United States Economic Update

by NAB Group Economics 16 March 2015

National Australia Bank

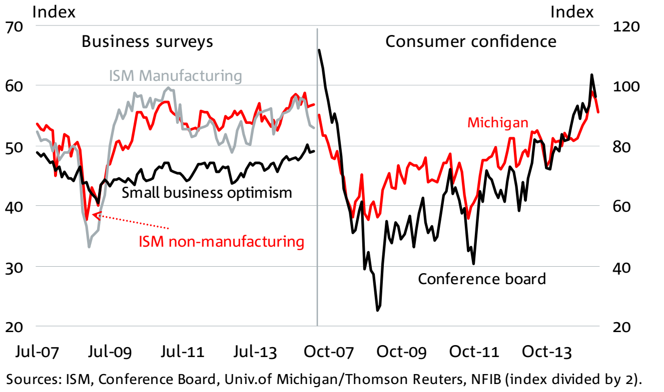
- **Partial data have been soft recently, perhaps partly reflecting severe weather conditions.**
- **With December quarter 2014 GDP also revised down, we have lowered our forecast for 2015 GDP growth to a still solid 3.1% (was 3.3%).**
- **Unemployment continues to fall. As a result we still expect the Fed to begin rate hikes in June, although subdued inflation means there is a risk that this will be delayed to later in the year.**

Economic Overview

Even with some recent softness in the partial indicators, and the risk that severe weather conditions may (temporarily) disrupt economic growth, the outlook for the U.S. economy remains positive. In particular, the labour market continues to strengthen. The unemployment rate is now close to what the Federal Reserve considers its longer run level. This brings into stark relief the pressures on the Fed to start raising rates off their current historical low, although continued soft inflation readings may delay action until later in the year.

The softness in inflation is in large part due to the plunge in oil prices as well as the appreciation of the US dollar. These two factors are producing both winners and losers across the economy. 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 ISM survey has held up better. Overall, the ISM survey readings are still consistent with above-trend growth. For consumers, who were the major beneficiaries of the decline in oil prices, confidence has been trending up, although confidence measures have given up some of their gains as oil prices have stabilised.

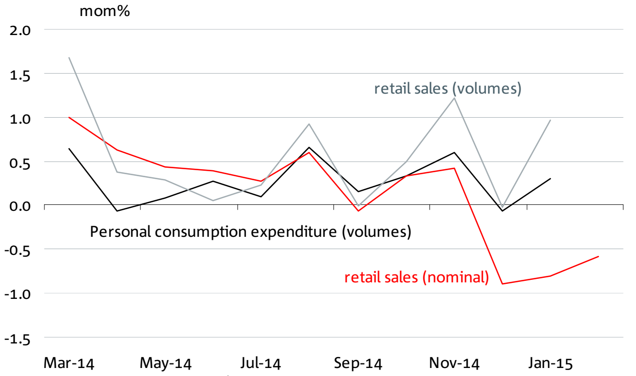
Business surveys and consumer sentiment



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

However, despite the improvement in confidence, rising household wealth, strong employment growth boosting incomes, and falling oil prices, consumption data has softened recently. Nominal consumption has been held down by falling prices, but in volume terms total (PCE) consumption has so far decelerated in 2015. Retail sales data for February were particularly weak, down 0.6% mom, and with gasoline prices actually increasing slightly this month this reflects weak volumes. One possible explanation is severe winter weather. It is worth noting, however, that cold weather induces large increases in power (utility consumption) which is not captured in the retail sales data, and this will provide an offset.

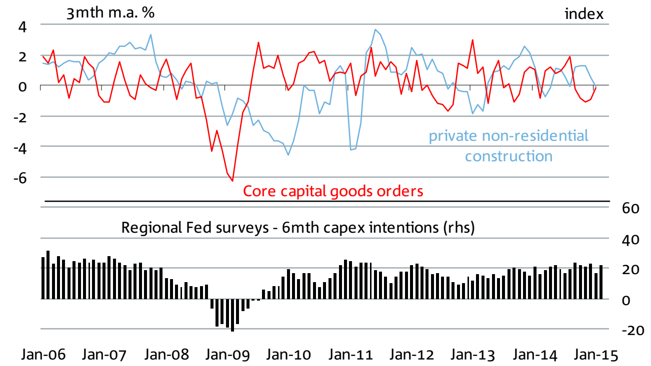
Recent softness in consumption



Sources: Census Bureau, BEA, ThomsonReuters Datastream, NAB

Signals around near term prospects for business investment remain soft, although there were some positive signs in February. Business equipment investment growth, after two strong quarters, softened considerably at the end of 2014. This was consistent with partial data on capital goods shipments, which declined in the quarter (even outside of oil and gas equipment). However, core capital goods orders rose in January for the first time in five months. Future capital expenditure intentions, as indicated by regional Fed manufacturing surveys, also recovered in February. On a less positive note, private non-residential construction fell sharply in January, and continuing declines in oil rig counts point to a likely fall in business structures investment in the March quarter.

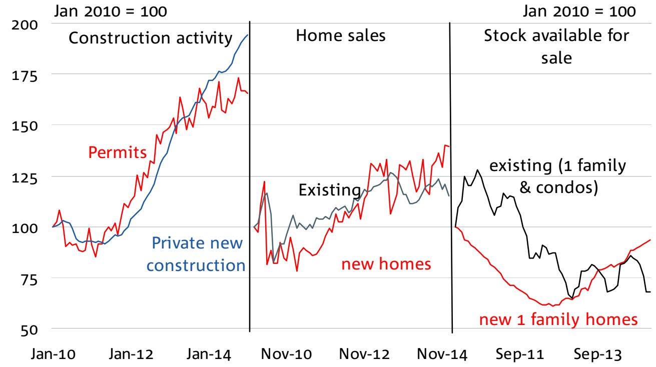
Signs of a turnaround in equipment investment



Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

At the same time, residential investment indicators remain mixed. Construction activity continues to trend upwards and this should continue given the broad upwards trend in new home sales. In contrast, existing home sales have fallen in recent months. At the same time the stock of existing homes for sales has also fallen, suggesting a lack of supply may have been an issue. After slowing in the middle of last year, house price growth picked up towards the end of 2014 which may bring extra supply onto the market.

Housing indicators mixed

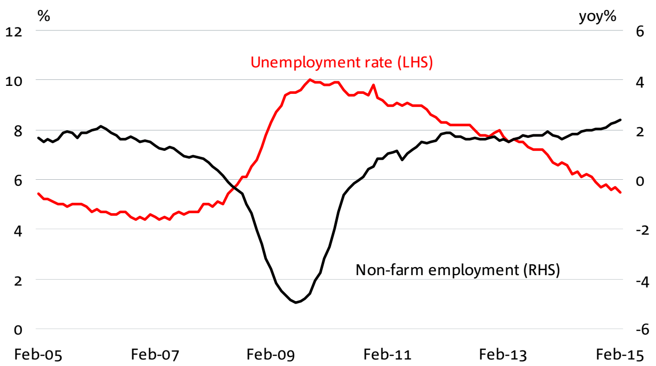


Sources: Census Bureau, NAB

Trade data were very weak at the start of 2015, with both goods imports and exports falling in volume terms (by 1.6% and 2.0% mom respectively) in January. However, interpreting these data, which are volatile at the best of times, is made more difficult by disruptions at West Coast ports due to a labour dispute (which has now been resolved). The ISM indicators suggest that trade should bounce back, but still point to underlying softness in exports, which is consistent with sluggishness in the world economy and reduced competitiveness for exporters due to the more than 10% appreciation of the USD since mid-2014.

While some of the data have been soft at late, this cannot be said of the labour market. Non-farm employment grew by just under 300,000 in February, taking the annual growth rate to 2.4%, its strongest level in almost fifteen years. This is more than double the rate of both population and labour force growth. As a result the unemployment rate is trending down and fell in February to 5.5%. The pace of recent Jobs growth represents a strong underlying dynamic which is helping sustain the economic recovery. While business investment indicators have been soft recently, their continued investment in labour suggests overall business confidence in the outlook is still positive.

Labour market recovery picking up pace



Sources: BLS, NAB

Due to the downwards revision to December quarter GDP by the Bureau of Economic Analysis (from 2.6% qoq annualised to 2.2%) and the recent softness in some partial indicators we have revised down our forecast of GDP growth in 2015 to 3.1% (previously 3.3%), although have we left our 2016 forecast unchanged at 2.7%.

However, we still retain our overall positive view on the outlook for the economy over the next few years. Monetary policy still remains stimulative and the headwinds from fiscal policy have largely faded. Households are experiencing rising wealth and, spurred by rapid employment growth, income. The decline in oil prices has only added to their real spending power. As the labour market tightens, wage pressures should also emerge, further supporting household income growth.

While the oil price decline will be a negative for some businesses, particularly the capital intensive oil industry, the broader investment dynamic is still solid. Generally positive expectations of further economic growth should encourage investment, and this will be supported by the continued easing in credit conditions.

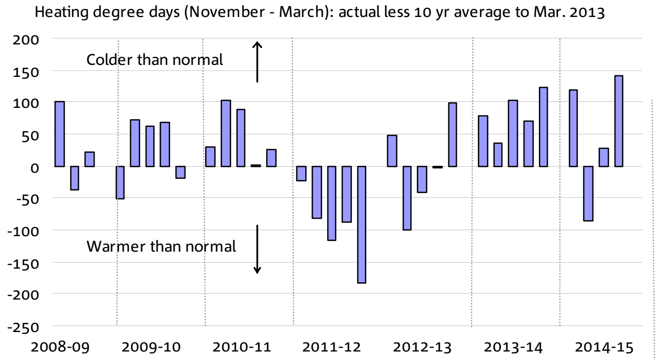
Moreover, there is still considerable scope for a pick-up in residential investment, as it remains at relatively low levels, even as vacancy rates have fallen.

A headwind facing the economy is the appreciation of the USD – by more than 10% over the year to February - which effectively reduces the competitiveness of the traded goods sector. However, we are expecting world economic growth to strengthen this year, which should assist exporters.

Severe winter weather – a repeat of 2014 Q1?

A concern for current quarter growth is the severe winter weather being experienced in parts of the United States. Last year, the fall in Q1 GDP was widely attributed to severe weather conditions. This winter there have been large snowfalls (particularly in New England) and since mid-February it has been abnormally cold. This can be seen in the heating degree measure for February which was higher than the historical norm (and even higher than last year), although the December and January readings were moderate (unlike last year).

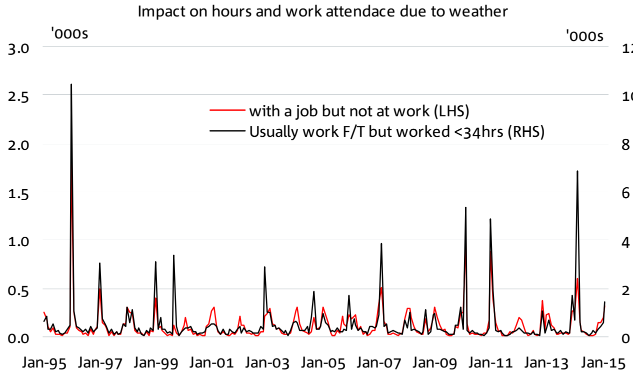
February cold snap



Sources: NOAA, NAB. 2014-15 data only till February

One way of gauging the economic impact is through employment data, which includes measures of those who were unable to work, or who worked reduced hours, due to weather conditions. For January and February, these measures were not particularly high (by winter standards) and well below that of last year when weather conditions had a big impact. That said, the employment survey is run during one week of the month, and for February it was just before the cold snap, so it might be understating the impact. Initial jobless claims rose in the second half of February (but moved back down in early March) and, as noted above, retail sales were weak in February, consistent with some weather impact.

Employment data shows little weather impact so far



Source: Bureau of Labour Statistics

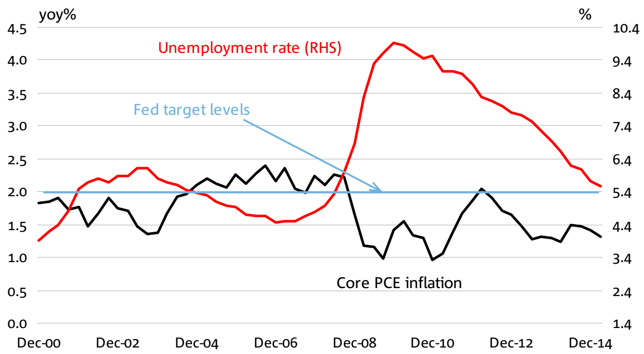
As a result, there is a downside risk to our March quarter forecast due to the possible impact of the weather. However, as with last year, any such impact will be temporary and soon reversed, and will not fundamentally change the outlook for the economy.

Monetary policy

At the same time as the unemployment rate has been falling rapidly, inflation has also been declining presenting a conundrum for the Federal Reserve. The Federal Reserve has a so-called dual mandate where it aims to achieve both stable inflation (which it interprets as annual price growth of 2% over the long run) and maximum employment.

The fall in the unemployment rate to 5.5% means that it is now at the top end of the 'central tendency' forecast of Fed members for the long-run unemployment rate (the central tendency excludes the three highest and lowest forecasts). It is also just above the mid-point of the long-run unemployment rate of all members.

Fed closing on one target but away from the other

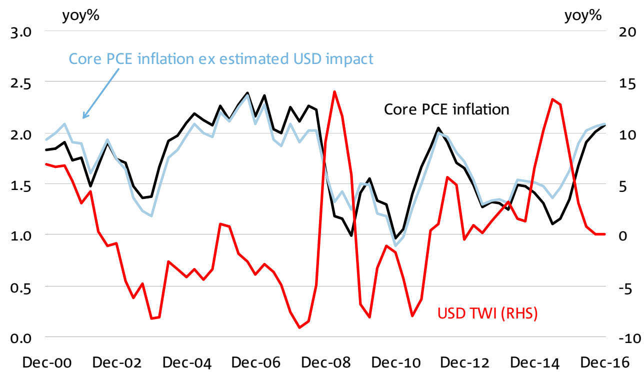


Sources: BEA, Federal Reserve, NAB estimates for 2015Q1. Data are qtly. Fed unemployment 'target' set at mid-point of Fed member long-run projections

At the same annual CPI inflation has turned negative (-0.2% yoy in February) and the Fed's preferred inflation measure, the PCE price index, is only a little stronger at 0.2% yoy making both well below the Fed's target.

This has largely been driven by the plunge in oil prices and the Fed has indicated that it will look through the impact of this factor on inflation. However, even the core inflation rate – which excludes food and energy costs – has softened lately. Oil prices can also affect core inflation (though lower transport costs) and another factor also pulling inflation down is the dollar's appreciation. Our modelling suggests that the peak downwards impact of the dollar on inflation is underway right now and will only start to ease in the second half of the year (assuming the pace of dollar appreciation slows down) assuming our expectation that the pace of appreciation will start to slow is correct.

Inflation also being pulled down by dollar appreciation



Sources: BEA, Federal Reserve, NAB estimates

Our call for a while has been that the Fed would start the process of raising the fed funds rate at its June meeting. The improvement in the labour market continues to lend support to this timing. The softening in inflation means that there is a risk that it will happen later.

The January FOMC meeting minutes suggested that many members would consider tightening even if inflation was low as long as they were confident that inflation would return to target. Factors that might make them confident, apart from continued economic growth, included stable or rising core inflation (not that likely by June) or for an alternative underlying inflation series (the Cleveland Fed's median CPI has held up better), or an improvement in market based measures of inflation expectations (there has been some improvement but they remain low), or signs of wage growth (mixed currently but possible by June).

Clearly, given these varied considerations, it is not possible to be definitive about timing, but with unemployment almost at what the Fed considers its long-run level, it is hard to see rates remaining at their historical lows for too much longer. Consistent with this, the Fed is expected to remove its 'patient' language from its statement in its meeting next week, which will give it the option of tightening from June onwards.

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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	3.4	2.8	0.3	0.6	0.8	1.0	**0.8**	**0.9**	**0.8**	**0.7**	**0.7**	**0.6**
Private fixed investment	4.7	5.3	5.6	6.3	0.0	2.3	1.9	1.1	**0.8**	**1.5**	**1.7**	**1.6**	**1.6**	**1.5**
Government spending	-2.0	-0.2	1.1	1.3	-0.2	0.4	1.1	-0.4	**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	0.0	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.2	-0.3	-0.2	-0.4	-0.1	0.2	-0.3	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.2**	**2.4**	**3.1**	**2.7**	**-0.5**	**1.1**	**1.2**	**0.5**	**0.6**	**0.8**	**0.7**	**0.7**	**0.6**	**0.6**
Note: GDP (annualised rate)					*-2.1*	*4.6*	*5.0*	*2.2*	*2.3*	*3.3*	*3.0*	*2.7*	*2.6*	*2.5*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.1	0.8	2.3	0.3	0.6	0.3	-0.1	**-0.5**	**0.2**	**0.5**	**0.6**	**0.6**	**0.6**
Core	1.3	1.4	1.4	2.1	0.3	0.5	0.3	0.3	**0.2**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.7	5.0	4.7	6.6	6.2	6.1	5.7	**5.6**	**5.4**	**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	**2.00**	**2.25**	**2.50**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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