more give, less take

United States Economic Update

by NAB Group Economics 10 April 2015

National Australia Bank

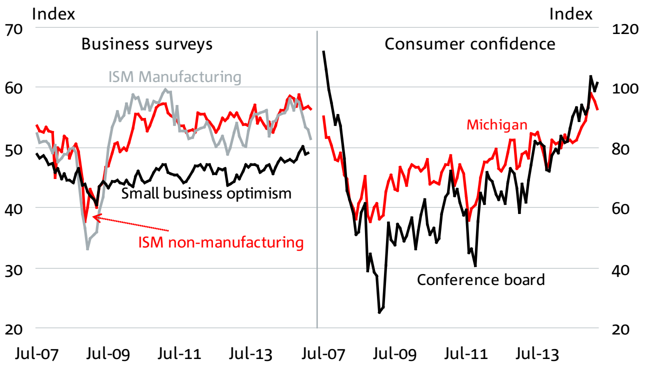
- **Economy has got off to a slow start in 2015. While we expect it to be a temporary slowdown, we have revised our 2015 forecast to 2.7% (previously 3.1%).**
- **If achieved, this would still represent an above trend rate of growth, and is consistent with further labour market improvement.**
- **We now expect that the the first increase in the fed funds rate will be in September (previously June).**

Economic Overview

Growth in the U.S. economy appears to have slowed at the start of 2015, similar to last year (when it actually went backwards in the first quarter). Like last year the winter has been unusually harsh but other factors are clearly also in play this time around, including US dollar strength and sectoral impacts from the oil price declines. Like last year, we expect the weakness to be short-lived, and for the economy to resume growing at an above trend pace. Nevertheless, we have revised down our 2015 forecast to 2.7% (from 3.1%).

The ISM business surveys highlight some of the cross-currents affecting the U.S. economy. The manufacturing survey has fallen in each of the last five months; although the headline measure still remains above 50 indicating manufacturing is still growing. The export orders indicator reported in the survey, however, has fallen below 50, consistent with manufacturing exporters feeling the pinch from the rapid appreciation of the USD.

Business surveys and consumer sentiment

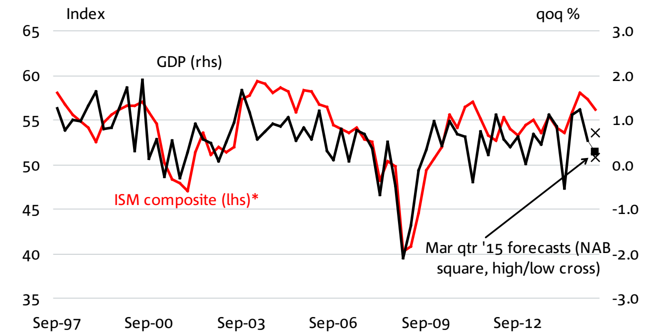


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, NFIB (index divided by 2).

At the same time, however, the non-manufacturing ISM has remained at relatively high levels. Small business optimism has also improved as has that of consumers, the major beneficiaries of the plunge in oil prices.

With the manufacturing sector only making up around 12% of the U.S. economy, taken together the ISM surveys suggest that the economy remains on a solid footing (see our 'composite ISM' measure in the chart below). Our forecast for Q1 – which is at the lower end of the forecast range) is for only weak growth. However, as with last year, the ISM has held up (as it did in the March 2011 and 2014 quarters when growth turned temporarily negative, as well as the December quarter 2012 when growth was zero).

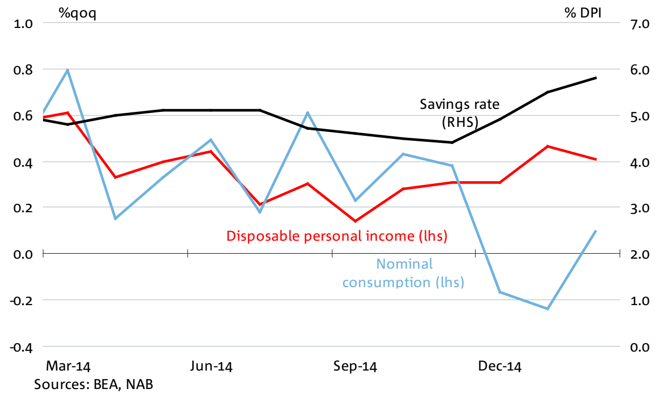
ISM suggests Q1 weakness will be only temporary



Sources: BEA, ISM, NAB, Bloomberg. * weighted average of manuf. & non-manuf. ISM surveys (based on GDP shares). Forecast range based on Bloomberg (ECFC), with sample limited to forecasts updated in April (as at 8 April)

One of the more surprising elements of the softer data has been consumption, which rose rapidly in October and November, but then slowed noticeably even as the boost to effective household budgets from falling oil prices continued. At the same time, household spending power was also benefiting from strengthening income growth. Together with continued upwards trend in household wealth, this suggests that consumption growth is likely to rebound in coming months.

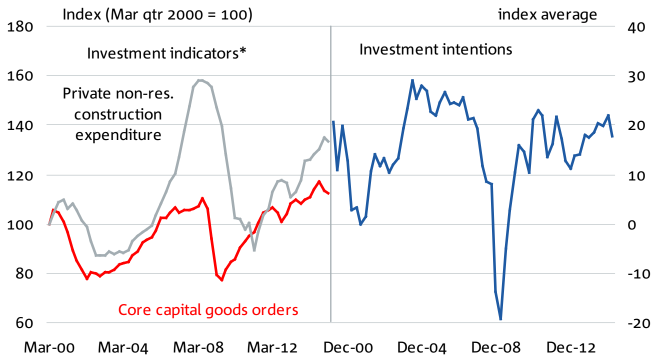
Increased household savings point to scope for stronger consumption ahead



Sources: BEA, NAB

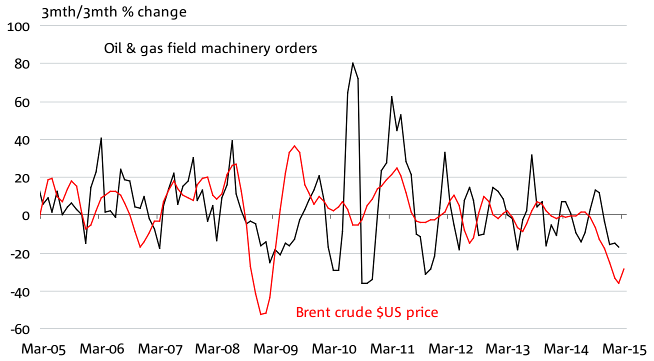
Signals around near term prospects for business investment are, however, weak. In last month's update we noted some positive signs in February but these faded (or were revised away) just as quickly. Future capital expenditure intentions, as indicated by regional Fed manufacturing surveys, which appeared to have recovered in February, slipped back in March. Core capital goods orders have fallen six months in a row (to February). Equipment orders for energy & gas have fallen particularly rapidly, but this directly explains only one-fifth of the fall in core orders (although there are probably some indirect affects as well). With oil prices stabilising in recent months, the negative impact from the oil sector will eventually recede, and other factors that support investment –such as business profitability and credit conditions – remain solid.

Investment indicators are weak…



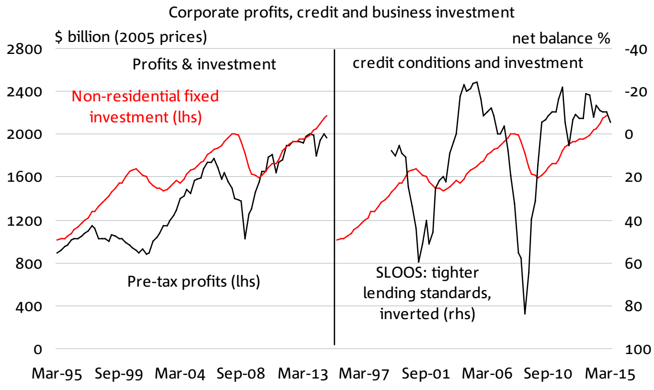
Sources: Census Bureau, Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys. * March qtr '15 is average of January and February.

…partly due to weakness in the energy sector



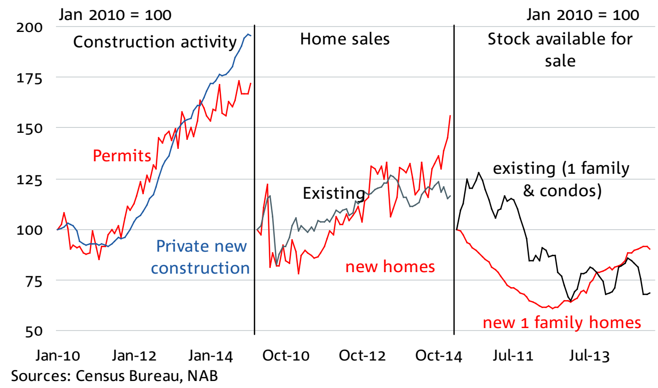
Sources: Census Bureau, ICIS Pricing, NAB

…investment conditions still sound



Residential investment indicators also remain mixed. Housing starts plunged in February but this was likely weather related. Construction activity continues to trend upwards and this trend will get support from the recent spike in new home sales. In contrast, existing home sales have fallen over recent months, but pending home sales have started to pick up in signalling a turn around is likely. The stock of existing homes for sales has also fallen, suggesting a lack of supply may have been an issue; with house price growth strengthening towards the end of 2014, this may bring extra supply onto the market.

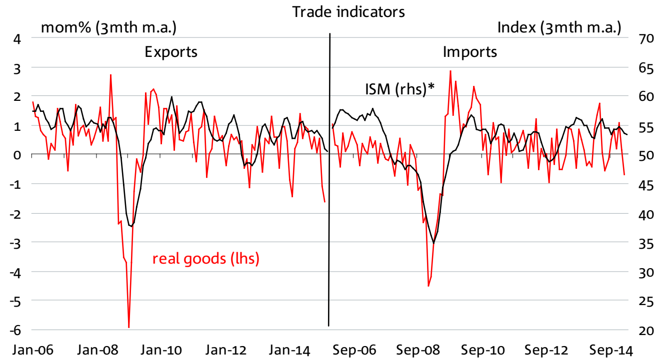
Housing indicators mixed



Sources: Census Bureau, NAB

Both goods exports and imports fell noticeably in January and February, by around 5% over the two month period. This likely reflects 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 point to underlying softness in exports, consistent with reduced competitiveness for exporters due to the large appreciation of the USD since mid-2014 (by almost 15% on a trade weighted basis) and a still sluggish global economy. With the USD expected to appreciate further, net exports are likely to be a drag on growth for a while to come.

Port disruptions affecting trade data



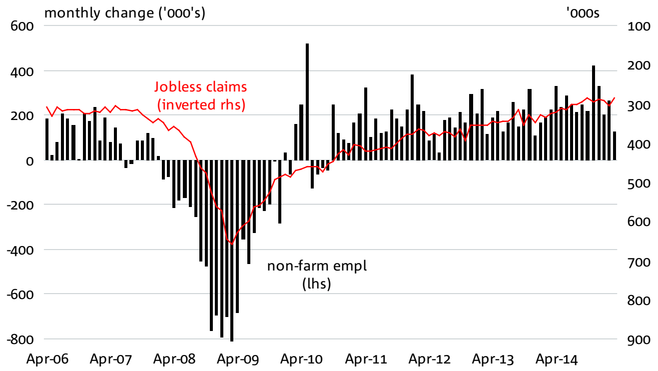
* Average of ISM manuf./non-manuf. surveys using goods/serivces trade shares.

We have been noting for a while that the fiscal policy headwinds of recent years have largely faded. However, quarter-to-quarter government investment and consumption can still be volatile. After government demand fell last quarter due to a large decline in defence spending we had expected a return to growth in early 2015. This looks to have been delayed, as partial indicators suggest government construction expenditure and defence spending fell again in the March quarter, while employment gains slowed.

Amongst the softer data flow the one constant had been strong labour market gains. However, in March, non-farm-employment growth slowed to 126,000, its lowest gain since December 2013. It is possible that this reflects the broader slowdown feeding into the labour market. Moreover, the pace of jobs had been so strong that it was unlikely to be sustained for much longer; it was running at more than twice the rate of population growth.

However, as always, not too much should be made of one months report (which is subject to revision). For the March quarter as a whole employment growth was basically the same as in the three prior quarters. Moreover, other labour market indicators continue to be solid; job openings in February reached their highest level in around 14 years, while initial jobless claims – which tend to move with non-farm employment – showed no weakening in March.

March jobs weakness not matched by other indicators



Source: BLS, Department of Labor, NAB

Despite the recent soft data, 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.

While the oil price decline has, and will continue to 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 and still solid profitability.

Households are experiencing easing credit conditions, rising wealth and, spurred by rapid employment growth, income. The decline in oil prices has only further strengthened their financial position. Moreover, as the labour market tightens, wage pressures should also emerge, further supporting household income growth. There is also still considerable scope for a pick-up in residential investment, as it remains at relatively low levels.

Nevertheless, with the March quarter looking quite soft, investment indicators subdued and the exporters feeling the headwind from the strong USD, we have revised down our forecast for 2015 growth to 2.7% (from 3.1%). This still represents an above trend rate of growth for the U.S. economy, and is consistent with continuing improvement in the labour market and, in-time, a strengthening in inflation which should gradually move back to around the Fed's inflation target.

Monetary policy

Following the Fed's March policy meeting we changed our forecast track for the fed funds rate to incorporate a slower pace of policy tightening.[1] At the time we left our call for the first hike to be in June, although noting that the risks of it being later had gone up.

In a recent speech, the Fed Chair emphasised the importance of labour market indicators in the decision about when to start lifting rates. She also noted, in the context of the likely pace of rate increases, that the Fed will proceed slowly due to asymmetries in the effectiveness of policy when rates are close to zero (i.e. their ability to counter negative shocks to the economy is limited).

Given this, with the softness in data now showing up in some labour market indicators, the Fed will probably want to see at least several months of much more solid data before starting to raise rates. While not totally out of the question, this makes a June rate hike much less likely, and so we have changed our call for when the Fed will start raising rates to September.

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[1] See Forecast path for US Fed funds rate revised lower, 30 March (available at http://www.wholesale.nabgroup.com/Pages/default.aspx)

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	3.1	2.8	0.3	0.6	0.8	1.1	**0.5**	**0.9**	**0.7**	**0.7**	**0.7**	**0.6**
Private fixed investment	4.7	5.3	5.6	6.5	0.0	2.3	1.9	1.1	**0.7**	**1.6**	**1.8**	**1.7**	**1.7**	**1.6**
Government spending	-2.0	-0.2	0.9	1.4	-0.2	0.4	1.1	-0.5	**-0.1**	**0.6**	**0.3**	**0.3**	**0.3**	**0.3**
Inventories*	0.0	0.0	0.0	-0.1	-0.3	0.3	0.0	0.0	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	0.2	-0.2	-0.4	-0.3	-0.4	-0.1	0.2	-0.2	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.2**	**2.4**	**2.7**	**2.7**	**-0.5**	**1.1**	**1.2**	**0.5**	**0.3**	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**
Note: GDP (annualised rate)					*-2.1*	*4.6*	*5.0*	*2.2*	*1.1*	*3.2*	*2.9*	*2.7*	*2.7*	*2.6*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.0	1.1	0.8	2.2	0.3	0.6	0.3	-0.1	**-0.5**	**0.2**	**0.4**	**0.6**	**0.6**	**0.5**
Core	1.3	1.4	1.4	2.0	0.3	0.5	0.3	0.3	**0.2**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	7.0	5.7	5.1	4.7	6.6	6.2	6.1	5.7	5.6	**5.3**	**5.2**	**5.1**	**5.0**	**4.9**
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	0.25	0.25	0.75	1.75	0.25	0.25	0.25	0.25	0.25	**0.25**	**0.50**	**0.75**	**0.75**	**1.25**
10-year bond rate	3.03	2.17	2.50	3.00	2.72	2.53	2.49	2.17	1.92	**2.25**	**2.50**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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