26 June 2014

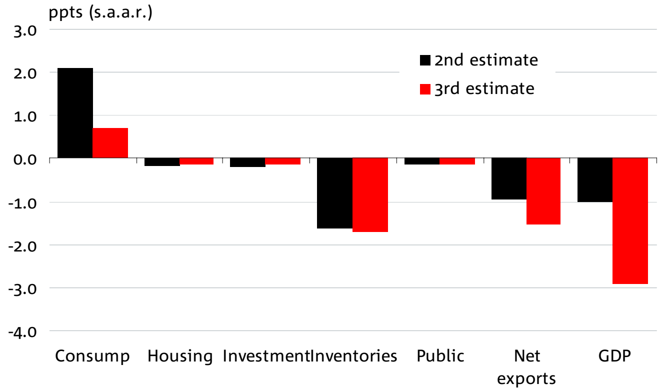
United States 2014Q1 GDP update

National Australia Bank

- **U.S. GDP is now estimated to have declined by a recession like 2.9% qoq (annualized rate) in the March quarter.**
- **However, we still think the March quarter weakness is a one-off. Other indicators do not point to an economic downturn and partial indicators of activity point to a bounce back in the June quarter.**

The third estimate of U.S. GDP in the March quarter 2014 shows that the economy went backwards at an even greater rate than previously thought. The annualized growth rate is now estimated to be -2.9% qoq compared to -1.0% in the second estimate (and 0.1% in the advance estimate).

Contribution to quarterly GDP growth



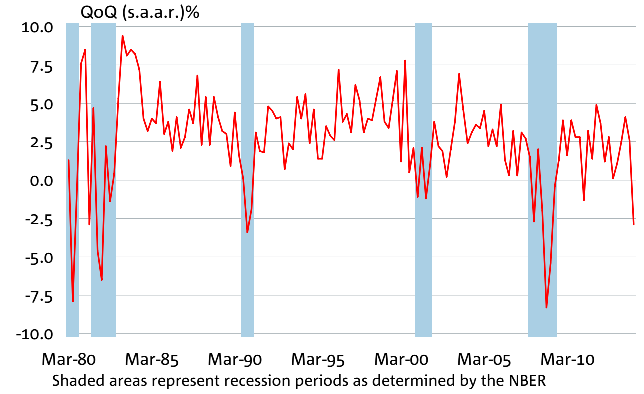
Source: Bureau of Economic Analysis (BEA)

There were two main factors for the downward revision. Firstly, the Bureau of Economic Analysis had previously estimated strong health care consumption growth following health care law changes ("Obamacare"). However, this has now been revised away – indeed estimated growth has changed from an unusually strong 9.1% qoq (s.a.a.r.) to an unusually weak -1.4% qoq (s.a.a.r.). The other factor was a downward revision to exports, and a small upwards revision to imports, resulting in a larger detraction from net exports.

Previously our view had been that the weak March quarter result reflected a correction to strong growth in the second half 2013 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 (possibly due to tax reasons). Moreover, although difficult to quantify, a harsh winter also likely had an impact. Consumption – ex health care and utilities – was also weak which is now more apparent in the aggregate data as well.

Markets have reacted calmly to the news. However, the obvious question it raises is whether it is signalling that the underlying strength of the U.S. economy is weaker than previously thought. As can been seen in the chart below, falls in GDP of the magnitude experienced in the March quarter have in the past occurred in periods of recession.

Historical GDP growth



Sources: BEA, NBER's Business Cycle Dating Committee, NAB

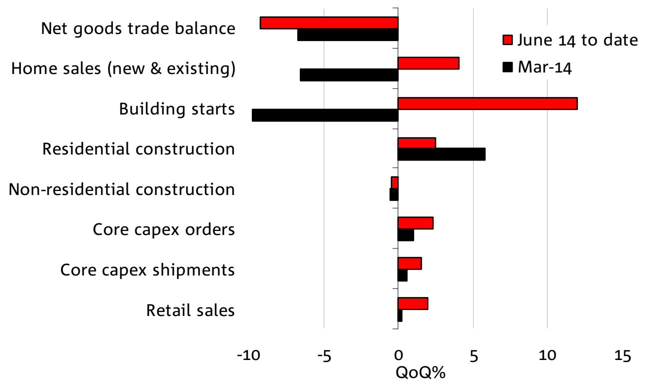
We look at answering this question in a couple of ways. Firstly, are available indicators for the current (June) quarter pointing to continuing weakness or a rebound in activity? Secondly, were other measures of the economy and confidence in the March quarter consistent with a recession?

To answer the first question we have looked at a range of indicators covering private consumption, housing investment, business investment (structures and equipment) and trade. We have simply calculated the quarterly growth rate in each based on data available for the current quarter (e.g. if we have April and May data, then the average of the two is compared to the previous quarters average). In the case of consumption we limited ourselves to retail sales – the broader personal consumption expenditure measure is not shown as the data are not consistent with the 3rd GDP estimate (revisions, including a May estimate, to be released later today).

The result of this exercise can be seen in the chart on the following page. Overall, they are consistent with a rebound in activity in the June quarter. In the areas of consumption, capital expenditure (equipment) and housing there is clear improvement. There are still some areas of weakness: non-residential construction is still soft (but we only have one month's data for the current quarter) and trade at his early stage appears to have contracted again.

However, trade data are only available to April and are very volatile, making any conclusions very tentative. This is particularly so given that the ISM export indicators suggest that the measured weakness in exports looks exaggerated.

Partial activity measures



Sources: BEA, Census Bureau, NAB. June quarter data based on average of monthly data available. Data available to April for residential and non-residential construction and trade, and to May for the other indicators. Non-residential construction is for the private sector and residential construction is the private new residential construction series. For the net goods trade balance the quarterly growth rate has been multiplied by -1 so that deterioration is shown with a negative sign (the trade balance is negative).

To answer the second question, we have identified all the quarters back to 1969 where GDP has declined by 1% qoq (s.a.a.r.) or worse. We have then selected a series of indicators which are likely to be weak at times of recession. These factors include durable consumption (which tends to be weaker than other elements of consumption as it can often be deferred), business sentiment (measured by the ISM), employment, the unemployment rate, consumer confidence and industrial production. Where these variables were meeting the specified criteria (e.g. industrial production or employment falling, unemployment rate rising) then they are given a dark shading for that quarter. In most cases where the NBER business cycle dating committee considers that the economy was in a recession many of these indicators were also showing weakness.

However, in cases when the NBER considered that the economy was not in recession, few (or none) of these indicators were showing clear weakness. This is true of the last two quarters of negative GDP growth in excess of 1% - the March 2011 and 2014 quarters. In short, while GDP growth was recession like in the March quarter, this does not accord with a range of other indicators. Given that data for June quarter show a rebound in activity, this suggests that the March quarter GDP result is a one-off or outlier and that it is not signalling a downturn in the U.S. economy.

Implications

While a rebound in activity is underway in the June quarter, overall the indicators do not currently suggest that our forecast for the June quarter (3.6% qoq s.a.a.r) is unduly conservative. As a result our forecast for 2014 as a whole is likely to be marked down from its current 2.2% in our next monthly update. A major uncertainty is health care, and whether a rebound from the March quarter weakness (plus above trend growth going forward due to the increase in numbers with health insurance) leads to stronger consumption than we expect, or whether the first quarter's weakness will continue.

Prior to the release of the 3rd estimate for March quarter GDP, Fed members had been indicating that they were looking through the weak result for the quarter. For the reasons we have identified above, this is still likely to be the case. That said, Fed officials in the past have stated that they like to see the GDP data corroborate the labour market data; if GDP is weak (as in the March quarter) and if partial indicators were to point to this continuing (not the case yet) then the Fed would be concerned about the outlook for labour market.

Our current call for the first tightening in the fed funds rate (above its current target range) is mid -2015 (or Q3 to be more precise). We noted in our last regular monthly update, the unemployment rate and inflation have been moving closer to the Fed's targets. This has raised some speculation that the Fed might tighten earlier. However, the Fed is still sending generally dovish signals, something that the fall in GDP in the March quarter will only reinforce. As a result we see no need to change our call on continued QE tapering (to end in the December quarter) or on the timing of rate tightening.

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

Economic Comment

[redacted]

	GDP	Durable consumption	Manufacturing ISM	Manufacturing ISM - production	employment	Unempl. Rate	Consumer confidence: Michigan	Consumer confidence: Conference Board	Industrial production	NBER recession period
	qoq <1% saar	qoq% < 0	<50	<50	qoq% < 0	rising	falling	falling	qoq% < 0	recession
Dec-69	-1.7									
Dec-70	-4.1									
Sep-73	-2.2									
Mar-74	-3.3									
Sep-74	-3.8									
Dec-74	-1.6									
Mar-75	-4.7									
Jun-80	-7.9									
Jun-81	-2.9									
Dec-81	-4.6									
Mar-82	-6.5									
Sep-82	-1.4									
Dec-90	-3.4									
Mar-91	-1.9									
Mar-01	-1.1									
Sep-01	-1.2									
Mar-08	-2.7									
Sep-08	-2.0									
Dec-08	-8.3									
Mar-09	-5.4									
Mar-11	-1.3									
Mar-14	-2.9									?

Sources: BEA, ISM, Bureau of Labor Statistics, University of Michigan/Thomson Reuters, The Conference Board, Federal Reserve, NBER Business Cycle Dating Committee. Other than for GDP and NBER recession period, a dark shading indicates that the specified criterion has been met. Dark shading for the NBER recession period column indicates that the NBER committee considered the economy to be in recession.

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