U.S. Economic Update, 2014Q2 GDP

by NAB Group Economics 31 July 2014

National Australia Bank

- **GDP bounced back strongly in the June quarter, growing by a 4.0% annualised rate. The improvement was broad based and revisions to recent quarters were also positive.**
- **Early indicators for the September quarter are positive. We expect solid growth over the rest of the year and into next year. The forecast for 2014 has been revised up to 2.1% (previously 1.6%).**
- **QE tapering continuing and we expect the program to end following the Fed's October meeting. The first hike in the fed fund rate is not expected for a while yet – June quarter 2015 – so monetary policy still accomodative.**

After declining in at the start of the year, GDP bounced back strongly in the June quarter, growing by a 4.0% annualised rate. While this included a sizeable contribution from stocks, the improvement was broad based with consumption and business and residential investment all strengthening, as did government expenditure, while net exports were less of a drag.

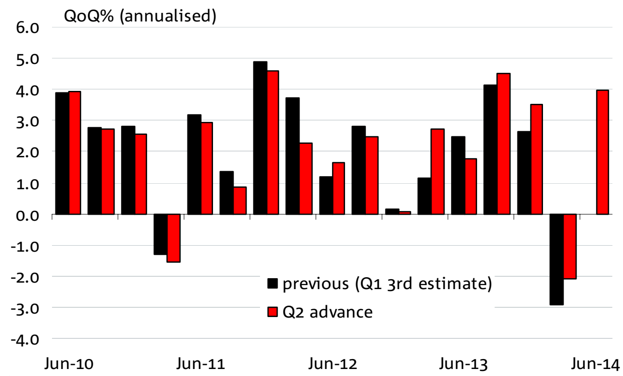
There were also revisions to past GDP estimates. In particular growth over 2011 and 2012 was revised down but 2013 was revised upwards. Moreover, the extent of the fall at the start of 2014 was revised down. While the net result is that the level of GDP in the March quarter is broadly unchanged, the revisions suggest more momentum in the economy over the last year or so than previously thought.

The rebound in private consumption in the June quarter from its weak March quarter pace was due to increased goods consumption. In particular, durable goods consumption was rapid, recording its strongest growth in almost five years. Services, however, were again soft due to a decline in the 'housing and utilities' category - almost certainly due to lower power use following the harsh winter. Health care consumption, which was strong at the end of 2013 and then declined in early 2014, resumed growing, suggesting that the swings caused by health care law changes might be fading.

Business investment also strengthened in the quarter after a soft start to the year, and was broadly based with structures, equipment and intellectual property investment all growing. Structures investment was led by rapid growth in mining investment (6.2% qoq) as the impact of the energy boom continues to be felt.

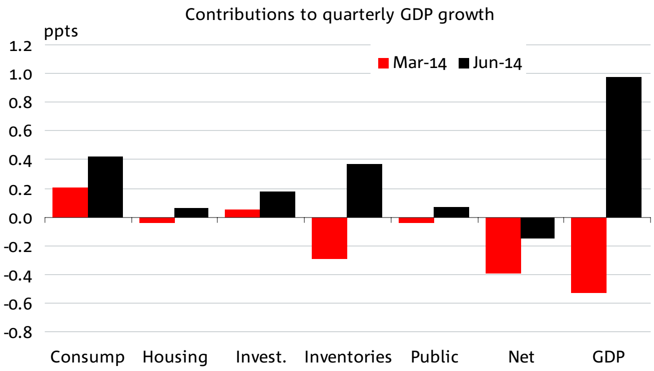
Residential investment has been a source of weakness since mortgage rates rose sharply mid last year. While partial indicators continue to remain mixed, they overall appear to suggest some improvement. Consistent with this residential investment resumed growing in the June quarter with new construction as well 'other structures' growing. The 'other structures' category includes ownership transfer costs (related to house sales) and improvements and was the source of the overall fall in residential investment in the previous two quarters.

GDP bounces back and recent data revised upwards



Source: BEA

Record breaking revisions so far to March quarter GDP



Sources: BEA, NAB. Data not annualised

2014 Q2 GDP detail

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.6	0.4	2.3
Fixed investment	1.4	0.2	4.7
Structures	1.3	0.04	7.9
Equipment	1.7	0.1	6.1
Intellectual property	0.9	0.03	3.6
Residential	1.8	0.1	0.9
Ch. in inventories		0.4	
Public Demand	0.4	0.1	-0.7
Net exports		-0.1	
Exports	2.3	0.3	3.5
Imports	2.8	-0.4	3.9
GDP	1.0	1.0	2.4

Source: BEA, NAB. Data not annualised.

Net exports again subtracted from growth but by a smaller amount. While a pick-up in exports is clearly a positive the same is also true of stronger imports - while, mechanically, they detract from growth, they indicate that domestic demand is improving.

Government consumption and investment also grew for the first time in three quarters. This was entirely driven by state and local government spending as federal government spending fell, consistent with recent trends.

Inventories contributed 0.4ppts to growth in the quarter (1.7% annualised) which was greater than expected. As the strength in the June quarter was in goods (most relevant for inventories) rather than services, it does not necessarily mean there was a large, unwanted, run-up of inventory. With growth expected to rebalance more towards services in the September quarter, a slower pace of inventory accumulation is likely – a negative for GDP growth – but we aren't factoring in a major inventory correction.

Assessment

The June quarter GDP result, together with the upward revisions to recent quarters, lends further support to our view of solid underlying momentum in the U.S. economy. While the advance estimate suggests that the economy grew by only 0.9% (annualised rate) over the first half of the year, this needs to be seen in the context of the strong growth at the end of 2013 and the positive signals coming from other indicators – in particular employment growth.

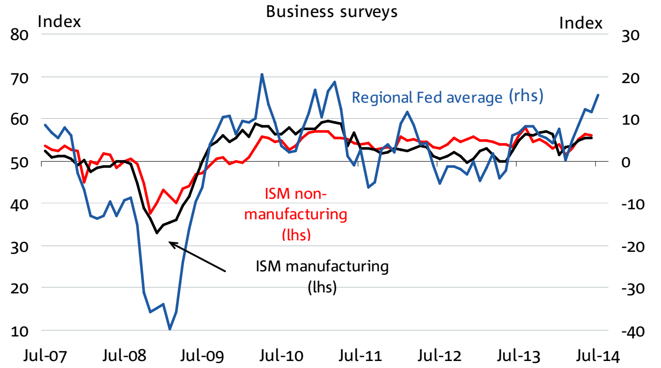
While there are little data available for the September quarter, regional Federal Reserve surveys for July have shown further improvement and, overall, are at their strongest levels since early 2011. The Conference Board measure of consumer confidence – including its expectations measure which broadly tracks consumption expenditure - also jumped higher in July (although not all measures of confidence were as strong).

Household disposable income increased at an annualised pace of just around 3¾%, after allowing for inflation, in the first half of 2014. With only relatively modest consumption over this period the savings rate rose and is now at its highest level since end-2012. These factors, combined with more optimism about the future and ongoing improvement in household balance sheets should underpin future solid consumption growth.

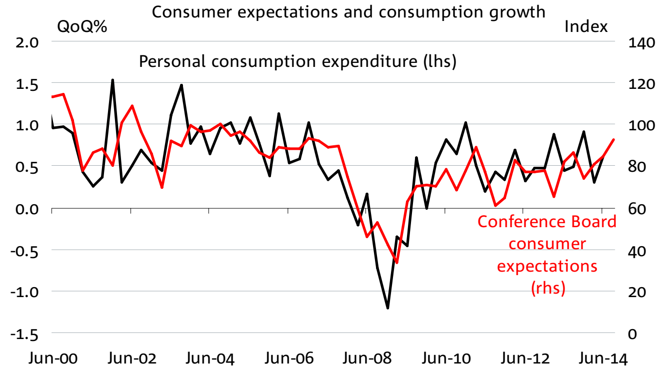
While partial indicators are mixed for the housing sector, we expect residential investment to keep growing as activity is still below normal levels and strong employment growth should encourage more people to start up new households. Business investment should also remain positive – while profits data are not yet available for the June quarter, it is likely that the large fall in the March quarter will be at least partially reversed, taking profits back to relatively high levels. Credit conditions also continue to ease which should further support investment.

Fiscal headwinds are also fading. While federal fiscal policy is again contractionary this year, it is less so than last year. Monetary policy also remains accommodative.

Early indicators for September quarter also positive



Sources: ISM, Philadelphia, Dallas, Kansas City, Richmond, New York Federal Reserves, NAB



Sources: BEA, Conference Board, NAB. Expectations for Sep '14 qtr based on July '14.

The Fed's July meeting statement (also released yesterday) included another reduction in its monthly asset purchase (QE) program. QE asset purchases are likely to end following the Fed's October meeting. The Fed does not regard this as 'tightening' but as an end to easing.

The Fed's July meeting statement acknowledged that inflation has moved back towards its (2%) target. It also noted 'the likelihood of inflation running persistently below 2 percent has diminished somewhat.' The GDP accounts show consumer inflation was 1.6% yoy in the June quarter, up from the 1.0% yoy end-2013 reading. Core inflation has also moved up (1.5% yoy in the June quarter).

With Inflation moving back towards target and the other side of the Fed's mandate - the labour market - improving more quickly than expected, we recently brought forward our expectation of the first fed funds rate hike from the September quarter to the June quarter 2015. This still means any tightening will not be happening soon and the Fed continues to signal that when it does start tightening it will be gradual.

We have revised our forecast for GDP growth for 2014 up from 1.6% to of 2.1%, reflecting the stronger than expected June quarter outcome and revisions to prior quarters. Our forecast for 2015 (3.0%) is unchanged.

For more information, please contact

Tony Kelly +613 9208 5049
antony.kelly@nab.com.au

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	2.4	2.4	2.7	2.6	0.5	0.9	0.3	0.6	**0.8**	**0.7**	**0.6**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.1	7.7	6.1	1.6	1.5	0.0	1.4	**2.1**	**2.2**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.0	-0.6	0.2	0.8	0.0	-1.0	-0.2	0.4	**-0.1**	**-0.1**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.0	0.0	-0.1	0.0	0.3	-0.1	-0.3	0.4	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.2	0.0	-0.1	0.1	0.3	-0.4	-0.1	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.1**	**3.0**	**2.8**	**1.1**	**0.9**	**-0.5**	**1.0**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*4.5*	*3.5*	*-2.1*	*4.0*	*3.0*	*2.9*	*2.9*	*2.9*	*2.9*	*2.9*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.8	1.7	2.0	0.4	0.3	0.3	0.6	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Core	1.3	1.7	1.9	2.0	0.4	0.3	0.3	0.5	**0.4**	**0.4**	**0.5**	**0.5**	**0.4**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.9	5.3	4.9	7.3	7.0	6.7	6.2	**6.1**	**5.9**	**5.7**	**5.6**	**5.5**	**5.3**
US Key Interest Rates (end of period)														
Fed funds rate	0.25	0.25	1.00	2.50	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.25**	**0.50**	**0.75**	**1.00**
10-year bond rate	3.03	2.75	3.50	3.00	2.61	3.03	2.72	2.53	**2.75**	**2.75**	**3.00**	**3.25**	**3.50**	**3.50**

Source: NAB Group Economics

*Contribution to real GDP

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Phin Ziebell
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

International Economics

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Head of Credit Strategy
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350