United States Economic Update

by NAB Group Economics 14 November 2014

- **The U.S. economy is growing at an above trend pace, with strong jobs growth.**
- **We expect the Fed to start raising rates in mid-2015. While there signs wages growth is starting to strengthen, with oil prices falling and the dollar strengthening, low inflation remains the main risk that may delay rate hikes.**
- **The overall impact on economic growth of the fall on oil prices is probably positive, although it may slow growth in the mining sector.**

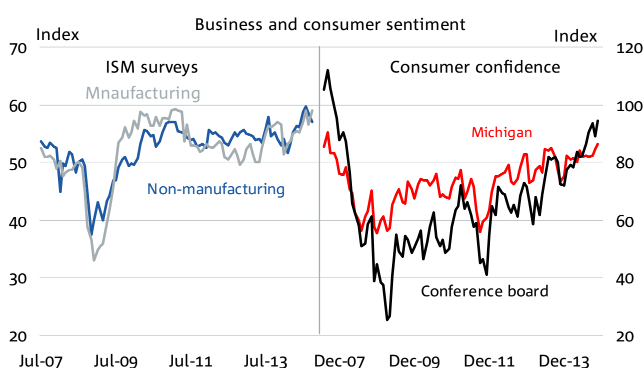
Economic overview

The advance estimate for GDP growth came in at 3.5% qoq (annualised), a reasonably strong result considering that it included a negative inventory contribution. That said, our view at the time was that a couple of factors temporarily boosting growth in the quarter – a strong net export contribution and a spike in Federal defence spending – were unlikely to be repeated in the December quarter. In the event, it looks likely that the net export contribution will be revised away if the subsequently released September month trade data are any guide, with goods exports falling in September.

As a result, tracking estimates suggest that Q3 GDP growth may be revised down to around 3% when the second estimate is released later this month. Even if this were to eventuate, this is still a solid result as it is above the longer-term potential growth rate of the economy, and so is consistent with continued labour market improvement.

Moreover, business and consumer surveys remain generally positive. The ISM manufacturing surveys are at levels consistent with around 3.5% GDP growth. At the same time, while still below pre-recession levels, consumer confidence continues its recovery. Both the Michigan University and Conference Board consumer measures reached recovery highs in October.

Business and consumer confidence indicators

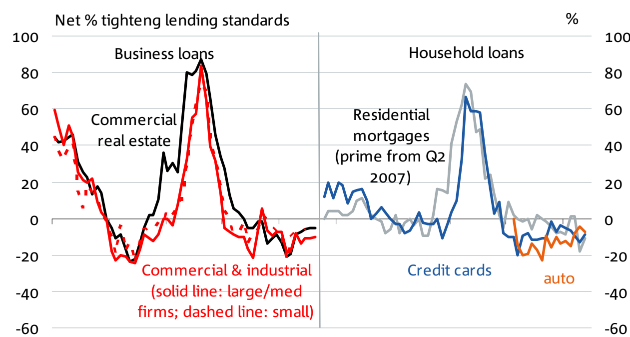


Sources: ISM, Conference Board, Uni.of Michigan/Thomson Reuters. Data are to Oct' 2014.

Looking ahead, rising confidence, coupled with strong employment growth, ongoing improvement in household balance sheets and easing bank lending standards should underpin solid future consumption growth. The recent falls in gasoline prices (and associated softer inflation readings) are also a plus for household budgets and may serve to boost consumption.

While residential activity indicators continue to be mixed we expect residential investment to grow over time as activity returns to more normal levels. The level of construction is still low by historical standards and with, on-going employment growth likely to spur demand and vacancy rates declining, activity should recover. Business investment is also expected to remain positive, supported by a high level of profits and improving credit conditions.

Banks continuing to ease lending standards



Source: Federal Reserve (Senior Loan Officer Opinion Survey. Commercaial Real Estate from Dec. '13 Qtr is a simple average of the three CRE categories.

If anything, the recovery in the labour market is occurring at a faster pace than general activity indicators. In October, non-farm employment grew by 214,000, the ninth consecutive month of plus 200,000 growth. Average monthly job gains have gone from 186,000 in 2012, to 194,000 in 2013 to 229,000 this year.

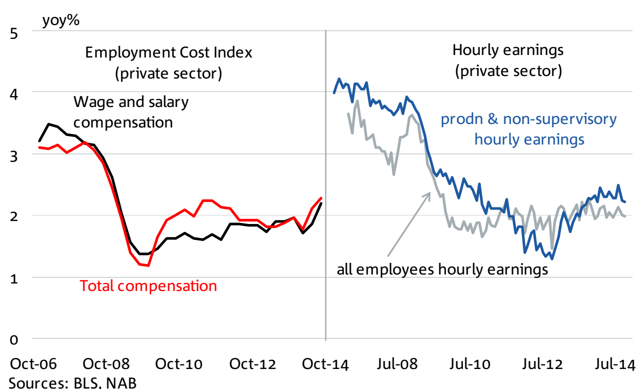
This represents strong jobs growth. Non-farm employment in October 2014 was 1.9% higher than a year ago, more than double the estimated increase in the population (aged over 16) over the same period. Consequently, the unemployment rate has been falling, and did so again in October. At 5.8% it is already below the Fed's September meeting 'central tendency' forecast for end 2014. Broader measures of labour underutilisation are also declining.

Of course the Fed has a dual mandate and is concerned not just with ensuring full employment, but also aims to achieve annual inflation of 2% over time. Inflation has been running well below target for a while. The PCE inflation measure in September was 1.4% yoy. While central banks often look through swings in inflation caused by commodity prices, even the core (excluding food and

energy) inflation measure has stabilised at around 1.5% yoy in recent months, also below the Fed's goal.

Like us, the Fed's view has been that the continuing recovery would see a gradual increase in inflation. A concern of the Fed has been the absence of clear signs of a strengthening in wages growth. Indeed this is one of the measures the Fed Chair has indicated that she looks at, in addition to the unemployment rate, in assessing the labour market. While the employment report's hourly earning measure for all employees continues to show little growth, other measures are starting to. The Employment Cost Index grew by 0.7% qoq in both the June and September quarters, signalling a rise in the annual growth rate to 2.3%. The non-farm business sector compensation per hour measure (not shown in chart) from the BLS' productivity report has also moved higher to 3.3% yoy.

Some indicators showing wage growth strengthening



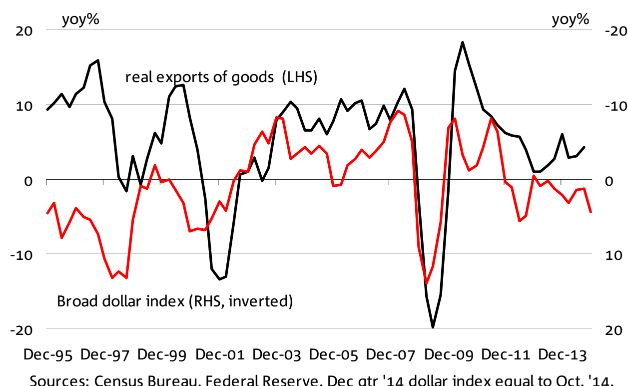
Sources: BLS, NAB

These developments leave us comfortable with our view that the Fed will start increasing rates in mid-2015. The main risk of a delay comes from the inflation side, with both oil prices and dollar appreciation placing downward pressure on prices. Our currency team recently revised its forecasts, suggesting even stronger currency appreciation than we had been factoring in, reinforcing the likely gradual nature of any rise in inflation. If inflation doesn't show signs of moving up (abstracting from oil price impacts), or if a broad range of inflation expectation measures move down below their typical range, then the Fed may delay any tightening.

Apart from its impact on inflation the appreciation of the dollar also poses a risk to the growth outlook, particularly when coupled with global economic growth concerns. Historically there have been periods where an appreciation of the dollar has led to, or been associated with, a slowdown in export growth. We say 'associated with' because the dollar may have moved higher because of weakness in other economies, and it is this weakness which causes the export drop-off (which is then reinforced by a loss of U.S. competitiveness due to the currency move).

While, as noted previously, real goods exports fell in September, monthly data are volatile and for the quarter as a whole, real goods exports were still up a solid 1.9% on the June quarter. Looking at annual growth rates – as shown in the chart below – real export growth appears to have been strengthening since early 2013, despite this being a period of US dollar appreciation. Nevertheless, we think net exports will likely detract from growth in coming quarters but not by enough to derail the economy. Consistent with this, the ISM export indicators – which generally provide a good indicator of the underlying trends - have moved lower in recent months (but are still consistent with export growth).

Exports have held up in face of USD appreciation…so far



Sources: Census Bureau, Federal Reserve. Dec qtr '14 dollar index equal to Oct. '14.

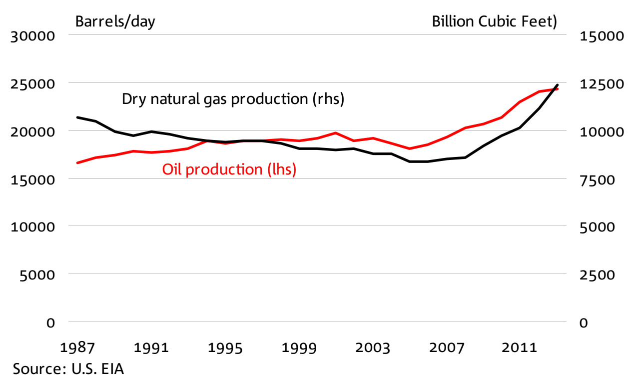
Another risk to the outlook is the return of budget battles in Washington. Congressional midterm elections held in early November kept everyone on their best behaviour but with these out-of-the-way, and some looming deadlines, tensions may re-emerge. In particular, the Government is funded only through to mid-December so an appropriation bill (or continuing resolution) will need to be passed. The debt limit is currently in suspension until March 2015 and will need to be raised, or again suspended, shortly after.

Overall, we remain comfortable with our view that in the rest of 2014 and into 2015 there will be solid, above trend growth. With fading headwinds from fiscal policy and still loose monetary policy, a generally supportive environment for business investment, considerable scope for further increases in residential investment and the labour market continuing to recover the outlook is positive.

Implications of the decline in oil prices

In recent years the U.S. has been enjoying an energy boom. As a result between 2005 and 2013, the real value added of the mining sector increased by 64%, compared to GDP growth of only around 10% over the same period. Growth in the sector has been concentrated in oil and gas due to the use of horizontal drilling, and hydraulic fracturing in shale formations.

Oil and gas production has surged since mid-2000s



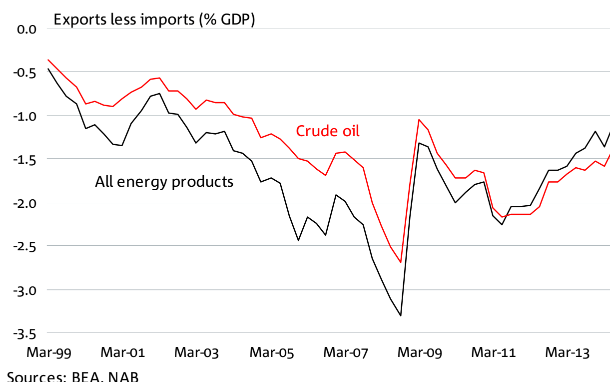
Source: U.S. EIA

Apart from its impact on inflation, the other question raised by the large fall in oil prices is the impact on the U.S. economy. Since the middle of the year oil prices (Brent crude) have fallen by around 30%, and they are now at around four year lows.

At first glance any potential impact might appear small – despite its rapid growth, the mining sector in 2013 only made up 2.7% of the U.S. economy (and more than a quarter of that was in mining other than oil and gas). Its share of employment is much smaller – at 0.6% - due to the capital intensive nature of mining operations. However, with most post-WWII recessions in the U.S. being preceded by oil price spikes, swings in oil prices have long been regarded as potentially important.

One possible channel is through broad income effects. The U.S. has been a net importer of oil (and energy in general) and despite the energy boom this remains the case despite a marked reduction in recent years.

U.S. is still a net oil (and energy) importer



Sources: BEA, NAB

Given that the U.S pays more abroad than it is receives, a reduction in the price of oil effectively provides a boost to national income, although there will be some losers (oil producers) as well as winners.

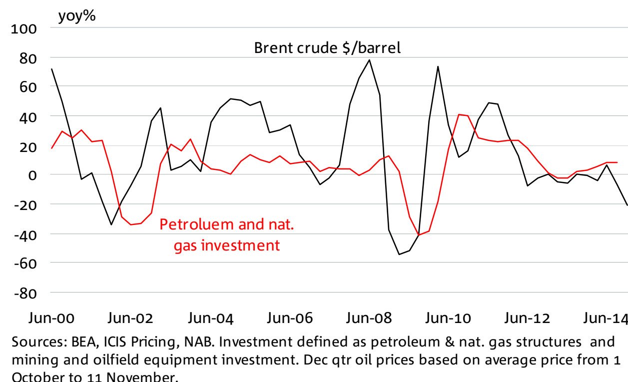
Amongst the winners are households. Spending on gasoline and other energy goods was around 3% of household disposable income in recent quarters. The 20% fall in gasoline prices between June and November (to-date) therefore increases household spending power by 0.6ppts. Part of the decline in gasoline prices is seasonal, but even allowing for this spending power is still up 0.4ppts. How much short-term impetus this has on the economy will in-part depend on how households react – do they spend (or save) the money they now have left over in their pockets after a trip to the petrol station?

Another factor that needs to be balanced against this is the impact on the mining sector. Here there are broadly two issues - will there be any immediate impact on production (e.g. through shutting downing wells) or any impact on future investment in capacity (which will affect future production)?

The U.S. Energy Information Agency's (EIA) latest forecasts included a small downward revision to projected production because of the impact of the oil price decline; but the extent of revision – 80,000 barrels – is only around 1% of 2013 actual production and they are still forecasting production to rise over time. According to the EIA, the wells that will not be drilled (or exploration that will not occur) are in low producing areas. It expects prices to remain high enough to support activity in the areas which make up most U.S. oil production growth.

Historically, large swings in oil prices have had an impact on investment in mining. A simple econometric model suggests that a 10% fall in oil prices will lead to a 6% decline in investment, although the impact occurs with a delay and takes over a year to fully show up. Of course, many factors affect investment decisions, and the sensitivity may change over time. With the growing importance of shale production, more U.S. oil production is now associated with natural gas, so the price of gas is also relevant for oil investment decisions. The natural gas price in the U.S. has not moved greatly, and remains within its range of the last several years. Therefore, the impact on investment may be more limited than in the past. Moreover, the correlation appears strongest around recessions when other factors are in-play. Even if this simple relationship holds, business investment in mining only makes up around 1% of U.S. GDP, so, it suggests a total GDP impact of only 0.2ppts spread over a year.

Past oil price swings have affected investment



Sources: BEA, ICIS Pricing, NAB. Investment defined as petroleum & nat. gas structures and mining and oilfield equipment investment. Dec qtr oil prices based on average price from 1 October to 11 November.

More fundamentally, why oil prices are falling can be just as important as by how much. If it is due to a global economic slowdown (a 'demand shock') then the overall impact on the U.S. is likely to be negative, as any positive effects from lower oil prices are overwhelmed by the more negative global environment. In contrast, if it is due to a global supply shock, then for the U.S. the overall impact is likely to be positive. To illustrate the potential magnitudes, the IMF, in its September 2014 World Economic Outlook, modelled a 20% oil price supply shock. The IMF estimated that it would have a second year impact of around 0.5ppt to 1ppt on U.S. GDP with the range reflecting the extent to which confidence was affected by the oil price change.

In the current instance both supply and demand factors are in play. On the supply side there are continuing production increases in the U.S. as well the restoration of supply from Libya, while on the demand side there are concerns over stagnation in the Euro-zone, the strength of the Japanese economy and the pace of the slowdown in China.

Overall, our assessment is that with the demand concerns centred outside of the U.S. (and with world economic growth expected to strengthen next year), and U.S.

consumer confidence rising, the overall impact is probably positive. However, with the USD appreciating more quickly than expected, we have been content to leave our overall GDP forecast unchanged. Moreover, our commodity team do not expect the current lows to be maintained (see our Minerals & Energy Commodities Update), and expects prices to rise over 2015 although the forecast remains under review. In contrast, the EIA's October Short-Term Energy Outlook forecasts oil prices to average $83/barrel next year, more in line with recent prices (but the degree of uncertainty with any forecast is highlighted by its October forecast being $18/barrel lower than its September forecast).

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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	2.2	2.6	2.6	0.5	0.9	0.3	0.6	0.4	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.2	7.4	6.3	1.6	1.5	0.0	2.3	1.2	**2.0**	**1.9**	**1.8**	**1.7**	**1.6**
Government spending	-2.0	-0.1	0.6	0.8	0.0	-1.0	-0.2	0.4	1.1	**-0.3**	**0.0**	**0.1**	**0.2**	**0.2**
Inventories*	0.0	0.0	-0.1	0.0	0.3	-0.1	-0.3	0.3	-0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.1	0.0	-0.1	0.1	0.3	-0.4	-0.1	0.3	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.2**	**3.0**	**2.8**	**1.1**	**0.9**	**-0.5**	**1.1**	**0.9**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*4.5*	*3.5*	*-2.1*	*4.6*	*3.5*	*2.5*	*2.7*	*2.9*	*2.9*	*2.9*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.3	1.9	2.0	0.4	0.3	0.3	0.6	0.3	**0.0**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.3	1.5	1.8	2.0	0.4	0.3	0.3	0.5	0.3	**0.3**	**0.4**	**0.5**	**0.4**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.8	5.2	4.8	7.3	7.0	6.7	6.2	6.1	**5.8**	**5.6**	**5.4**	**5.3**	**5.2**
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	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	2.50	3.50	3.00	2.61	3.03	2.72	2.53	2.49	**2.50**	**3.00**	**3.25**	**3.50**	**3.50**

Source: NAB Group Economics

*Contribution to real GDP

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