more give, less take

U.S. Economic Update

by NAB Group Economics 15 January 2016

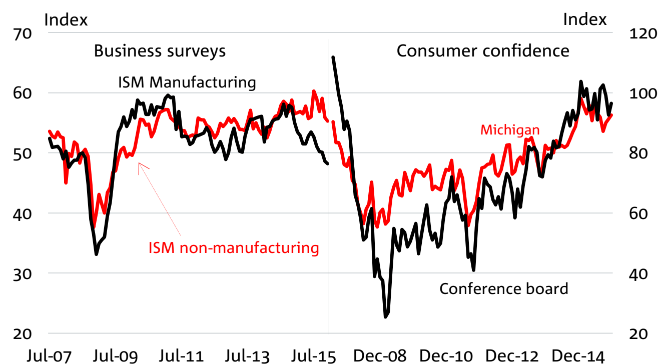
- **We expect another year of moderate growth in 2016, with further labour market improvement and inflation starting to move back towards the Fed's target.**
- **Recent partial data have been on the soft side pointing to only slow GDP growth in the December quarter 2015.**
- **Fed rate hikes expected to be only gradual this year; we expect the next hike will be in March.**

Overview

At we start 2016, many of the themes from last year are repeating themselves. Oil prices have fallen and the dollar has again appreciated, keeping up the pressure on the energy and manufacturing sectors. This will also keep inflation down, providing a boost to household budgets. As a result consumption, as in 2015, is likely to continue being the main driver of growth. Partial indicators are pointing to only weak growth in December quarter GDP, continuing the recent volatility in GDP growth. In contrast non-farm employment has been consistently stronger, which was highlighted by the December jobs report.

Of course low quarterly GDP growth may not represent volatility but could indicate that growth is slowing. Business conditions – based on the ISM business surveys – have fallen in recent months. However, the non-manufacturing indicator, which covers most of the economy remains reasonably solid, and is broadly consistent with the average rate of GDP growth we have seen in recent years. Consumer confidence also remains solid; a risk is that the recent falls in stock markets dampen confidence, although this may be offset by lower gasoline prices.

Business conditions and consumer confidence



Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

Our expectation is that the economy will grow in 2016 at a moderate rate, similar to that seen in 2015. Consumption will again be a key driver, but if, as expected, the pace of USD appreciation slows and oil prices recover some lost ground, some of the headwinds on investment will fade. Housing investment still has the scope to grow reasonably rapidly and fiscal policy will be more growth supportive than in 2015. As a result unemployment should continue to fall and inflation move towards the Fed target, leading to further, but only gradual, fed funds rate hikes.

The main risks appear to be external, with concerns over conditions in China in particular destabilising global financial markets.

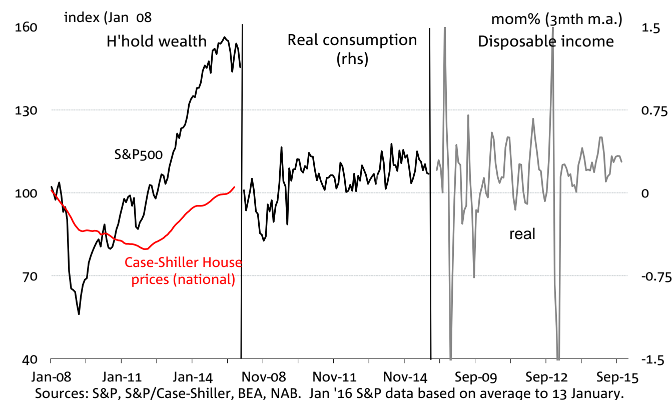
Review of recent trends and outlook

Consumption was reasonably solid in November, growing by 0.3% mom. However, this followed a weak October so the trend growth rate appears to have softened a bit recently. Mild weather, as it depresses power consumption, may explain some of this although arguably it should be a positive for some other parts of consumption.

With income growth still solid the result has been a rise in the household savings rate in recent months. With consumer confidence still at reasonable levels, this suggests ample scope for consumer spending to pick up in coming months. Consumers real spending power will also be given a further boost from declining gasoline prices due to recent falls in world oil prices.

With solid consumer confidence, income gains supported by strong employment growth and in-time stronger wages growth as the labour market tightens, and banks easing credit conditions, the outlook for consumption over this year is positive. However, recent declines in share prices – a drag on household wealth – will provide a headwind, and we also expect oil prices to come off their lows over 2016.

Income supporting consumption, but shares a drag



Sources: S&P, S&P/Case-Shiller, BEA, NAB. Jan '16 S&P data based on average to 13 January.

Business fixed investment was sluggish in the first three quarters of 2015 and partial indicators suggest that this remained the case in the December quarter as well. This reflects a combination of various headwinds and tailwinds.

USD appreciation has weighed on the manufacturing sector while large falls in energy prices have led to sharp cutbacks in energy sector investment. Both of these sectors are

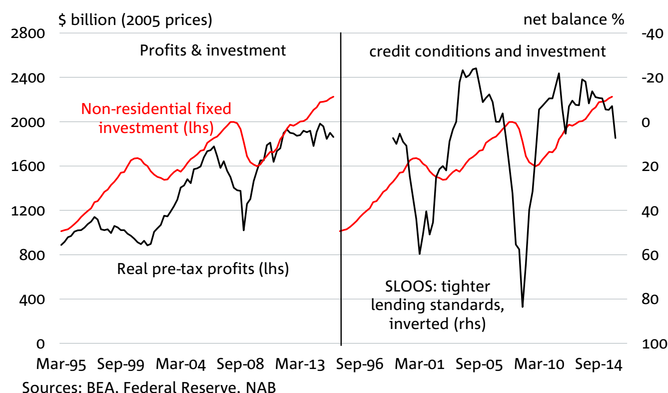
relatively capital intensive. At the same time, however, domestic demand has been solid, credit conditions are reasonably favourable and low energy prices spurred investment in other sectors, such as the chemical industry.

Over the last month or so the USD has appreciated again and oil prices have fallen to around $US30/barrel. After stabilising around mid-year, the oil and gas rig count resumed a downward path in September and the most recent price falls will only exacerbate this.

We expect oil prices to stabilise and recover some lost ground over 2016, which means that the drag on total business investment from the energy sector should decline. Similarly, as we expect the pace of USD appreciation to slow, this headwind on the manufacturing sector should also ease.

More broadly, some of the fundamentals that influence business investment remain reasonable, although they are by no means stellar. Corporate profits are still high but are basically tracking sideways, credit conditions are still favourable although the latest loan officer survey suggested that the easing trend may have come to an end, and domestic demand is expected to be solid.

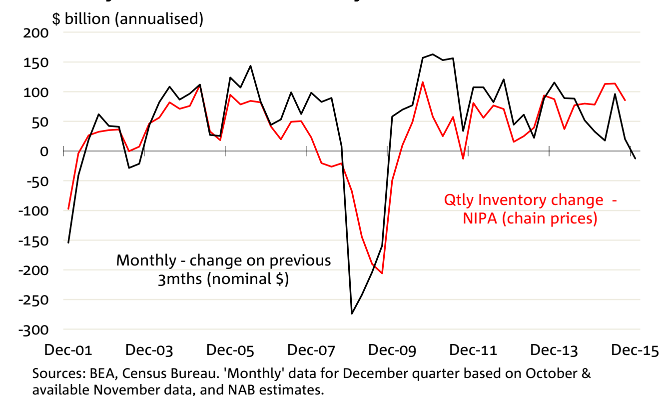
Investment fundamentals still reasonable



Sources: BEA, Federal Reserve, NAB

In contrast to fixed investment, inventory investment was strong over the first three quarters of 2015. However, the pace of inventory growth slowed somewhat in the September quarter. Partial data suggest a further correction occurred in the December quarter which would weigh on December quarter GDP growth.

Inventory correction underway



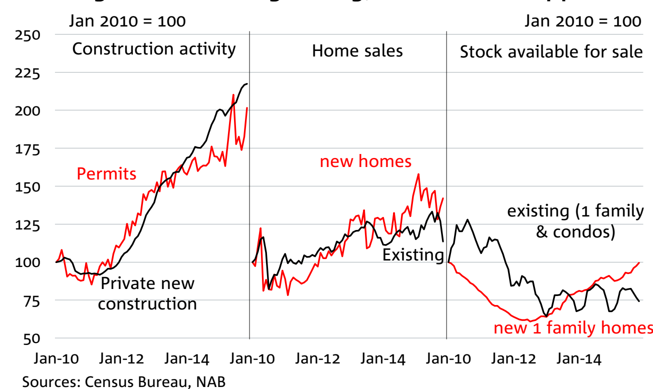
Sources: BEA, Census Bureau. 'Monthly' data for December quarter based on October & available November data, and NAB estimates.

Housing indicators have been mixed recently, pointing to a continuation of the trend rise in new construction but a decline in the housing sales. As sales commissions (and other sales costs) are part of residential investment, this suggests that residential investment growth in the December quarter will be weak.

The slowdown in sales may be due to new mortgage rules that started in early October. Weekly mortgage purchase agreements fell substantially after their introduction, but started to recover from mid-November.

The outlook for residential investment remains positive. The stock of new homes for sale remains relatively low, as are vacancy rates (although they appear to have bottomed out) and the ongoing strength of employment growth should encourage more people to start their own household. Moreover, mortgage rates remain low; while Fed tightening may put some upward pressure on rates we do not foresee a significant increase.

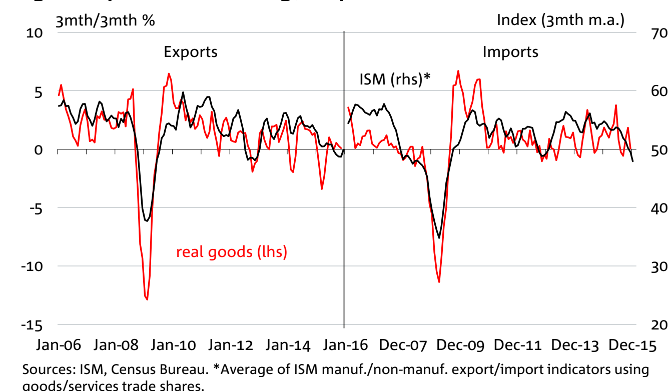
Housing construction growing, sales have dropped off



Sources: Census Bureau, NAB

Reflecting strong USD appreciation and lacklustre global demand, US exports growth has been slowing since mid-2014. However, the annual change in the Fed's broad dollar index has slowed from around 16% in August 2015 to around 11%. This suggests that the headwind on export growth is close to peaking. Tentative support for this comes from the manufacturing ISM's export indicator which moved about the break-even 50 mark in December for the first time in over half a year. Import growth has also weakened recently, perhaps due to the current inventory correction underway.

Signs exports stabilising; imports have weakened



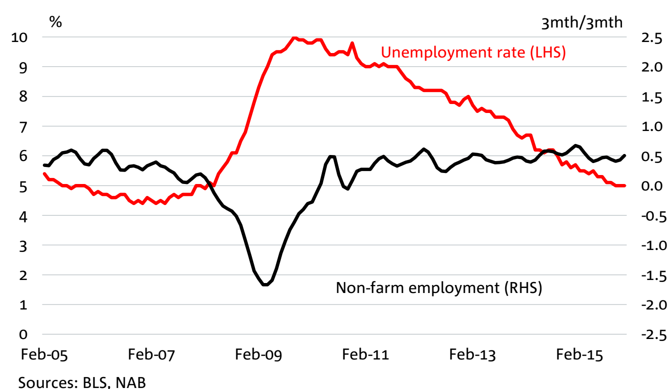
Sources: ISM, Census Bureau. *Average of ISM manuf./non-manuf. export/import indicators using goods/services trade shares.

While the headwind from USD appreciation may ease, it hasn't gone away. With domestic demand expected to remain solid and little improvement in the global economy expected, net exports are likely to detract from growth for some time.

Overall we expect GDP to have grown by 2.4% (previously 2.5%) in 2015. For 2016 we expect growth of 2.3% (previously 2.4%). The downward revisions to the 2015 and 2016 estimates reflect the small downward revision to the BEA's estimate of September quarter 2015 growth and a lower estimate of December quarter 2015 growth based on recent partial data (although we have allowed for some rebound in the first half of 2016).

While the partial indicators of GDP growth may have slowed, this is not the case with employment, which continues to remain strong. Non-farm employment grew by a very strong 292,000 in December, and the weaker growth in August/September already seems a distant memory. The recent strength might be partly due to mild winter weather; one sign of this is the large increases in construction employment in recent months. Nor does looking at the three monthly trend growth rate (see chart below) suggest any real change in momentum.

Employment growth still strong



Sources: BLS, NAB

Regardless, employment growth is strong and more than enough to bring unemployment down over time. While the unemployment rate has been unchanged in the last two months this reflects an increase in workforce participation, another sign of labour market healing.

Meanwhile, the Fed's other target, inflation, remains subdued in large part reflecting the impact of USD appreciation on import prices and falling energy costs. However, energy costs rose slightly in October and while declining in November (and, we estimate, December) the fall was smaller than the same time last year. As a result, annual personal consumption expenditure (PCE) price index growth has crept up from its low of 0.2% to 0.4% yoy in November. In contrast, annual core (ex energy and food) PCE inflation has been around the 1.3% mark all year; also well below the Fed's 2% target.

Monetary policy

At its last meeting, in December, the Fed lifted the Fed funds rate target range from 0-0.25% to 0.25-0.5%. However, it signalled that future increases would occur only gradually. We expect there will be three rate hikes this year assuming our projections for the economy hold.

There appears to be little chance of a rate hike in January. Apart from the recent weakness in economic indicators, the fall in the stock market since late December is reminiscent of what was seen in late August/early September 2015, which led the Fed to delay the decision to increase the Fed Funds rate.

The December meeting minutes suggest that some members want confirmation that inflation is rising before lifting rates again. While this may not be the majority view, it does suggest that the Fed that future rate hikes will become increasingly dependent on what happens to actual inflation. Fed members are also expressing concern over some lowering in survey measures of inflation expectations.

We currently expect the next hike will be in March but, at a minimum, this will require more stable financial markets, an improvement in activity measures, and no further slippage in either core inflation or inflation expectation measures. Another factor worth watching is the dollar; while the Fed views appreciation impacts on inflation as transitory, a stronger dollar nevertheless represents a tightening in financial conditions which could delay future rate increases.

That said, PCE core inflation was very soft in December and January last year, so some increase in annual core inflation by the next meeting is quite possible, and we expect the partial indicators to improve.

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US Economic & Financial Forecasts

	Year Average Chng %				Quarterly Chng %							
					2015		2016				2017	
	2014	2015	2016	2017	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US GDP and Components												
Household consumption	2.7	3.1	2.8	2.4	0.7	**0.5**	**0.8**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**
Private fixed investment	5.3	4.1	4.7	5.0	0.9	**0.4**	**1.3**	**1.5**	**1.5**	**1.3**	**1.2**	**1.1**
Government spending	-0.6	0.8	1.5	1.4	0.4	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.1	-0.3	0.0	-0.2	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	-0.3	-0.4	-0.1	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.4**	**2.3**	**2.3**	**0.5**	**0.2**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)					*2.0*	*0.9*	*2.7*	*2.6*	*2.5*	*2.4*	*2.3*	*2.2*
US Other Key Indicators (end of period)												
PCE deflator-headline												
Headline	1.1	0.4	1.5	2.4	0.3	**0.0**	**0.1**	**0.2**	**0.6**	**0.6**	**0.5**	**0.6**
Core	1.4	1.3	1.7	2.1	0.3	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.5	4.3	5.1	5.0	**4.9**	**4.8**	**4.7**	**4.5**	**4.4**	**4.4**
US Key Interest Rates (end of period)												
Fed funds rate (top of target range)	0.25	0.50	1.25	2.50	0.25	0.50	**0.75**	**1.00**	**1.25**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.27	2.75	3.00	2.04	2.27	**2.50**	**2.75**	**2.75**	**2.75**	**3.00**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP

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