more give, less take

U.S. Economic Update, 2014Q4 GDP

by NAB Group Economics 2 February 2015

National Australia Bank

- **GDP growth declerated in the December quarter to 2.6% qoq (annualised). While lower than expected, this still represents solid, above-trend, growth.**
- **Consumption was strong, assisted by falling gasoline prices, as was inventory accumulation. However, business fixed investment weakened, while both net exports and public demand were a drag on growth.**
- **We have maintained our forecasts of GDP growth of 3.3% in 2015 and 2.7% in 2016.**

U.S. GDP growth decelerated in the December quarter to a still solid 0.65% qoq (2.6% on an annualised basis). This suggests that the economy is growing at an above long-term trend rate. As a result, unutilised capacity in the economy continues to decline.

The stand-out expenditure category was household consumption. Inventories also made a strong contribution to growth. However, business investment softened noticeably while net exports and public consumption detracted from growth.

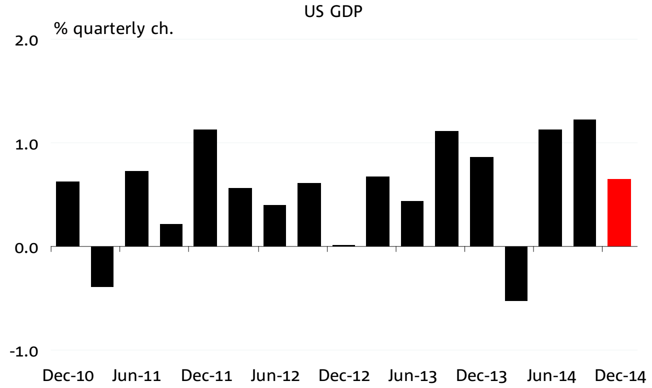
The growth in private consumption, of 1% qoq was the strongest recorded since 2006, with all three major categories (durable and non-durable goods, and services) growing rapidly. Households' disposable income grew at the same rate as the previous quarter (0.8% qoq), but the fall in consumer prices (mainly due to gasoline price declines) boosted effective household spending power and so, even as growth in spending slowed, growth in the volume of purchases increased.

In contrast, business fixed investment growth slowed down to only 0.5% qoq from over 2% in each of the last two quarters. The slowdown was modest for non-residential structures investment and intellectual property products but equipment investment turned negative. Within the equipment category, industrial and transport equipment both fell, while 'other equipment' was down marginally.

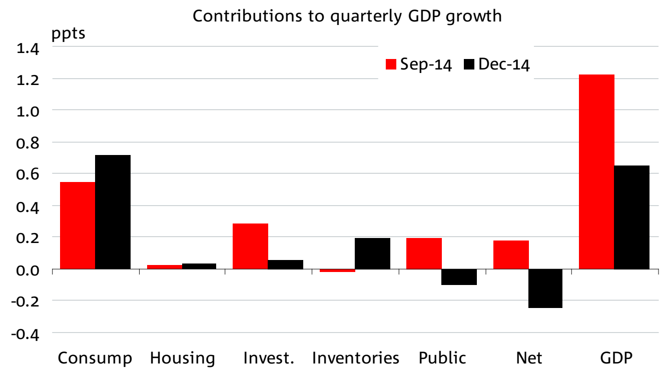
While the plunge in oil prices is expected to weigh on investment, there is no clear impact so far. 'Mining exploration, shafts, and wells' structures investment rose slightly faster than in the previous quarter (2.2% qoq). While the 'other equipment' category includes mining and oilfield equipment its share is small. The falls in industrial/transport investment could be mining related but they follow some strong growth in previous quarters and so may be no more than a correction.

Residential investment grew moderately for the second quarter in a row, although there was some change in composition. New residential construction (the 'permanent site' category) after being flat last quarter grew strongly, but the 'other' category (which includes real estate

GDP growth decelerated in Q4 but was still solid…



…due to strong growth in consumption & inventories



Sources: BEA, NAB. Data not annualised

2014 Q4 GDP detail

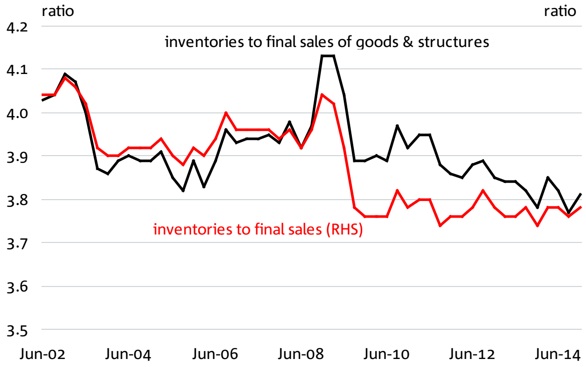
	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	1.0	0.7	2.8
Fixed investment	0.6	0.1	4.9
Structures	0.7	0.02	5.7
Equipment	-0.5	0.0	4.7
Intellectual property	1.7	0.1	6.5
Residential	1.0	0.0	2.6
Ch. in inventories		0.2	
Public Demand	-0.5	-0.1	0.7
Net exports		-0.2	
Exports	0.7	0.1	2.0
Imports	2.2	-0.3	5.3
GDP	0.7	0.7	2.5

Source: BEA, NAB. Data not annualised.

commissions related to house sales and improvements) fell.

Inventory accumulation was its strongest since the September quarter 2010 (in the aftermath of the recession when stocks were being re-built). It probably reflects a build-up of stocks in anticipation of sales (rather than sales falling short of expectations) given strong recent consumption and the widely discussed boost to household purchasing power from falling oil prices. Ratios of non-farm inventories to sales do not indicate a major problem with the level of inventories, although December quarter's rapid build-up is unlikely to be sustained.

Ratios of non-farm inventories to sales



Source: BEA

On the trade front, export growth softened while import growth strengthened. Annual import growth in the December quarter was at its highest level in over three years, likely reflecting the strength of the U.S. economy as well as dollar appreciation. Conversely, export growth has slowed down over the last two quarters as exporters battle currency appreciation and a soft global economy.

The decline in government consumption and investment was due to the bounce in Federal defence spending in the September quarter being largely reversed. Federal non-defence demand rose, as did state & local government (which has increased in seven of the last eight quarters).

The personal consumption expenditure (PCE) price index – the Federal Reserve's preferred inflation measure – declined in the quarter, taking the annual growth rate down to 1.1% (from 1.5% yoy in the September quarter). The core (ex food and energy) measure only softened a little, but at 1.4% yoy remained well below the Fed's long-term inflation target of 2%. With declines in gasoline prices accelerating in January, and with further dollar appreciation constraining import prices, inflation will likely be negative again in the current (March) quarter.

Assessment

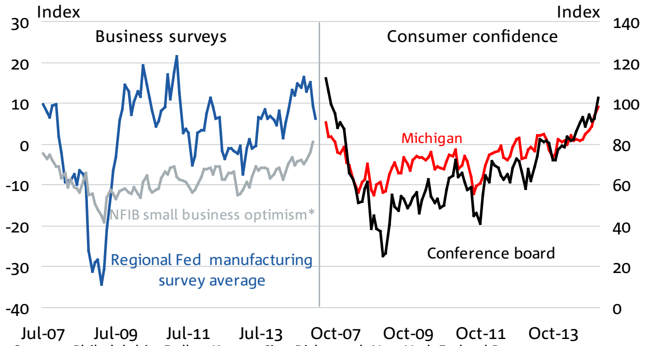
While the advance estimate for 2014 December quarter GDP growth was a bit below market (and our own) expectations, it was nevertheless a solid result. Our estimate of long-term trend growth in the U.S. is around 2% so the 2.6% (annualised) growth in the quarter is consistent with spare capacity in the economy continuing to decline (also signalled by the declines in the unemployment rate).

In the short-term, there is likely to be a headwind from a slower pace of inventory accumulation (although we are not anticipating a major correction). This may be offset by the reversal of what looks like a one-off decline in government demand in the December quarter.

More fundamentally, the major undercurrents affecting the economy currently are the plunge in oil prices and the strengthening currency. These may be a negative for business investment. The fall in oil prices will hit industry profitability while dollar appreciation reduces the profitability (in USD terms) of U.S. businesses overseas activities and reduces the competitiveness of firms in the traded sector. Regional Fed surveys show some softening in the relatively trade exposed manufacturing sector (and it also provides inputs into the oil sector). Of course, some business will gain from these factors due to reduced input costs and the pick-up in consumption. Easing bank lending standards also remain a positive.

At the same time, however, small business optimism and consumer confidence have jumped. Increasing consumer confidence, coupled with rising effective incomes due to falling prices, should support strong real consumption expenditure at least in the first half of this year.

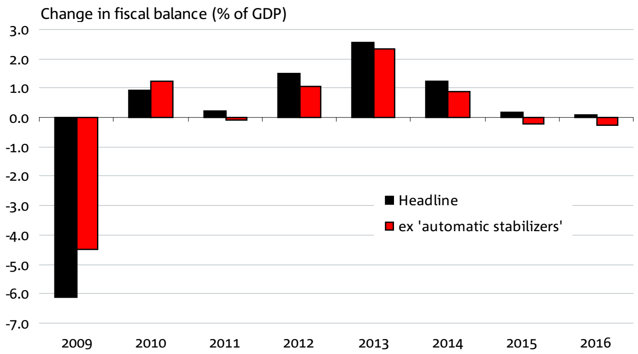
Business surveys and consumer sentiment



Sources: Philadelphia, Dallas, Kansas City, Richmond, New York Federal Reserves, Conference Board, University of Michigan/Thomson Reuters. Data are to January 201 except NFIB series which is to December '14. *NFIB index less 100.

Moreover, despite the likely prospect of monetary policy tightening later this year (we are currently factoring in June, but with a risk of delay), interest rates are low. Further, fiscal headwinds have largely ended. Congressional Budget Office estimates suggest that the impact of fiscal policy on the economy in f.y. 2015 will be minimal.

Fiscal headwinds largely over



Source: CBO (The Budget and Economic Outlook, January 2015). Fiscal years. A positive number indicates fiscal contraction, a negative fiscal stimulus

As a result we still expect the economy to grow at an above trend rate in coming years. We have left our forecasts for 2015 and 2016 unchanged (3.3% and 2.7% respectively) as the advance estimate is subject to considerable revision and the generally positive outlook for the economy has not changed.

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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	0.6	2.3	0.3	0.6	0.3	-0.1	**-0.6**	**0.2**	**0.5**	**0.5**	**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**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.7	4.9	4.5	6.6	6.2	6.1	5.7	**5.5**	**5.2**	**5.0**	**4.9**	**4.8**	**4.7**
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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