United States Economic Update

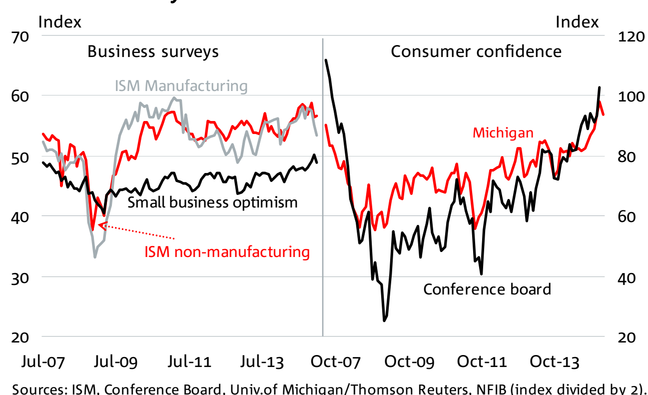
by NAB Group Economics 16 February 2015

- **GDP growth declerated in the December quarter to 2.6% qoq (annualised). This still represents solid growth, consistent with our outlook for above trend growth.**
- **Strong recovery in the labour market continues, but still waiting for clear signs of a pick up in wages.**
- **US banks have been easing lending standards, although by historical standards they still remain tight for some loan types (particularly residential mortgages).**

Following two strong quarters, U.S. GDP growth decelerated in the December quarter to a still solid 2.6% qoq (annualised). Subsequently released partial data suggest that GDP growth might be revised down in the second estimate later this month. Even if this eventuates, taking into account the very strong (annualised 5.0% qoq) growth in the previous quarter, the overall picture is of an economy growing at a solid, above long-term trend, pace. As a result the unemployment rate is on a downward trend.

The large fall in oil prices and the rise in the dollar are producing both winners and losers. Business surveys suggest that conditions within the manufacturing sector, which is relatively trade (and therefore dollar) exposed and which provides inputs into the oil sector – have softened, although it is still growing. The non-manufacturing survey has held up better. Taken together, the ISM survey readings are still consistent with above-trend growth. Within the business sector, optimism in the small business sector has improved recently. This is also true for consumers, who are the major beneficiaries of the decline in oil prices.

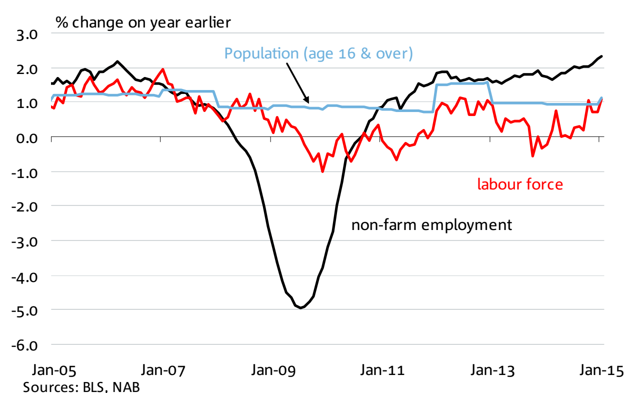
Business surveys and consumer sentiment



Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, NFIB (index divided by 2).

At the same time, employment growth has been strengthening. For a long period of time, employment growth was relatively steady. It grew at an annual rate of between 1.5 to 1.9% from late 2011 through to mid-2014. Since then it has strengthened, particularly over the last three months. In January, non-farm employment increased by 257,000, the eleventh consecutive month of 200,000 plus job gains. In the last three months, employment increased by over 1 million – the first time this has occurred over a three month period since 1997. As a result the annual growth rate has climbed to 2.3%.

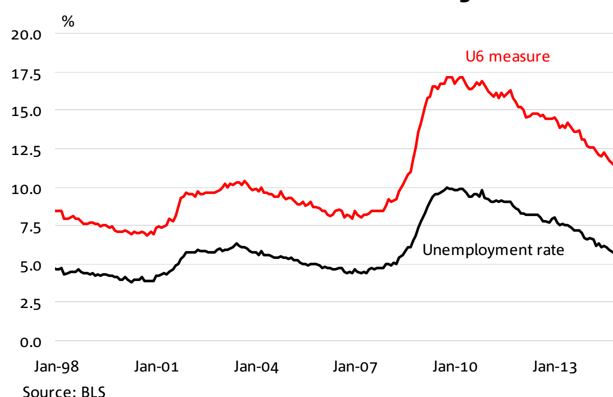
Employment growth strengthening and well above population & labour force growth



Sources: BLS, NAB

Moreover, over the last year, labour force participation has been broadly flat. With demographic factors putting downwards pressure on participation over time, this suggests some recovery in workforce participation which fell following the recession. As a result annual labour force growth in January matched civilian population (aged 16 and over) growth. Both these indicators are growing by around half the rate of employment growth.

Labour market underutilisation declining

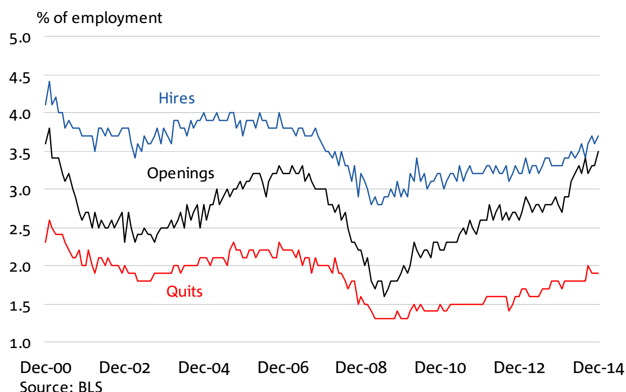


Source: BLS

Consequently, the unemployment rate continues to trend down, notwithstanding a small rise in January. Broader measures of unemployment and underemployment – such as the Bureau of Labour Statistics' 'U6' measure - while they have not made as much progress back towards pre-recession levels are also clearly declining. (The U6 measure includes workers marginally attached to the workforce and those working part-time who would like, and are available for, a full-time job.)

Measures of gross labour market turnover are also showing improvement. In particular, job openings are now above their pre-recession level, whiles hires are not far off. Quits are also trending up, which is a positive as it suggests individuals are finding it easier to find alternative jobs (in contrast layoffs are at relatively low levels).

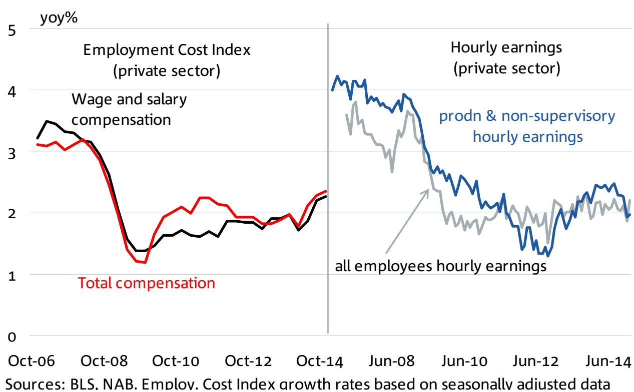
Labour market turnover measures also improving



Source: BLS

For many, including some at the Fed, the missing ingredient in the labour market recovery has been wages growth. The Fed's focus is on the need for wages growth to pick-up to a level consistent with an inflation rate closer to its 2% long-term target. The typical pattern for wages post recession is for growth to decline only slowly, suggesting a delayed reaction to higher unemployment. The slowdown in aggregate wages growth, however, often continues well after the unemployment rate has begun to decline. Later in the recovery, as unemployment reaches low enough levels wages growth starts to accelerate again.

Mixed signs on wages



Sources: BLS, NAB. Employ. Cost Index growth rates based on seasonally adjusted data

How low unemployment needs to be before wage pressures emerge is subject to much debate, although the strength of recent job gains suggests that this point is not far off. So far there have been only mixed signs of a strengthening in wages growth, with the reported decline in December hourly earnings in last month's Employment Report only adding to the confusion. However, this measure grew strongly in January; while this took the annual rate to its equal highest rate in over a year there is little sign of a sustained acceleration. In contrast, the Employment Cost Index has strengthened, although it is still only showing modest growth.

We expect that the labour market will continue to recover, which will, in-time, support higher wage growth. Consistent with this, we also expect the economy to grow at an above trend rate in coming years. We are forecasting GDP growth of 3.3% in 2015 and 2.7% in 2016.

The plunge in oil prices and the rising dollar may be a negative for business investment although it is not clear cut. The fall in oil prices will hit industry profitability while dollar appreciation affects import competing businesses and profits (in dollar terms) of firms operating overseas. However, some business will gain from these factors due to reduced input costs, and the general strength of activity should also encourage investment.

The improvement in consumer confidence, coupled with strong employment gains and rising effective incomes due to falling prices, should also support strong consumption growth. That said, retail sales were surprisingly soft in December and January (after two very strong months), suggesting some downside risk to our forecasts.

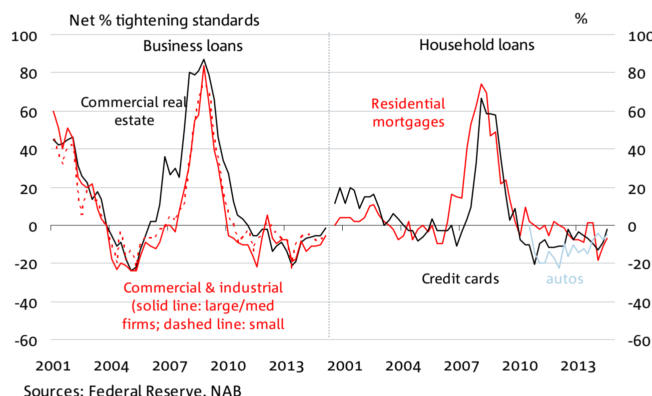
Moreover, despite the likely prospect of monetary policy tightening later this year (we expect in June but the risk is that it will be later), interest rates are low. Further, fiscal headwinds have largely ended.

With the outlook for economic growth reasonably positive, a major focus is on whether inflation will return towards the Fed's 2% inflation target. Inflation is currently well below the Fed's target - and set to move lower in coming months- due to the impact of oil price falls and, to a lesser extent, US dollar appreciation. However, over time, the fall in underutilisation in labour and other markets should ultimately lead to an upturn in inflation.

Credit conditions

Another general positive for the economy continues to be an easing in credit conditions. A guide to how lending standards and conditions are evolving is provided by the Fed's quarterly senior loan officer opinion survey (SLOOS). The survey asks loan officers about changes in standards and terms on, and demand, for bank loans to businesses and households over the past three months. (With the survey released early each quarter, this means that the survey answers mainly relate to the previous quarter.)

Bank lending standards easing



Sources: Federal Reserve, NAB

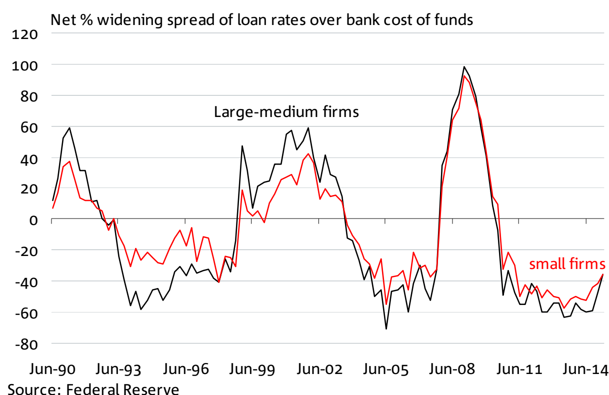
Note: From 2013 Q4 CRE is based on a simple average of the 3 CRE categories. For Residential mortgages, between 2007 Q2 and 2014 Q4 the 'prime' category is used & 2015 Q1 is a weighted average (NAB weights) of the GSE eligible, Government, QM non-jumbo non-GSE-eligible and QM jumbo categories.

The survey suggests that banks (on net) continue to ease lending standards for approving new loans, although the pace moderated in the latest survey. For businesses, commercial & industrial (C&I) loan standards have been easing almost continuously since early 2010, and for commercial real estate (CRE) since 2011. The net percentage of banks reporting an easing in C&I lending standards in the latest survey was its lowest for three years, with some banks tightening standards due to concerns with the oil/gas sector and because of changes in legislative, supervisory and accounting standards. Consumer loan lending standards have also been eased since mid-2010.

The major exception to this pattern of easing standards since 2010/2011 has been residential mortgages. Even for prime mortgages standards continued to be tightened up to the 2011 Q1 survey and then went for two years with little clear change up or down. Easing started more clearly in 2013 it was briefly interrupted in late 2013/early 2014. Moreover, non-traditional mortgages lending standards continued to be tightened up to the first half of 2014 while sub-prime mortgage standards – to the extent they have been offered at all – have not been eased at any time.

It has not just been lending standards that have changed in recent years, but also there has been an improvement in the terms of loans. As an example of this, the chart below shows that (on net) banks have been reducing the spread between their C&I loan rates and their cost of funds.

C&I loan terms also improving

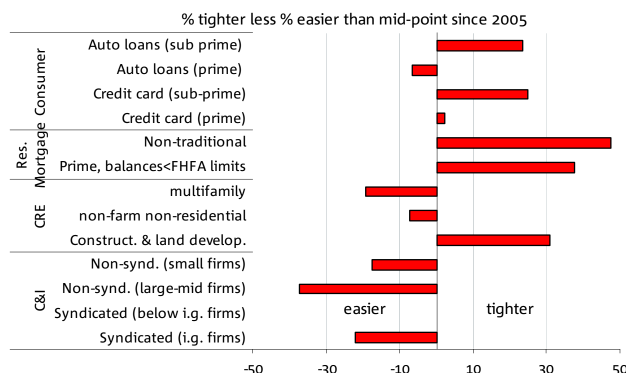


Source: Federal Reserve

The loosening in standards in recent years does not necessarily mean that it is 'easy' to get a loan. The SLOOS measures *changes* in standards, not whether they are tight or loose against a set benchmark. In recent years, in the July survey, banks have also been asked whether standards are tighter or easier in comparison to the past (specifically the mid-point of lending standards since 2005).

The responses from the July 2014 survey are shown below for selected loan categories. They suggest that current lending standards are, by historical standards, fairly relaxed for business but have tightened for households (although with 'prime' household borrowers have fared better). Lending standards remain most strict in the property sector, in particular residential but also some parts of commercial property. This is not surprising given the central role of the property market in the recession. That said, with more recent survey's showing a continued easing in standards, the chart probably overstates how tight, by historical standards, lending standards are.

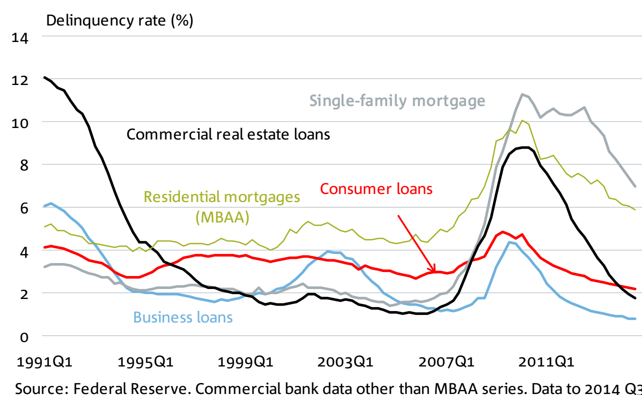
Lending standards compared to past norms



Sources: Federal Reserve, NAB. 'i.g.' denotes investment grade. Data for domestic respondents.

The general easing in standards is consistent with improvements in loan quality. For commercial banks, the delinquency rate on business and consumer loans is at historic lows. The CRE delinquency rate, which had been very high, has fallen rapidly and is also close to a more normal level. In contrast, delinquency rates for residential mortgages remain high, although they are also clearly improving. Improvement in loan quality will be reinforced by the ongoing strength in the economy.

Loan quality



Source: Federal Reserve. Commercial bank data other than MBAA series. Data to 2014 Q3

Historically, changes in lending standards lead changes in loan quality (suggesting that banks are not blind to emerging problems) so the improvements in mortgage quality are no guarantee that banks will continue to ease lending standards. When monetary policy tightening starts it is possible that this may cause stress to some borrowers. However, at this stage banks do not foresee major problems emerging, at least this year. In the January 2015 SLOOS, the banks surveyed indicated that they expected improvement in loan quality for most loan types in 2015 (syndicated leveraged C&I loans and sub-prime auto loans the exception).

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US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %									
					2014				2015				2016	
	2013	2014	2015	2016	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components														
Household consumption	2.4	2.5	3.8	2.8	0.3	0.6	0.8	1.0	**1.1**	**0.9**	**0.7**	**0.7**	**0.7**	**0.7**
Private fixed investment	4.7	5.2	5.4	6.2	0.0	2.3	1.9	0.6	**1.1**	**1.3**	**1.6**	**1.6**	**1.6**	**1.5**
Government spending	-2.0	-0.2	1.1	1.2	-0.2	0.4	1.1	-0.5	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.1	0.0	-0.1	-0.3	0.3	0.0	0.2	**-0.2**	**-0.1**	**0.0**	**0.0**	**-0.1**	**0.0**
Net exports*	0.2	-0.2	-0.3	-0.2	-0.4	-0.1	0.2	-0.2	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**
Real GDP	**2.2**	**2.4**	**3.3**	**2.7**	**-0.5**	**1.1**	**1.2**	**0.7**	**0.8**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Note: GDP (annualised rate)					*-2.1*	*4.6*	*5.0*	*2.6*	*3.1*	*3.0*	*2.8*	*2.7*	*2.6*	*2.7*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.1	0.7	2.3	0.3	0.6	0.3	-0.1	**-0.6**	**0.2**	**0.5**	**0.6**	**0.6**	**0.6**
Core	1.3	1.4	1.5	2.1	0.3	0.5	0.3	0.3	**0.3**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.7	5.0	4.6	6.6	6.2	6.1	5.7	**5.6**	**5.3**	**5.2**	**5.0**	**4.9**	**4.8**
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**	**0.50**	**0.75**	**1.00**	**1.25**	**1.75**
10-year bond rate	3.03	2.17	2.50	3.00	2.72	2.53	2.49	2.17	**1.75**	**2.25**	**2.50**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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