United States Economic Update

National Australia Bank

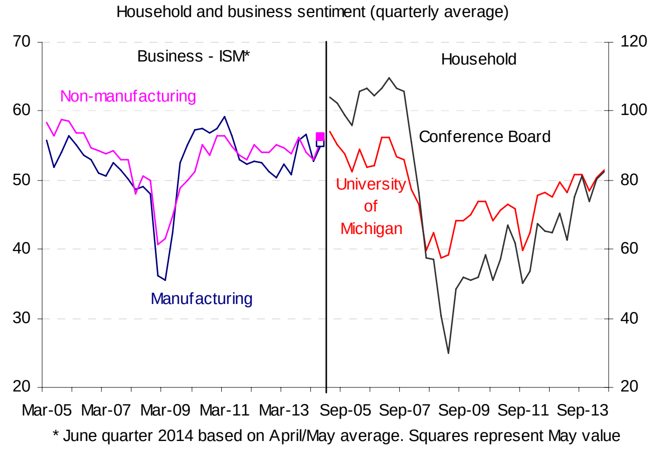
- **The economy is now estimated to have gone backwards in the March quarter. However, indicators point to a bounce back in the June quarter.**
- **Recovery expected to continue over the rest of 2014 and into 2015. We expect growth of around 2¼% this year and 3% in 2015.**
- **QE tapering to continue 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 risk is that when tightening starts it will be quicker than expected.**

Economic Overview

The initial estimate of U.S. growth in the March quarter of 0.1% qoq (annualised rate) was revised down in the second estimate to -1.0% qoq (annualised rate). This mainly reflected a greater estimated slowdown in inventory accumulation.

The downwards revision does not change our view that the poor March quarter outcome is only temporary and does not reflect the underlying state of the economy. It was the result of a correction to the strong growth in the second half of 2013 (which included an inventory build-up) and other factors such as an unusually harsh winter. Survey measures of business activity – while softening in the quarter – did not move to levels indicative of a downturn in the economy and they have since recovered.

ISM positive while households gradually regaining confidence



Sources: ISM, University of Michigan/Thomson Reuters, The Conference Board Inc., NAB.

Moreover, indicators point to a bounce back in economic growth in the current (June) quarter. Partial indicators of consumption, business investment, exports and employment are tracking above their March quarter level, and housing activity looks to have bottomed out. Imports have also grown strongly and, while mechanically this enters into GDP calculation as a negative factor, this is consistent with an increase in domestic demand and/or inventory accumulation.

We see conditions remaining generally favourable over the rest of 2014 and through 2015, supporting above trend growth in the economy.

Household consumption will be supported by continuing employment growth as well as improved household balance sheets and the ongoing recovery in household confidence. As the labour market recovery progresses, wage growth should also start to pick-up further boosting household budgets.

In line with the expected turnaround in the June quarter, the fall in corporate profits at the start of 2014 should prove to be temporary. Over the rest of the year still strong profit levels and easing credit conditions should support business investment. Consistent with this, regional Federal Reserve surveys of capital expenditure intentions have been improving.

Despite still tight lending standards, housing investment should 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. Further, by historical standards, mortgage rates remain low.

Exports should be supported by a gradual improvement in global economic conditions, although an appreciating dollar will constrain net export performance. While Federal fiscal policy continues to be a headwind it is fading. In terms of monetary policy, the QE asset purchases are likely to end in the final quarter of this year, but no increase in the fed funds rate is expected until mid-2015. The Fed has been signalling that when it does start to raise interest rates that it will do so only slowly. However, the risk is that this will occur more quickly than the market expects.

Overall, we expect growth of around 2¼% this year (specifically 2.2%, revised down from 2.4%) and 3% in 2015 (revised up from 2.9%).

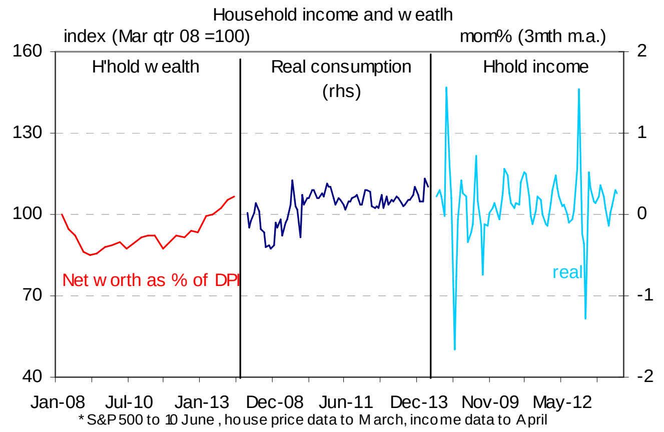
Consumption

While private consumption expenditure (in real terms) declined in April, this followed strong growth in March and April. However, motor vehicle sales – which had also dipped in April – grew strongly in May. Indeed motor vehicle sales are now at their highest level since mid-2006. The April result was also affected by a downturn in energy consumption (which had been boosted by the extreme winter) and flat health care consumption (following strong growth due to health care law changes[1]). Retail sales also increased in both April and May.

[1] However, recently released data on the services sector suggest health care consumption may be revised down. This may also lead to a further downward revision to GDP growth in the quarter.

The recent trend strengthening in consumption can also be seen in the middle panel of the chart below (which shows a three month moving average of the monthly growth rate). That consumption is holding up is not a surprise, given the recent rebound in household income and continuing growth in household wealth. The recently released March quarter Financial Accounts estimate that household net worth (assets less liabilities) increased by more than 10% over the year to the March quarter 2014.

Growth in wealth & income rebound supporting consumption

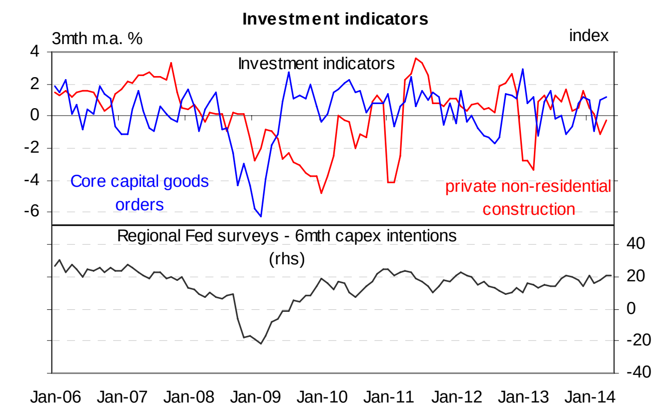


Sources: Federal Reserve, Bureau of Economic Analysis, NAB

Investment

After falling in the March quarter, partial indicators of business fixed investment are generally pointing to a rebound in the June quarter. Core (non defence and aircraft) capital goods orders surged in March and, despite falling in April, are well above their March quarter average. The same is true of shipments. Moreover, survey indicators of investment intentions continue to trend higher. The exception is non-residential construction, which fell in April for the fourth consecutive month, although by a smaller amount.

Partial indicators of business investment pointing to a rebound

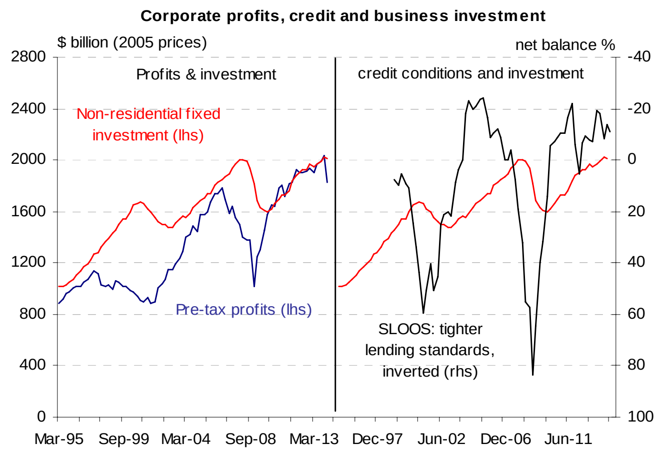


Sources: Census Bureau, Philadelphia, Richmond, Dallas, Kansas City and New York Federal Reserve banks, NAB

We have previously noted that strong profits, as well as easier credit conditions should underpin continued business investment growth. However, while banks continue to ease credit conditions, corporate profits in the March quarter plunged by almost 10% qoq. A fall was not a surprise given the decline in GDP. The previous time GDP fell – in the March 2011 quarter – there was also a large fall in profits.

While the fall in profits is of some concern, the business surveys do not suggest that business confidence has been dented. Moreover, there is a long lag between a downturn in profits and a cut back in investment. With the economy expected to bounce back this quarter the decline in profits should be temporary, although the size of the fall does create uncertainty about the underlying strength of profit growth.

Plunge in profits is likely temporary and credit still a positive



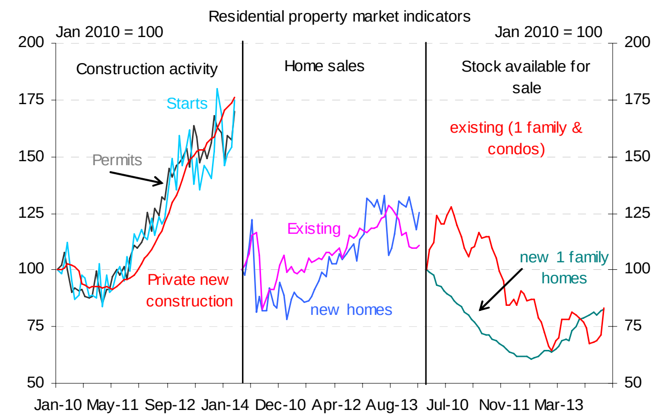
Sources: Bureau of Economic Analysis, Federal Reserve Senior Loan Officer Opinion Survey (SLOOS), NAB

Housing

There are tentative signs that the softness in the housing market – which resulted in a decline in residential fixed investment in both the December 2013 and March 2014 quarters – is coming to an end.

New construction expenditure continues to trend upwards, and both permits and starts have risen in recent months. While the gains have been largest in the volatile multi-family category single home activity also risen recently. In any event, the multi-family category should not be discounted as, with the apartment vacancy rate continuing to move down (reflecting the reduced home ownership rate and demographic changes supporting a move to smaller dwellings), this is likely to be the fastest growing segment over time.

Tentative signs period of housing weakness coming to an end



Sources: Census Bureau, NAB

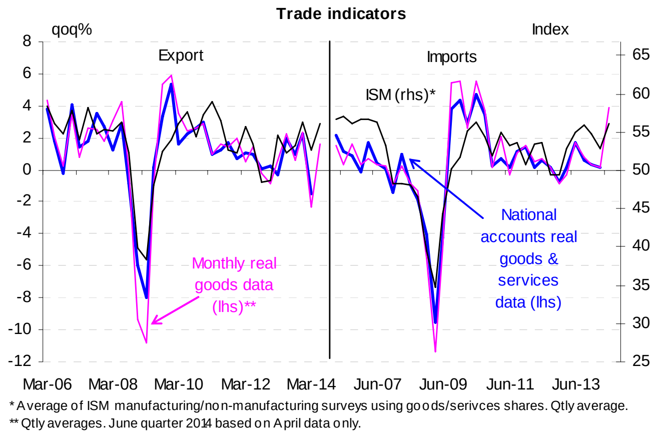
Home sales – falls in which were the main factor behind the overall decline in residential investment – have also stabilised. While the new home category continues to be volatile, the much larger existing home sales market appears to have bottomed out, with sales increasing in April, and pending home sales data pointing to further small gains.

Trade

After softness in the March quarter, trade has bounced back over March and April. This is particularly the case for real goods imports which in April were 3.9% higher than their March quarter average. Exports were also up by a solid 1.6% over the same period. These flows are supportive of the view that activity has picked up in the June quarter, as an important driver of imports is domestic demand, while strong export growth will flow through into U.S. production.

April's trade data point to a greater deterioration in the real trade balance (or net exports) in the June quarter than in the March quarter. We have factored in a more neutral net export contribution to growth in the quarter. This is consistent with the ISM surveys export/import orders readings. While this suggests downside risk to our GDP forecast, if the surge in imports is maintained then this is also likely to be reflected in greater inventory accumulation (a positive for measured GDP growth) or be absorbed by higher domestic demand.

Recent rebound in trade – particularly imports



Sources: Bureau of Economic Analysis, Census Bureau, ISM

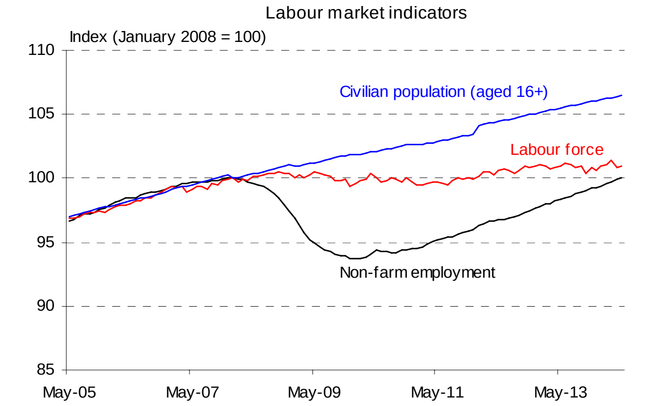
The world economy lost some momentum late 2013/early 2014 but we expect this to be temporary; we are forecasting around trend growth this year and slightly above trend growth the next. This should lend some support to U.S. exports although this may be tempered if the USD appreciates as we expect. At the same time the solid growth we are forecasting for the U.S. economy would suggest continued import growth – overall net exports will likely make little contribution to GDP growth over the next few years.

Labour market

There was another strong rise in non-farm employment in May. Non-farm employment rose by 217,000. This represented the fourth month in a row of job gains of over 200,000. It has been noted that this is the first time this has occurred since late 1999/early 2000. However, there have been four month periods of stronger growth (in 2004, 2005, 2006 and 2012). Moreover, over the year to May non-farm employment grew by 1.7% yoy, still within the 1.6-1.9% yoy range that has mostly been experienced since late 2011.

The May result also gained attention because it meant that for the first time non-farm employment was higher than its pre-recession peak in 2008. In a country with a growing population having the same level of employment as six years ago is no cause for celebration. That said, the unemployment rate is improving and at 6.3% is within one percentage point of what the Fed considers to be its longer-run level. This highlights the weakness in the supply-side of the economy. Labour force growth has been anaemic, and much lower than population growth, as participation in the labour force has declined either due to demographic and societal factors or because some people have given up looking for work.

Non-farm employment back to where it was at the start of 2008

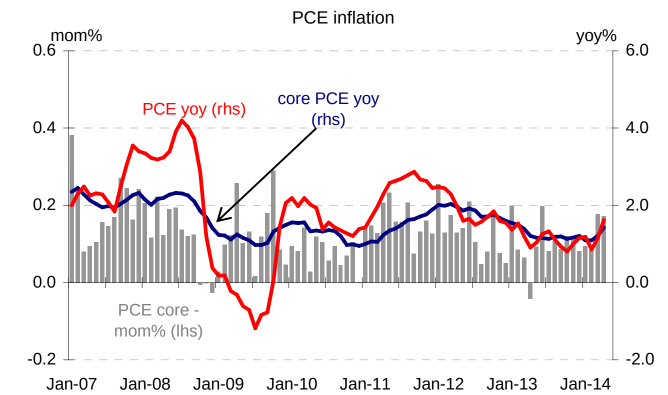


Source: Bureau of Labor Statistics, NAB

Inflation

Inflation strengthened in April with growth in the personal consumption expenditure (PCE) index jumping from 1.1% yoy in March to 1.6%. Core inflation also moved higher from 1.2% to 1.4% yoy. The reflected a combination of base effects – with the fall in March 2013 prices coming out of the calculations – and recent higher monthly readings. The downward drag from import prices has been moderating, and the depreciation in the USD in recent months suggests that this will continue in the short-term. Producer prices have also been strengthening.

Inflation starting to strengthen…but still below Fed's target



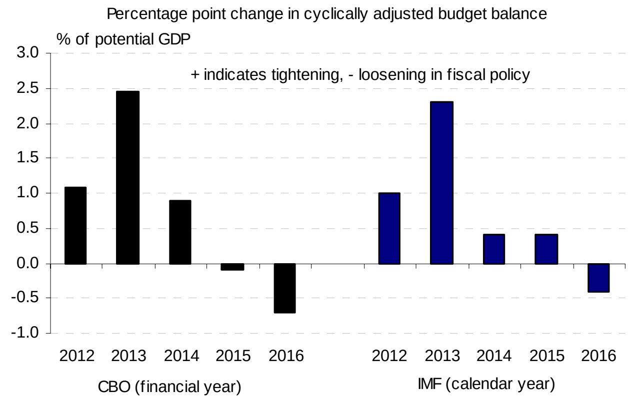
Sources: Bureau of Economic Analysis, NAB

The rise in inflation is likely to be sustained and core inflation to move a bit higher over the rest of the year. As the recovery continues prices (including wages) are likely to come under further upwards pressure although our expectation of a moderation in oil prices and an appreciation of the USD will constrain the acceleration in inflation.

Fiscal policy and public demand

While a continuing headwind for the U.S. economy remains Federal government fiscal policy it is fading. A common measure of the stance of fiscal policy is the change (on the previous year) in the cyclically adjusted budget balance. The cyclically adjusted budget balance is an estimate of what the budget position would be if the economy was at its 'normal' level. Two projections – one by the CBO and another by the IMF – of the change in the cyclically adjusted budget balance are shown in the chart below. On either measure, there was a major fiscal tightening in 2013 followed by another, but much smaller, tightening this year. This phase of fiscal tightening is expected to be over by 2016 at the latest.

Federal fiscal headwind fading



Sources: CBO (February 2014 report The Budget and Economic Outlook: 2014 to 2024), IMF (Fiscal Monitor April 2014), NAB

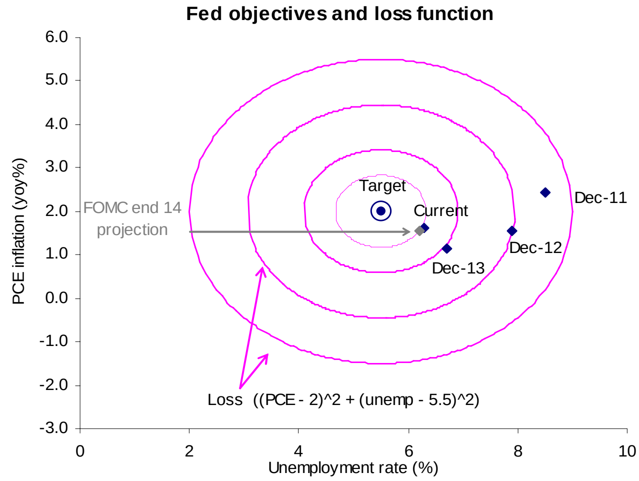
Changes in the budget balance are the broadest measure of fiscal spending. The government consumption and investment component (public demand) of GDP relates to actual purchases of goods and services or investment and so excludes government transfers (unemployment benefits etc). Public demand fell in the March quarter despite Federal spending experiencing its first increase in six quarters (due to the bounce back from the Federal shutdown in late 2013) as state and local government demand fell. Nevertheless, state and local government demand was still marginally higher than a year ago, and partial indicators continue to suggest that state and local spending is trending upwards.

Monetary policy

In last month's update we showed our version of the bulls-eye chart used by the head of the Chicago Fed (Evans). At the centre of the chart are the Fed's targets – the bulls-eye – for inflation of 2% and for the unemployment rate which we have set at 5.5%. Each inflation and unemployment rate combination on a circle is regarded equally and so circles closer to the bulls-eye are preferred.

The bulls-eye chart highlights the fact that, with the recent fall in the unemployment rate and rise in inflation, around as much progress towards the Fed's policy goals has been achieved half-way through the year as the Fed expected to see over the full-year. This suggests that the median value of Fed member projections for the fed funds rate at the end of each year of the projection period may rise when updated at the 18-19 June meeting.

Faster than expected progress towards the Fed's bulls-eye



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

The Fed is seemingly committed to a steady tapering of the QE program of an around $10 billion pace – which would see it end in December quarter 2014.[2] Moreover, it has stated that (dependent on future conditions) the fed funds rate will not increase until a 'considerable time' after the end of QE purchases. Therefore the risk is not for a significantly earlier than expected start to rate hikes, but rather that once the process starts rates will rise faster than the market is currently projecting.

As such we continue to factor in the first fed funds rate hike for mid 2015 (specifically July). By 'hike', we mean the first increase in the fed funds rate above its current target range of 0 to 0.25%. However, it is possible that, ahead of this step, the Fed will either try to move the effective funds rate to the top of its existing target range or replace the target range with a singe point target (0.25%).

Another issue to be resolved is when to stop re-investing principal payments from its QE holdings – in its June 2011 exit principles this step was to occur ahead of the first fed funds rate hike. Some – but not all – Fed speakers have recently indicated a desire for this to occur after the fed funds rate starts to rise. Given ceasing reinvestment of principal payments would representing a policy tightening, what the Fed decides to do in this regard would likely have implications for the timing of the first fed funds rate hike. For example, a decision to delay ending reinvestment of principal to after rates hikes commence would, other things equal, suggest an earlier start to rate hikes.

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

[2] At this pace the end of the program of purchases (currently $45 billion per month) would be announced in either the October or December meetings (there is no November meeting) depending on whether the residual $5b gets wrapped up into a bigger taper in October or left over to December.

US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %									
					2013		2014				2015			
	2013	2014	2015	2016	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	2.0	2.8	2.7	2.6	0.5	0.8	0.8	**0.8**	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.5	4.2	7.9	6.1	1.4	0.7	-0.6	**1.9**	**2.3**	**2.1**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.2	-1.2	0.1	0.8	0.1	-1.3	-0.2	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.2	-0.2	0.0	0.0	0.4	0.0	-0.4	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.1	0.0	0.0	-0.1	0.0	0.2	-0.2	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.9**	**2.2**	**3.0**	**2.8**	**1.0**	**0.7**	**-0.2**	**0.9**	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.6	1.8	2.0	0.5	0.3	0.3	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Core	1.2	1.6	1.9	2.0	0.3	0.3	0.3	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	6.1	5.5	5.0	7.2	7.0	6.7	**6.3**	**6.2**	**6.1**	**5.9**	**5.8**	**5.6**	**5.5**
US Key Interest Rates (end of period)														
Fed funds rate	0.25	0.25	0.75	2.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.50**	**0.75**
10-year bond rate	3.03	3.00	3.75	4.00	2.61	3.03	2.72	**2.8**	**3.0**	**3.0**	**3.3**	**3.5**	**3.8**	**3.8**

Source: NAB Group Economics

*Contribution to real GDP

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