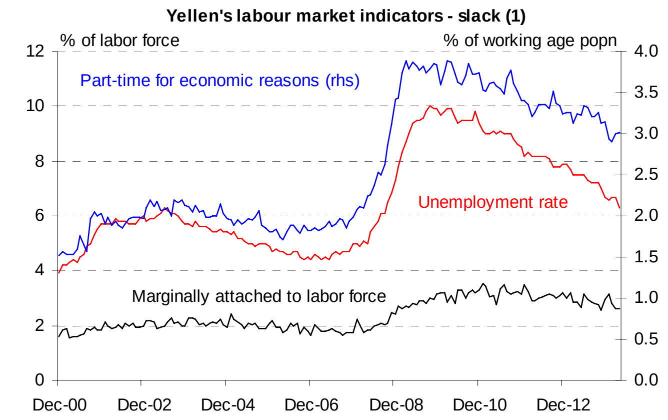
The unemployment rate only counts as unemployed those who are actively looking for work (i.e. participating in the labour force). However, there are large numbers of people who want a job and, while not actively looking, have looked for one in the last twelve months. This group are considered to be 'marginally attached' to the labour force and includes those who have given up looking for a job because of the difficulty of finding one (so called 'discouraged' workers). Moreover, there are many people with a part-time job that want a full-time one suggesting underemployment of labour. There has been some improvement in these categories, but not at quite the same rate as the unemployment rate itself. This suggests that there is more slack in the economy than the unemployment rate alone indicates.

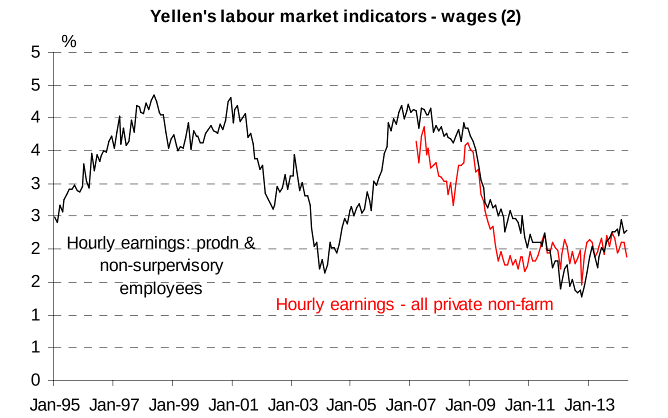
Labour market slack is considered important because it affects wage growth. Wages growth is also getting more focus because of the difficulty in interpreting the unemployment rate and other measures of slack – in other words it is an indirect measure of slack. Moreover, stronger wages growth would be a precursor to higher inflation so it is relevant to both of the Fed's objectives. While, there has been some pick-up in private non-farm production and non-supervisory employee wages growth, this is less evident for the broader measure for all private non-farm employees. The quarterly employment cost index (not shown) is also showing no up-turn as yet suggesting that while slack may be declining it has not yet done so by enough to put upwards pressure on wages.

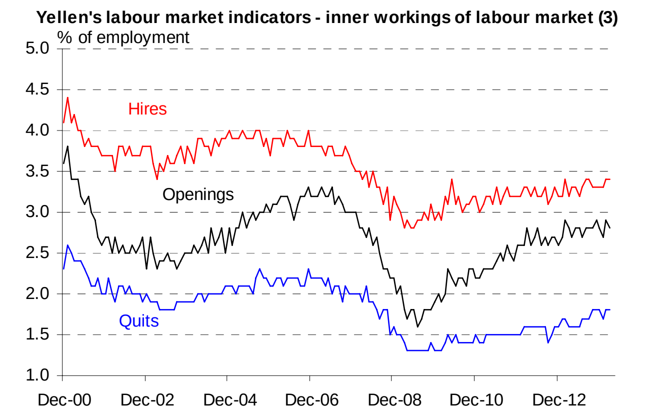
Underneath the net job gains reported in the monthly employment rate there are large number of people entering and leaving employment. These gross measures of the labour force may they show the degree to which the market is functioning normally – for example, a rise in quits is seen as a good sign, if driven by voluntary quits, as it suggests increasing confidence in the labour market rather than people holding onto a job they don't want because of fear they will not be able to find something more suitable. While job openings have substantially recovered, it is clear that quits and hiring have a way to go. That said, it is possible that changing demographics mean there is not a stable normal level of quits which will also affect gross hiring.

Taken overall, these measures suggest that while the labour market continues to recover, there is still a fair way to go before it returns to a more normal or desirable level.

Sample of Yellen's Labour Market indicators





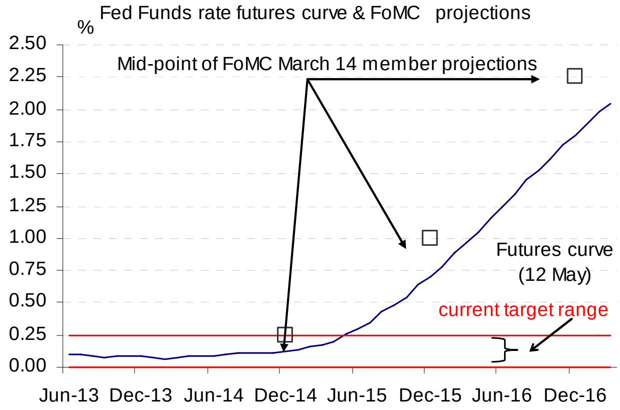


Sources: Bureau of Labor Statistics, NAB

Monetary Policy

The downplaying of the importance of the unemployment rate might be one reason why market reaction to the large fall in unemployment in April was relatively muted. While, there was some bring forward of the fed futures curve, the market is still noticeably pricing in a slower tightening phase then even the Fed member projections. This can be seen in the chart below which compares the fed futures curves as at 12 May with the mid point of Fed member projections released in March. As can be seen the market is expecting a lower fed funds rate both at end 2015 and end 2016.

Market not fully pricing in Fed member projections



Sources: Bloomberg, Federal Reserve, NAB

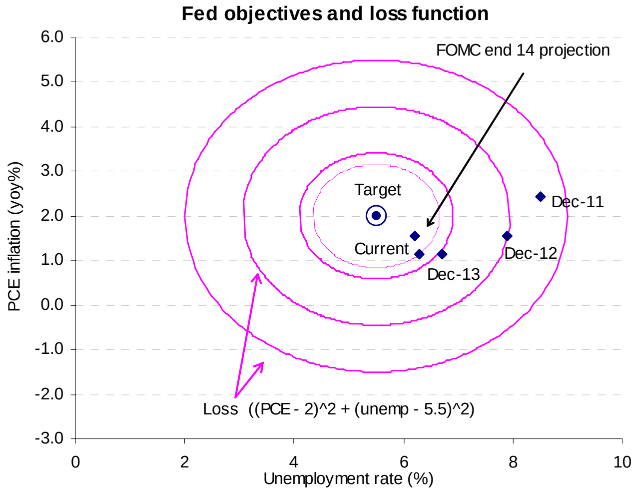
The mid-point of Fed member projections increased in March, and one of the factors cited in the meeting minutes for this was an improvement in the unemployment rate outlook. The Fed's 'central tendency' forecast for unemployment at end 2014 is 6.1 to 6.3%; so the forecast has almost been achieved less than half way through the year. April's large drop – if sustained (or reinforced) - suggests a risk that the Fed's member projections will tighten once again when next released in mid June, unless they consider progress in other labour market indicators to have been noticeably weaker.

The other consideration will be the inflation outlook. The Federal Reserve also has an inflation objective, and inflation is currently well below its target. The Fed has said that it places equal weight on both its inflation and employment mandates, and treats deviations either side of the target equally (so inflation 1% below target is as bad as inflation 1% above target). The head of the Chicago Fed has encapsulated this into a bulls-eye chart.[1] At the centre of the chart – the bulls-eye – is inflation of 2% and the unemployment target which we have set at 5.5% in the chart below.[2] The circles represent loss functions – each inflation and unemployment rate combination on a circle is regarded equally by the Fed given its objectives and its equal and symmetric treatment of them. Circles closer to the bulls-eye have a lower 'loss' and are therefore preferred.

[1] Evans C., Like it or Note, 90 Percent of a 'Successful Fed Communications' Strategy Simply Comes from Simply Pursuing a Goal-oriented Monetary Policy Strategy, U.S. Monetary Policy Action Forum, 28 February 2014.

[2] Based on the value adopted by Evans in his February speech, the mid-point of FOMC member projections of the long-term unemployment rate at that time. He has since used a different value in another speech but small changes in this value do not fundamentally change the analysis.

Getting closer to the 'bulls-eye'



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, NAB

As can be seen the Fed has been making steady, if unspectacular, progress towards its objectives for several years. Because of the large fall in the unemployment rate, the Fed appears to be a little ahead of track so far in 2014 although not by a lot as the projected upturn in inflation is yet to materialise. However, continuing falls in unemployment rate would be expected to eventually translate into wage pressures and in turn inflation.

All this serves to reinforce the broader point we have been making for a while now - the main risk is that when the Fed starts tightening it will occur more quickly than currently expected. This is because current and projected fed funds rates are below what normal monetary policy rules would suggest is appropriate, and the commitment to keeping them low falls far short of being a promise. There is also a risk that the process will start earlier than our current mid-2015 expectation (we have pencilled in July) but given the Fed's, admittedly loose, commitment to not raising rates for a considerable time after the QE program ends, a much earlier start is unlikely.

Meanwhile, the process of reducing the size of Fed's monthly asset purchases (QE "tapering") is continuing along a steady path. The monthly asset purchase program was again reduced by $10 billion in the April meeting taking it down to $45 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 continue to scale down QE in $10 billion lots in future meetings. This would mean the end of the program of purchases will be announced in either the October or December meetings (there is no November meeting) depending on whether the residual $5m gets wrapped up into a bigger taper in October or left over to December.

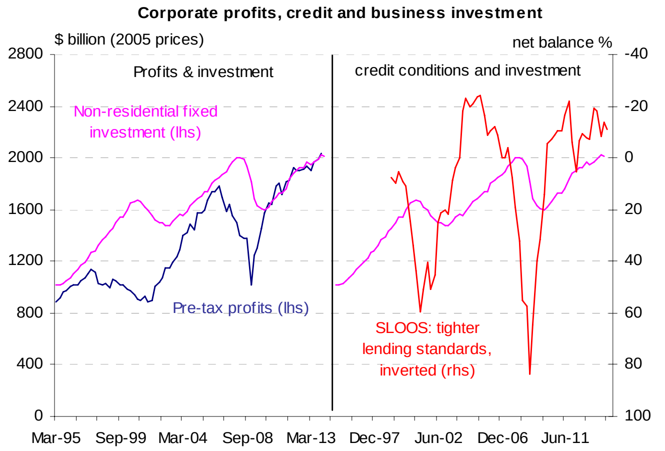
Outlook

Following a bounce back in growth in the June quarter, we see conditions remaining generally favourable over the rest of 2014 and through 2015, supporting above trend growth in the economy. Overall, we expect growth of around 2½% this year, and just under 3% in 2015.

Household consumption will be supported by continuing employment growth as well as improved household balance sheets, in part reflecting the upwards trend in wealth (equities and house prices). As the labour market recovery progresses, the modest wage growth of recent times will also start to pick-up further boosting household budgets.

Business investment should be supported by strong profit levels and the current absence of major debt limit and budget fights in Congress. Consistent with this, regional Federal Reserve surveys of capital expenditure intentions have been improving. Moreover, credit conditions also remain supportive. The recently released Senior Loan Officer Opinion Survey conducted by the Federal Reserve shows that banks are easing lending standards across most loan categories, including for business, with the major exception of residential housing.

Profits and credit conditions to underpin business investment



Source: Bureau of Economic Analysis, Federal Reserve, NAB. The lending standards in the chart are for the for Commercial & Industrial loans for large/medium firms.

Despite still tight lending standards, 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. Moreover, after several years of low numbers of people starting up their own new household, there is considerable pent-up demand. By historical standards mortgage rates are also still relatively low.

Exports should be supported by the overall improvement in global economic conditions, although an appreciating dollar will constrain net export performance. Federal fiscal policy, however, continues to provide a headwind, but not to the same extent as in 2013.

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	2.8	2.6	0.5	0.8	0.7	**0.7**	**0.6**	**0.6**	**0.6**	**0.7**
Private fixed investment	4.5	4.3	7.9	1.4	0.7	-0.7	**2.3**	**2.2**	**2.0**	**1.9**	**1.8**
Government spending	-2.2	-1.1	0.2	0.1	-1.3	-0.1	**0.0**	**-0.1**	**-0.1**	**0.1**	**0.1**
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	-0.2	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.9**	**2.4**	**2.9**	**1.0**	**0.7**	**0.0**	**0.9**	**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	0.4	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.2	1.5	1.9	0.3	0.3	0.3	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	6.1	5.5	7.2	7.0	6.7	**6.3**	**6.3**	**6.1**	**6.0**	**5.8**
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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