United States Economic Update

by NAB Group Economics 10 December 2014

- **GDP growth is expected to strengthen in 2015 to 3.0%, from 2.3% in 2014.**
- **This reflects rising business and consumer confidence, improving household balance sheets, a strengthening labour market, solid investment conditions, declines in oil prices and a fading headwind from fiscal policy.**
- **Headwinds are coming from the appreciation of the dollar and monetary policy is likely to start tightening from mid next year. Low inflation (actual or expected) remains the main risk that may delay rate hikes.**

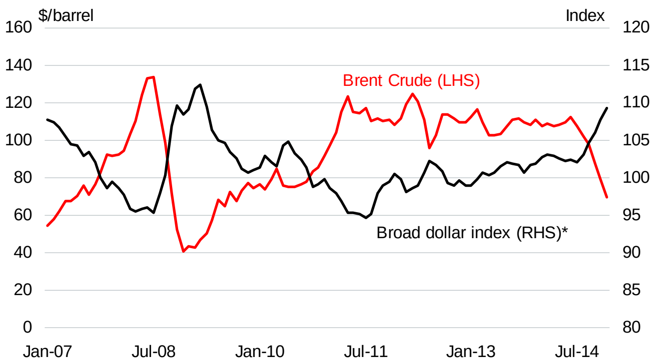
Economic overview

Indicators continue to suggest that the U.S. economy is experiencing solid growth, with the labour market in particular showing signs of rapid improvement.

At the same time, however, the economy is being affected by large movements in oil prices and the currency. These two factors have different (and therefore, at least to some extent, offsetting) implications for growth. In contrast, in they are both putting downwards pressure on headline inflation.

In last month's update we looked at the implications of the fall in the crude oil prices. Our conclusion then was that the impact was probably a positive one although it was being offset by the continuing appreciation of the U.S. dollar. Since then both factors have continued their recent trends – the oil price (Brent crude) has fallen below $70/barrel (down from $110 at mid-year) while the dollar has continued to gain (and is up around 7-8% since mid-year).

Cross currents hitting the economy



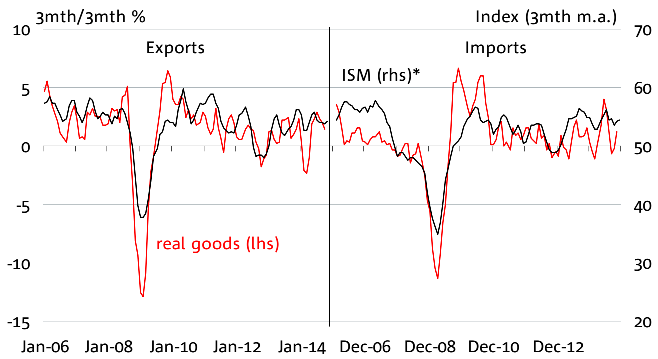
Sources: Fed. Reserve, ICIS Pricing. For Dec '14 the BDI and Brent values are the average to 5 Dec and 8 December respectively.

In last month's update we also noted IMF modelling which, given the size of the oil price declines to date, would suggest an increase in GDP by the second year of around 1-2ppts. However, this is assuming it is entirely a supply driven shock and, while supply factors are in play, demand (or expectations of weaker demand) also appears to be a factor.

Moreover, given the recent large increases in U.S. oil production over recent years it is possible that any estimates based on past experience will over estimate the positive impact on the economy. Further, the impact on oil industry and related investment is likely to get bigger with each $10 fall in the oil price – a fall from $100 to $90/barrel may have little impact as current and prospective operations are still profitable; a fall from $80 to $70 may not affect existing production much (but might stop new operations), while further falls from current levels may start to impact on existing operations.

In terms of the impact of the dollar appreciation, our import and export equations suggest that an 8% appreciation can be expected to lead to net exports detracting around ¾ppt from growth over time. However, the dollar has been on a modest upward path for a few years now so the additional headwind on growth from the recent move is smaller. While data in recent months do suggest some moderation in export growth and pick up in imports, at this stage the tradeables sector is coping. Moreover, we expect global growth to strengthen next year. However, the full effects of a higher dollar will show up over time and the strong positive boost from net exports in the September quarter looks like an outlier and a correction is likely in the December quarter. As a result we expect net exports to detract from growth in coming quarters.

Exports holding up…for now

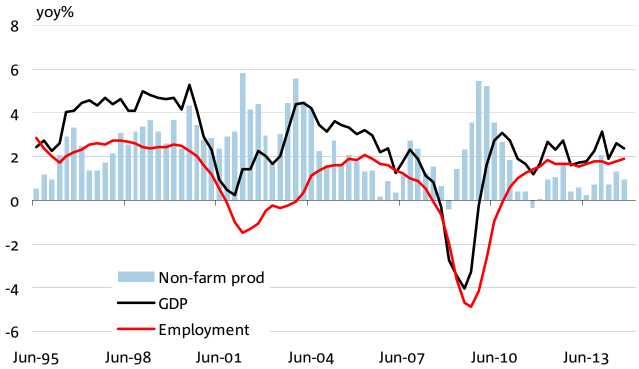


Sources: ISM, Census Bureau. *Average of ISM manuf./non-manuf. export/import indicators using goods/services trade shares.

Beyond this combination of strong tailwinds and headwinds, the prospects for the economy look positive. As the economy recovered from the recession Fed speakers were always on the look out for a 'self-sustaining' recovery. This envisages a world where confidence is rising, which encourages households to consume, which in turn boosts business conditions and leads to increases in investment – including in people (new jobs) – which in turn boosts household income and, as a result, consumption and confidence and the loop then repeats itself. Other influences reinforce this dynamic – falling employment and better business conditions reduce problem loans contributing to an easing in lending standards. Even a rising dollar has a silver lining as it lowers inflation which is not only a further boost to household budgets and spending but also means the Fed can delay rate hikes.

Seen in this light, the recent strong employment growth is an important dynamic. In November, non-farm employment grew by 321,000, much higher than expected. While our regular caution of not reading too much into a single month's numbers applies both for high and low results, the annual employment growth rate has been 2.0% in each of the last three months, the best outcome since 2006. This growth rate is only a little higher than what it has been for the last three years, signalling a sustained period of job creation. As a result the unemployment rate is clearly trending down.

Sustained jobs growth, but low productivity



Sources: BEA, BLS, NAB. Dec '14 qtr employ. based on growth over year to November.

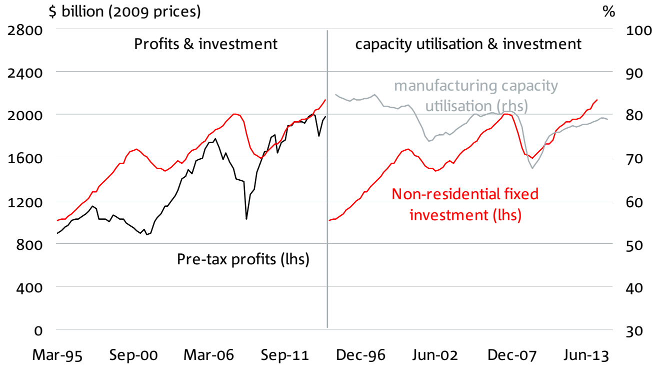
The rate of growth in employment has been strong relative to the growth in GDP, implying only low levels of productivity growth. Our forecasts include not only a pick-up in GDP, but also, in-time, a slowdown in employment growth as the unemployment rate returns to more normal levels and the amount of unemployed or underutilised labour diminishes. This implies a return to more normal levels of productivity growth. A risk is that, if the recent poor productivity experience were to continue, then the unemployment rate will continue falling at a faster than expected rate.

Nevertheless, the rapid growth in employment is currently a strong support to household incomes. At some stage, the improvement in the labour market should lead to stronger wages growth. There are some tentative signs this may already have started with stronger recent growth in the Employment Cost Index although other earnings indicators are more muted. Coupled with household balance sheets continuing to improve – household net worth as percentage of disposable income is not far off its pre-recession highs – and a positive impact on household budgets from falling gasoline prices, consumption growth is expected to be stronger in 2015.

As wages strengthen this may mean there is downward pressure on profit margins (particularly if our expectation of an improvement in productivity is not realised).

However, for now conditions for business investment remain generally favourable. Profits remain high, capacity utilisation is rising and credit conditions continue to be eased. The main negative is in the oil sector, where the lower oil prices will impact on investment (including in support industries).

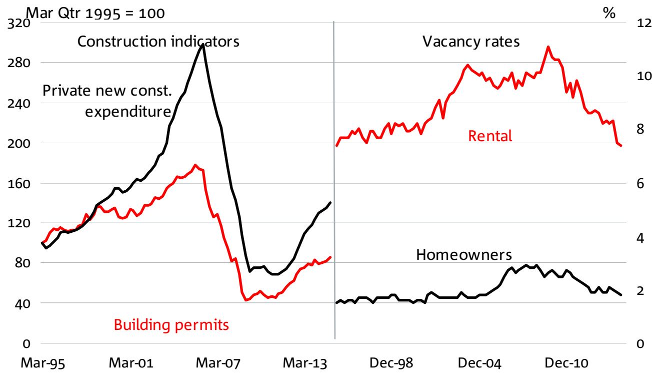
Investment conditions still generally favourable



Sources: BEA, Federal Reserve. Dec qtr '14 capacity utilisation equal to October '14

There is also plenty of scope for residential investment to grow next year. While construction activity has picked up from its pre-recession lows, it still remains low by historical standards. As a result vacancy rates continue to fall. This is despite still only subdued growth in the number of households; as more people gain jobs, and as confidence about the future rises, more people may be encouraged to leave home, or stop sharing, and start-up their own households, further adding to demand for new construction. Mortgage interest rates have also moved down over the course of this year (from 4.4% early in the year to around 3.9% on the Fed's measure). This should be a positive for activity in the short-term, but we expect rates to start rising from the second quarter of next year.

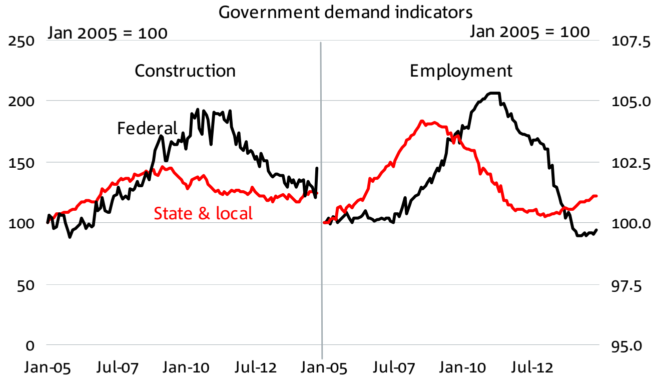
Residential construction still has plenty of upside



Sources: BEA, Census Bureau, NAB. Dec. '14 const. estimates based on October '14

The headwind from fiscal policy also continues to diminish. Estimates published by the CBO in August estimated that in fiscal year 2014 the federal fiscal deficit declined to 2.9% of GDP, 1.2ppts lower than in the previous year. On a no policy change basis, the deficit was expected to fall again in fy 2015, but only by 0.3ppts (before rising slightly the following year). This is being reflected in the partial indicators in which the fall in federal employment appears to have ended, as have cut backs in construction expenditure. That said, in the December quarter, we are allowing for some correction to last quarter's spike in defence spending to occur. Similar indicators for state and local government are more positive, and point to overall direct government demand actually turning positive in 2015.

Fading fiscal policy headwind



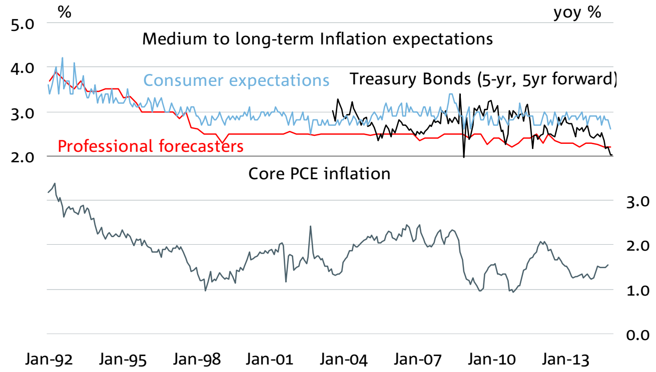
Sources: Census Bureau, Bureau of Labor Statistics, NAB

In contrast, we expect the Fed to actually start the process of tightening monetary policy next year (last year's end to QE only meant that it had stopped easing). Our view for a while has been that the Fed would start to raise the Fed funds rate in the June quarter (most likely at its June meeting). At 5.8% the unemployment rate is now close to what most members consider its 'normal' rate (the 'central tendency' forecast is for a long-run unemployment rate of 5.2 to 5.5%).

At the same time, however, inflation remains below the Fed's 2% target and is likely to come under further downwards pressure from declining oil prices. In October the annual growth rate of the personal consumption expenditure (PCE) price index was 1.4% and it is likely to move lower in coming months. However, the Fed's Vice Chairman has indicated that the Fed will look through the impact of oil prices on inflation. This makes the core (ex food and energy) measure the one to watch and in October it actually rose to 1.6%, yoy (from 1.5% in September) and is well above its low of 1.2% earlier in the year. Low oil prices can also flow through into core prices (e.g. though lowering transportation costs embedded in other goods and services) but if they provide a boost to the economy this can be offset by stronger pricing pressures elsewhere. The impact of the rise in the dollar on core inflation is clearer, and it will exert downward pressure. However, as with oil prices, the Fed will likely view the impact of the recent particularly strong dollar appreciation (assuming it is not sustained) as temporary.

The Fed will also be closely watching inflation expectations. Measures derived from financial markets have fallen to low levels recently and even some survey measures have shown a weakening. Once the price of oil stabilises the Fed will be looking to see signs of expectations moving back to more normal levels.

Inflation and inflation expectations



Federal Reserve (unofficial), Philadelphia Fed. Reserve, Thomson Reuters/Michigan University, BEA.

On balance, these developments leave us comfortable with our view that the Fed will start increasing rates in mid-2015. The risks around this call are that faster than expected falls in the unemployment rate (especially if accompanied by stronger wages growth) might mean that it occurs slightly earlier. However, a decline in core inflation or sustained weakness in inflation expectation measures could lead the Fed to delay rate hikes.

Putting this all together, GDP growth may slow in the December quarter as some temporary factors that boosted growth in the previous quarter drop out. However, rising business and consumer confidence, improving balance sheets, a strengthening labour market, solid investment conditions including easing credit conditions, declines in oil prices and a fading headwind from fiscal policy suggest that the U.S. is likely to see a stronger rate of GDP growth in 2015 - we are projecting 3% compared to 2.3% for 2014. Headwinds are coming from the appreciation of the dollar and monetary policy is likely to start tightening from mid next year.

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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	2.3	2.8	2.7	0.5	0.9	0.3	0.6	0.5	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.3	7.2	6.3	1.6	1.5	0.0	2.3	1.5	**1.9**	**1.8**	**1.7**	**1.7**	**1.6**
Government spending	-2.0	-0.1	0.8	0.8	0.0	-1.0	-0.2	0.4	1.0	**-0.2**	**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	0.0	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.2	-0.1	-0.1	0.1	0.3	-0.4	-0.1	0.2	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.2**	**2.3**	**3.0**	**2.8**	**1.1**	**0.9**	**-0.5**	**1.1**	**1.0**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*4.5*	*3.5*	*-2.1*	*4.6*	*3.9*	*2.4*	*2.7*	*2.9*	*2.9*	*2.9*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.2	1.6	2.1	0.4	0.3	0.3	0.6	0.3	**0.0**	**0.1**	**0.4**	**0.5**	**0.5**
Core	1.3	1.6	1.8	2.1	0.4	0.3	0.3	0.5	0.4	**0.4**	**0.4**	**0.4**	**0.5**	**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**	**5.5**	**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	2.25	3.00	3.00	2.61	3.03	2.72	2.53	2.49	**2.25**	**2.25**	**2.50**	**2.75**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP

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