US Economic Update – US GDP, 2014 Q1

National Australia Bank

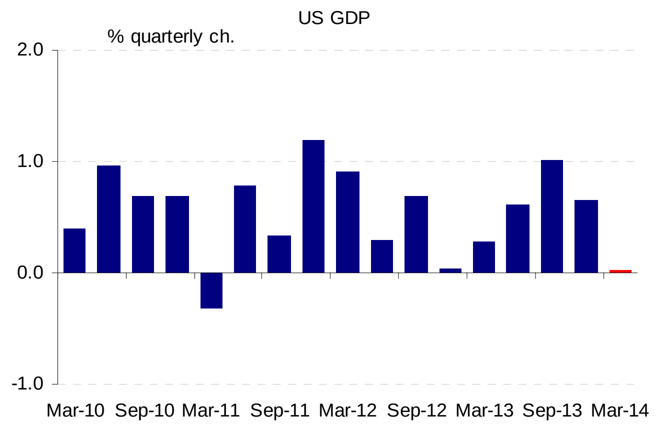
- **US GDP growth slowed sharply in the March quarter.**
- **This, at least in part, reflected the harsh winter and also a correction to the strong growth seen in the second half of 2013 as inventory accumulation slowed and net export gains were reversed.**
- **Growth is expected to be stronger over the rest of the year. We have revised our 2014 forecast down but still expect growth of around 2½% and just under 3% in 2015 (unchanged).**
- **The Fed continues to reduce the size of its QE asset purchases, which are likely to come to an end in the fourth quarter.**

US GDP growth slowed sharply in the March quarter, with growth of only 0.1% qoq (annualised rate). Several factors appear to be at play. 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, particularly given that strong power consumption provides an offset.

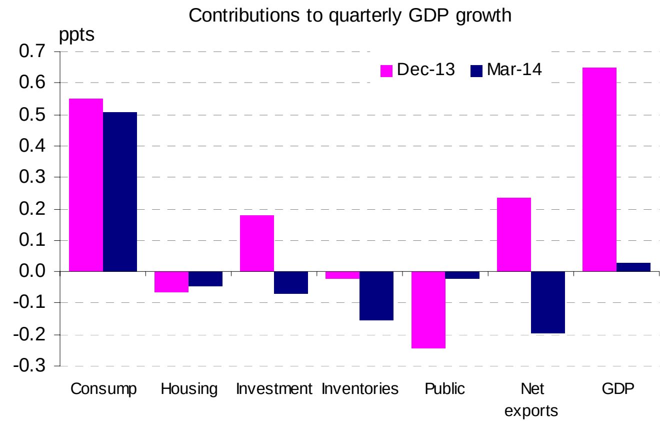
Despite the general slowdown, private consumption growth in the quarter held up at a reasonable rate and only slightly slower than in the previous quarter (itself the fastest quarterly growth in three years). However, most consumption growth came from just two categories – 'housing and utilities' (up 1.5% qoq) and health care (up 2.4% qoq). The strong growth in housing and utilities almost certainly reflects a boost to power consumption from the cold winter and will be reversed as conditions normalise. However, other categories of consumption were likely negatively affected by the harsh winter – e.g. food services & accommodations and recreation services both declined. Health care is a relatively fast growing part of consumption, but the strength in the quarter also reflected the impact of changes in health care laws; unlike utility consumption we would not expect this to be unwound but a more normal rate of growth going forward could be expected.

In contrast, business fixed investment declined by 0.5% qoq, the first fall since the same quarter a year ago. The weakness was centred in the 'equipment' category which declined. In contrast, intellectual property product grew modestly (but not as strongly as the previous quarter) while non-residential structures investment was almost flat. The decline in equipment investment might be payback for the strong growth in the previous quarter; one possible factor was an end to investment related tax-breaks which may have brought forward investment into late 2013 and out of early 2014.

Sharp growth slowdown in March quarter



…as most categories weakened



Q1 2014 GDP Details

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.7	0.5	2.5
Fixed investment	-0.7	-0.1	3.0
Structures	0.0	0.0	7.0
Equipment	-1.4	-0.1	2.0
Intellectual property	0.4	0.01	2.4
Residential	-1.5	-0.05	2.2
Ch. in inventories		-0.2	
Public Demand	-0.1	-0.02	-1.5
Net exports		-0.2	
Exports	-2.0	-0.3	3.2
Imports	-0.4	0.1	2.3
GDP	0.03	0.03	2.3

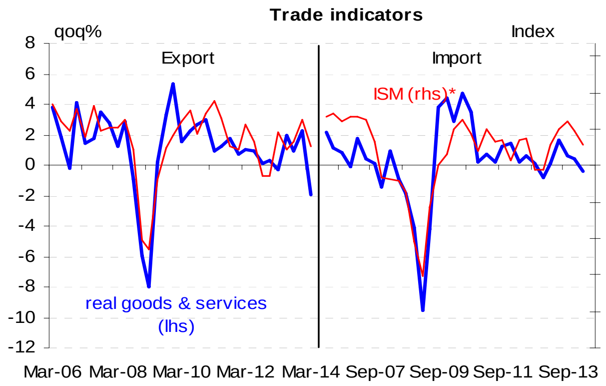
Source: US Bureau of Economic Analysis, NAB. Growth rates are not annualised.

As expected the rate of inventory investment declined in the quarter, subtracting 0.2 percentage points from the quarterly growth rate. This follows rapid inventory accumulation in the second half of 2013. The slowdown in inventory accumulation was centred in the non-farm sector, and with the inventories to sales ratio still above trend this process has got further to go.

Residential investment declined for the second consecutive quarter (-1.5% qoq). The weakness in the March quarter was not in actual construction activity, with 'permanent site' investment increasing 2.6% qoq (Its strongest growth rate since the June quarter last year). Rather, there was another large decline in 'other structures' which includes ownership transfer costs (commissions etc) from house sales which have been falling. It is likely that there was some impact from the harsh winter, but the weakness in residential investment started before this, following the sharp rise in mortgage rates in mid last year. Distressed housing sales have also been falling – as mortgage foreclosures decline - which may also be affecting overall sales figures.

After making its strongest positive contribution to growth in three years in the previous quarter, net exports made its largest negative contribution in over three years in the March quarter. Both exports and imports fell, but the decline in exports was much greater (at -2.0% qoq compared to -0.4% for imports). With improvement in the world economy in the second half of last year, a decline in exports was unexpected, notwithstanding US dollar appreciation, and the figures may simply be a correction to unsustainably strong growth in the previous quarter. The ISM surveys' trade measures suggest that the underlying trend is stronger than the March quarter data suggests. It is worth noting that the advance estimate for GDP is based on trade data for only January and February, with March data to be incorporated in the second estimate.

March quarter trade weakness looks exaggerated



* Average of ISM manufacturing/non-manufacturing surveys using goods/serivces shares. Qtly averages.

Sources: ISM, Bureau of Economic Analysis, NAB

Public demand again fell in the March quarter. A rebound had been expected after the December quarter's large fall because of the partial government shutdown for around half of October. The fall in public demand was much smaller than in the previous quarter, including growth of 1.5% qoq in Federal government's non-defence spending (its first increase in over a year). However, continuing defence cutbacks and the first decline in state and local demand in a year, weighed on overall demand.

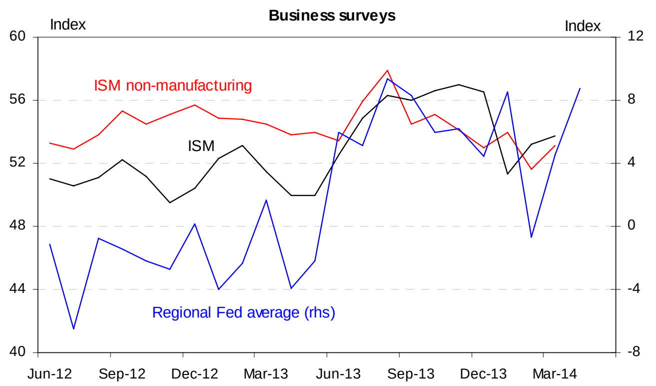
Inflation remains subdued and well below the Fed's 2% longer-term goal. The headline personal consumption expenditure (PCE) price index grew by 0.4% in the March quarter and over the last year by only 1.1%. Core inflation (excluding food and energy) is also tracking at 1.1% yoy. Quarterly core PCE growth has been just over 0.3%qoq in the last three quarters, so while the slowdown in inflation has ended there are not yet any signs of it picking up.

Assessment

A deceleration in growth was not a surprise as the harsh winter and slower inventory accumulation were expected to take a toll. However, the extent of the slowdown was much greater than expected. The impact of extreme weather conditions is hard to isolate, so it is possible that it was greater than first thought. However, it does not appear to be the only factor in play; components of GDP that were strong at the end of 2013 such as net exports and equipment investment went into reverse in the March quarter suggesting that the result is also partly a correction to the strong growth in the second half of 2013.

We expect to see a bounce back in the June quarter. Partial indicators such as retail trade, manufacturing production, durable capital goods orders generally suggest that activity started to strengthen towards the end of the quarter. Pending home sales also rose in March for the first time in nine months, suggesting that sales activity is stabilising. This is also the message from available business surveys – the ISM surveys recovered some lost ground in February/March and regional Federal Reserve manufacturing survey continued their recovery into April. However, some factors that supported activity in the first quarter will likely be unwound (power consumption) or moderate (health care consumption) limiting the extent of the rebound. The pace of inventory accumulation is also likely to slow further.

Business surveys picking up late March/early June quarter



Sources:Federal Reserve, Philadelphia Federal Reserve, Kansas City Federal Reserve, Richmond Federal Reserve, Dallas Federal Reserve, New York Federal Reserve.

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. By historical standards mortgage rates are also still relatively low. Business investment should be supported by strong profit levels and easing credit conditions. Consistent with this, regional Federal Reserve surveys of capex intentions are also showing an improvement.

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.

As a result of the lower than expected result for the March quarter, we have lowered our forecast for GDP growth in 2014 but still expect it to be around 2½%. We are still forecasting growth of just under 3% in 2015.

On the monetary policy front, in its April meeting (29-30 April), the Fed continued its process of QE tapering, reducing the size of its monthly asset purchase program by a further $10 billion (down to $45 billion per month). The Fed, in its post-meeting statement, partly attributed the first quarter slow down to 'adverse weather conditions' and noted that activity had picked up recently. In short, they are looking through the weak March quarter GDP result and do not see any major change to the outlook. As a result, the GDP release does not change the monetary policy outlook.

As a result, 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 for a while longer; we are currently projecting that the first rate hike will be in the September quarter 2015.

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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**	**0.3**	**0.4**	**0.4**	**0.4**
Core	1.2	1.4	1.8	0.3	0.3	0.3	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Unemployment rate - qtly average (%)	7.0	6.3	5.7	7.2	7.0	6.7	**6.5**	**6.4**	**6.3**	**6.2**	**6.0**
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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