U.S. Economic Update

by NAB Group Economics 12 February 2016

National Australia Bank

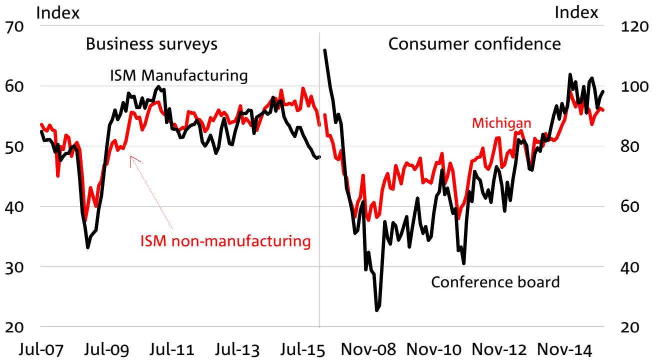
- **GDP growth slowed at the end of 2015. We expect this to be temporary but there are downside risks.**
- **Labour market strength and lower gasoline prices supporting consumption growth. Residential investment is strong and fiscal policy a tailwind.**
- **Risks are coming from weakness in energy, manufacturing, traded sectors and recent tightening in financial conditions.**
- **Little chance of a fed funds rate hike in March.**

Broadly in line with expectations, quarterly U.S. Gross Domestic Product (GDP) growth slowed in the December quarter to 0.2% qoq or 0.7% annualised. As a result, the annual growth rate (December quarter on same time last year) declined to 1.8%, its lowest level in almost two years.

Domestic final demand has held up better, growing by 2.5% over 2015. This reflected solid consumption growth and strong growth in residential investment.

Low quarterly GDP numbers have not been unusual during the period of reasonably steady annual growth we have seen in recent years. Our forecasts are based on an expectation that the December quarter weakness will also be temporary. The risk is that, coupled with recent turbulence in financial markets and a tightening in U.S. financial conditions, it is actually signalling a slowdown in the economy.

Business conditions softening, h'hold confidence steady



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

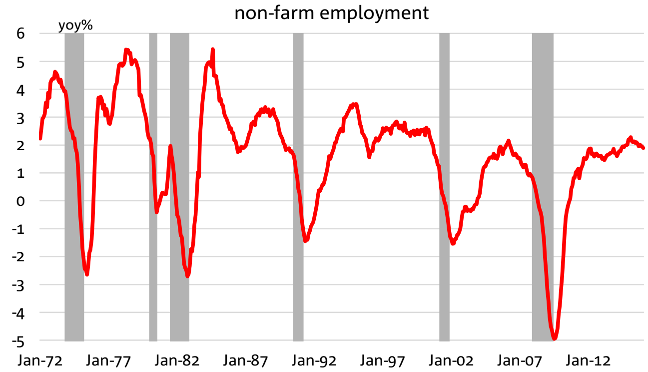
This risk was highlighted by the weakening in the ISM non-manufacturing index in January, taking it down to its lowest level in almost two years, although it still remained in positive (above 50) territory. At the same time the manufacturing index remained below 50, although it did stabilise in January. Our composite of the manufacturing and non-manufacturing index, based on historical experience, is consistent with annual GDP growth of around 2.0% over time, but the downwards direction of recent moves is concerning.

In contrast, consumer confidence has held up. It might have been expected that the turbulence in financial markets may have had a negative impact, but, at least for now, this is probably being offset by factors closer to home – namely an improving labour market and lower gasoline prices. One way of thinking about what is occurring is that some of the factors weighing on the corporate sector (particularly energy and manufacturing) – low oil prices and stronger dollar – are a direct benefit to households as they lead to lower prices. Of course, households (although not just domestic ones) are the ultimate owners of corporates but the lower prices benefit all households while share ownership is more concentrated.

To illustrate these divergent forces another way, the decline in equity prices since August 2015 is around 10%. Assuming that households spend around 3-5c of each dollar gained in wealth[1], and utilising U.S. Financial Accounts data on households' stock of U.S. corporate equities, suggests a direct GDP impact of -¼ to -½ ppts. However, over the same period, gasoline prices have come down around 25%, representing a boost to household budgets of around 0.50% of GDP. This suggests that the potential impact of negative share prices is being offset by lower oil prices.

Moreover, continued strength in the labour market is providing underlying support to the economy. While non-farm employment growth dropped to 151,000 in January, this followed several months of very large gains. On a trend basis, job growth is still rapid – well above population growth – and has not changed significantly. This suggests that talk of a U.S. recession is premature; typically jobs growth slows down appreciably ahead of a recession.

Labour market improving - jobs growth remains strong



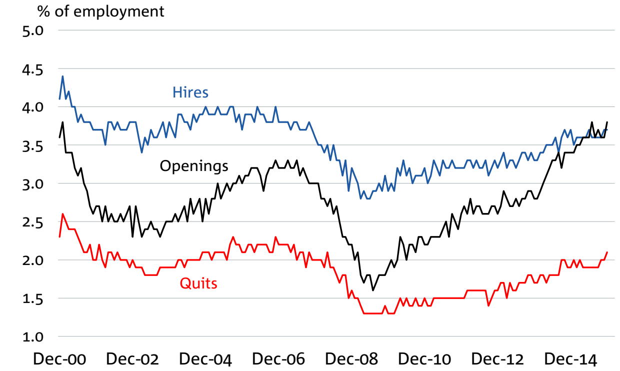
Sources: BLS, NBER, NAB. Shaded areas represent recession periods.

Other labour market measures are also improving. Job openings, hiring and 'quits' are trending higher. As quits do not include layoffs or retirement but are generally

[1] "Conventional wisdom" as reported in Carroll, Otsuka, Slacalek, How Large are Housing and Financial Wealth Effects? A New Approach, July 2010

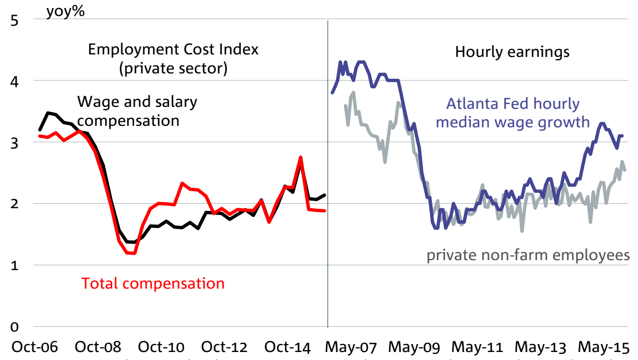
voluntary departures, a higher quits rate is seen as a positive as it suggests that people are more confident about finding alternative employment.

Gains in vacancies, hiring and quits and…



Source: BLS, NAB

…further signs that wages growth is strengthening



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

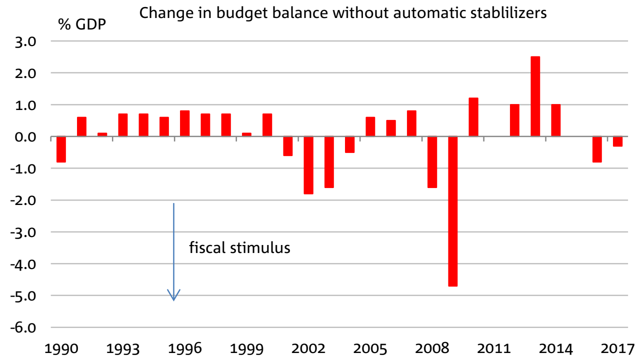
Moreover, there are increasing signs that the improvement seen in the labour market is flowing through into wages. While the quarterly Employment Cost Index only shows mild acceleration in wages, and none in total compensation, this is solely due to one very sub-par quarter. Other measures, such as the monthly average hourly earnings series and the Atlanta Fed's wage growth tracker have strengthened. Again, this highlights the current dichotomy between the household and corporate sectors – strong employment and strengthening wages growth while output measures have softened suggests low productivity growth, rising unit labour costs, and pressure on profit margins.

While these factors should support the household sector and consumption growth, the risk is that the current negative environment (falling equities etc) – particularly if sustained – will lead to large falls in consumer confidence.

Support for the economy should continue to come from residential investment as well as from fiscal policy. Residential investment remains low by past standards and has considerable room to grow, particularly in an environment of rising employment, low mortgage rates and banks easing mortgage lending standards.

Fiscal policy is also providing a tailwind. The latest estimates from the Congressional Budget Office of the budget balance without automatic stabilizers – a measure that should show discretionary changes in policy – suggests fiscal policy will be expansionary in fiscal 2016.

Fiscal policy now a tailwind



Sources: CBO, NAB

While these factors are expected to support the economy over 2016, there are clear downside risks to the outlook.

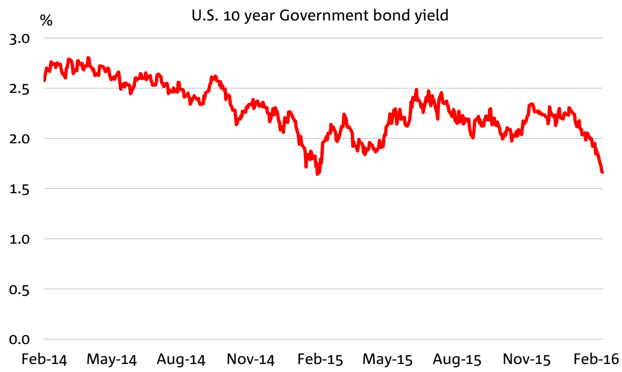
Although the U.S. economy has continued to perform solidly overall, this has not been true of all sectors. The energy sector in particular has cut back on employment and investment while growth in manufacturing has slowed to a crawl. Net exports are detracting from growth due to dollar appreciation and a lack lustre global economy. Further recent oil price declines and U.S. dollar appreciation means these headwinds are not going away.

The concern is that problems in these sectors may eventually spill-over to other parts of the economy.

Moreover, in part reflecting these factors but also due to global economy concerns, we have recently seen a tightening in U.S. financial conditions. As the charts on the next page show, the change in conditions has occurred across many different markets. Not only has the US dollar been appreciating and equities seen large declines, but spreads on corporate debt – and high yield corporate debt in particular – have widened, and some banks have been tightening lending standards on their business loans.

To some extent the problems remain sector specific – outside of energy and other commodity related sectors – the rise in spreads has been smaller. The reported tightening in bank lending standards also appears in part to be industry specific (energy), and banks are still easing lending standards on consumer/mortgage loans.

Falling Govt. bond yields – a blessing or a warning sign?



Source: Bloomberg. Last observation is 11 February 2016

It is also the case that Government bond yields and swap rates have been falling; meaning that the rise in spreads does not equate to a commensurate increase in yields (indeed liquid corporate yields have fallen slightly from their end 2015 peak). However, bond yields can decline because of expectations, or the reality, of weaker economic conditions. In this circumstance, the fall in yields only serves to mitigate the decline in activity. That said, another possible – more positive - reason for the decline in yields are changes in monetary policy abroad – e.g. the Bank of Japan has recently eased and the European Central Bank is expected to ease further.

Monetary policy

Against this backdrop of financial market volatility and increased risk, the Fed appears to be in wait-and-see mode. The chance of a change to the Federal funds rate at the March Fed meeting appears remote.

The case for a rate hike in March is based on labour market developments – a falling unemployment rate and signs of stronger wages growth. However, inflation remains subdued and well below the Fed's target. While the Fed still sees the impact of US dollar appreciation and oil price falls on inflation as transitory, they are concerned about the potential for slippage in inflation expectations, particularly given further recent oil price declines and dollar appreciation.

More fundamentally, they are not just concerned with how the labour market and economy is performing now, but how it will perform in the future. How transitory the recent tightening in financial conditions proves to be is therefore an important consideration as are global economy developments. The Fed will want, at the least, some stabilisation in markets, if not recovery before it starts lifting rates. It will also want actual activity indicators to improve over a reasonable period of time so that it can be comfortable with the view that the end-of-year GDP slowdown was just temporary and that the weakness in certain sectors (oil/manufacturing) and tightening in financial conditions has not significantly spilled over onto the real economy.

We are currently projecting the next fed funds rate hike will be in June, with a further two over the rest of the year (as opposed to the median Fed member view of four hikes). Of course, this is dependent of an improvement in activity indicators in line with our forecasts as well as stabilisation in financial conditions, and the risk is that there will be fewer hikes.

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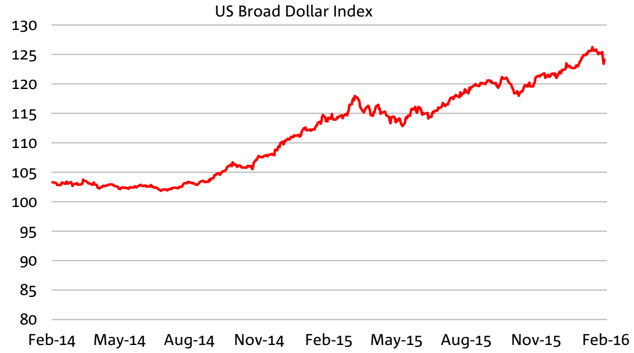
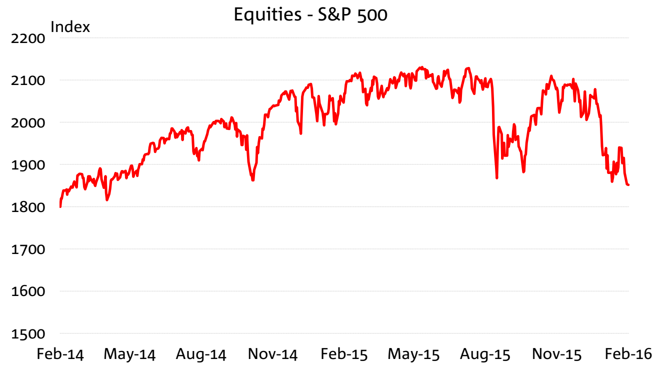
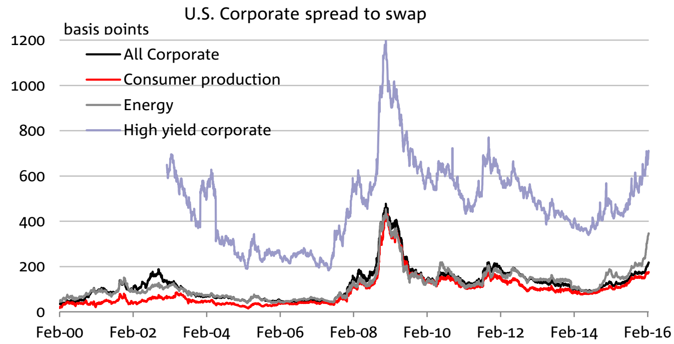
Financial conditions have tightened



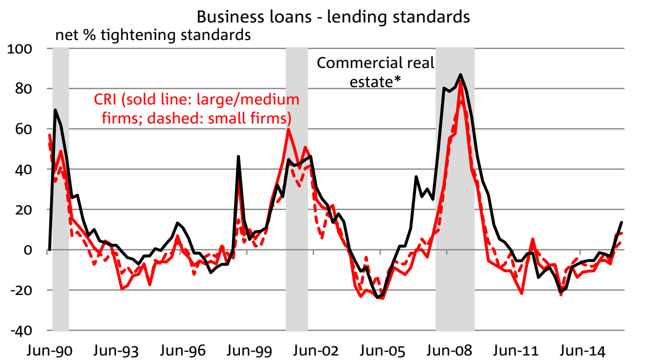
Source: Federal Reserve. Data are daily to 5 February 2016



Source: ThomsonReuters Datastream. Daily data to 10 Feb 2015



Source: Bloomberg (LUCI). Data to 11 February 2016.



* From Dec 13 qtr simple average of three CRE components. Shaded areas are recession periods

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	4.0	4.2	5.0	0.9	0.1	**1.2**	**1.4**	**1.5**	**1.3**	**1.2**	**1.1**
Government spending	-0.6	0.8	1.4	1.6	0.4	0.2	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.2	-0.3	0.0	-0.2	-0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.7	-0.4	-0.3	-0.1	-0.1	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Real GDP	**2.4**	**2.4**	**2.2**	**2.3**	**0.5**	**0.2**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)					*2.0*	*0.7*	*2.5*	*2.5*	*2.4*	*2.4*	*2.3*	*2.2*
US Other Key Indicators (end of period)												
PCE deflator-headline												
Headline	1.1	0.4	1.2	2.4	0.3	0.0	**-0.1**	**0.3**	**0.5**	**0.6**	**0.6**	**0.6**
Core	1.4	1.4	1.7	2.1	0.3	0.3	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.6	4.4	5.1	5.0	**4.9**	**4.8**	**4.7**	**4.6**	**4.5**	**4.5**
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	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.27	2.75	3.00	2.04	2.27	**2.40**	**2.75**	**2.75**	**2.75**	**3.00**	**3.00**

Source: NAB Group Economics

*Contribution to real GDP

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