U.S. Economic Update
by NAB Group Economics

11 March 2016

National Australia Bank

- **After a soft end to 2015, activity indicators have stabilised or shown improvement.**
- **Economic growth in 2016 is expected to be moderate, but sufficient for the unemployment rate to continue falling.**
- **We expect the Fed will be cautious in tightening rates this year. While we expect the next rate hike will be in the September quarter, the chance of an earlier (June quarter) hike has increased, mainly due to a pick-up in inflation.**

Overview

After a soft end to 2015, activity indicators have stabilised or shown improvement. In particular, consumption growth got off to a strong start in January, while capital goods orders rebounded suggesting that investment may be stabilising, at least outside of the mining sector. Measures of financial conditions have also shown improvement recently.

We expect that the economy will grow in 2016 at a moderate rate. As a result, unemployment should continue to fall and inflation move towards the Fed's target.

Consumption will continue to be a key driver. Household confidence remains solid, and household incomes are benefiting from strong employment growth and, we expect, also over time from stronger wages growth as the labour market tightens further. Housing investment should also be a positive as it is still below normal levels, and low unemployment, low mortgage rates, an easing in bank lending standards, and low inventories make for a favourable environment. Fiscal policy is also acting as a gentle tailwind.

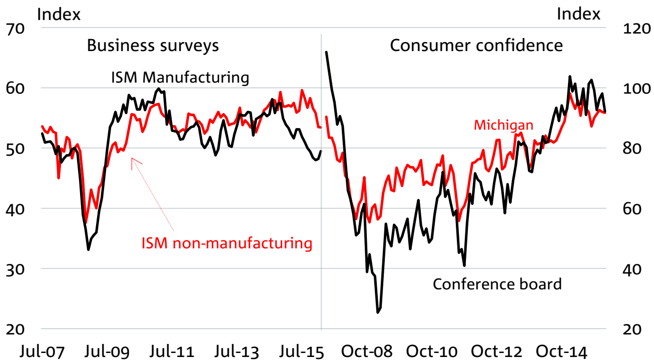
Business investment is still facing headwinds, particularly in the mining sector. If, as expected, the pace of US dollar appreciation slows and oil prices recover some lost ground, the headwinds may soften. The US dollar is also a drag on net exports, as is weak external demand, and we are not expecting any major improvement in global economic conditions.

The main risks to the outlook appear to be external; not only through the impact of weak demand for exports but also through potential spill over effects onto financial conditions and confidence in the United States. Despite the recent improvement in financial conditions, the risk is that repeated market turbulence (or a sustained period of financial tightening) in the future will weigh on the economy. Similarly, on the domestic front, there is still the risk that weakness in certain sectors could affect other parts of the economy (e.g. through stress in high yield corporate bond markets from the energy sector).

Review of recent economic developments

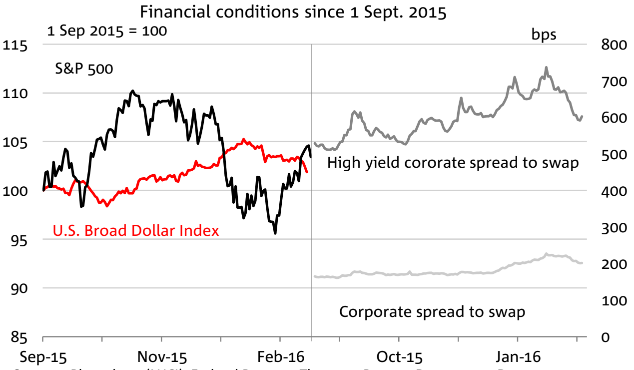
The February ISM business survey outcomes did not change significantly from the January results. After recent falls, the signs of stabilisation were welcome given the turbulence in markets at the time of the surveys, and given that history suggests that the direction of the ISM, not just its level, is important. Even at its new lower level, our composite measure of the ISM surveys is consistent with annual GDP growth of around 2% (similar to our forecasts). At the same time, consumer confidence continues to hold up.

Consumer confidence holding up, business sentiment stabilised in February



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

Financial conditions starting to show improvement



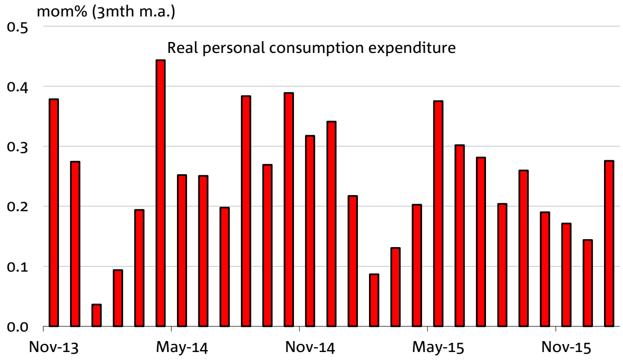
Sources: Bloomberg (LUCI), Federal Reserve, Thomson Reuters Datastream. Data to 8 March 2016 (U.S BDI 4 March)

Another positive development has been the recent improvement in financial conditions. The S&P500 has recovered much of the ground lost earlier in the year and corporate spreads have started to narrow again. High yield spreads are now around where they were at the start of the year while the US dollar is a little lower (although both are still well up on year ago levels).

After slowing somewhat towards the end of 2015 consumption growth rebounded strongly in January 2016, growing by 0.4% mom in volume terms. The January bounce is in part due to the return to more typical weather conditions in January following a period of seasonally mild weather which had supressed power consumption.

More fundamentally, consumers are benefiting from strong employment growth, rising house prices (a positive for wealth) and from falling gasoline prices, although weakness in equity prices has probably been a drag.

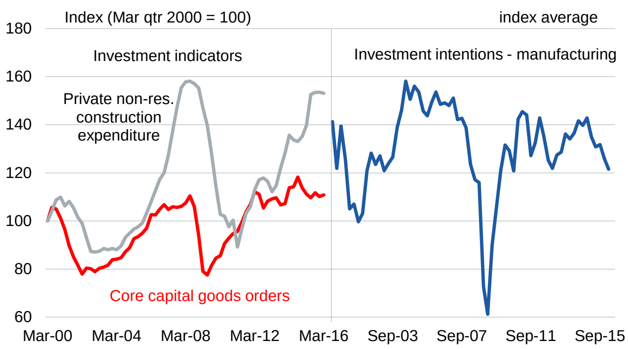
Strong start to 2016 by consumers



Sources: BEA, NAB

In contrast business investment has been weak recently, falling by 0.5% qoq in the December quarter. Over the year to the December quarter business investment growth was only 1.6% yoy, with a major drag coming from a fall of over 50% in 'mining exploration, shafts & wells' investment due to the large downturn in energy prices. Excluding this drag, business investment would have been around 5% yoy. Other indicators of business investment have, however, stabilised in recent months – while non-residential construction has flattened out it is at a high level while the fall in capital goods orders has been arrested with a large rise in January offsetting December weakness.

Business investment indicator stabilising; manufacturing still weak

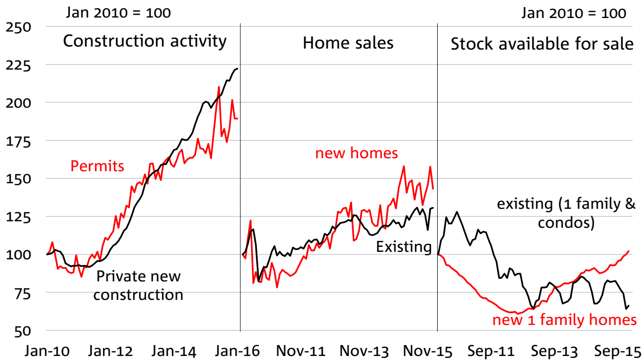


Sources: Census Bureau, Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys. * Mar qtr '16 is based on data available for the quarter.

Rig counts are continuing to fall, but the drag on overall investment over 2016 is likely to be smaller. This reflects the fact that the mining sector's share of investment is now much smaller and our view that oil prices will stabilise and then gradually rise over the course of this year. Indicators of future manufacturing investment also appear weak; investment intentions as indicated by regional Fed surveys are around post-recession lows. This may in part reflect energy sector weakness, as parts of the manufacturing sector feed into this sector, as well as the impact of USD appreciation and weak external demand. There are also signs that banks have been tightening their lending standards for businesses, although at least some of this is likely industry specific (e.g. energy).

In contrast, residential investment has been doing better, growing by 9% over the course of 2015. Partial indicators, while volatile, continue to trend upwards. The housing sector is benefiting from low mortgage rates, an easing in lending standards by banks and low levels of inventory by historical standards. Moreover, there is potential for strong growth to continue - the number of new households starting up – which had shown signs of picking up but has returned to weak levels – could be expected to gather pace given the ongoing improvement in the labour market.

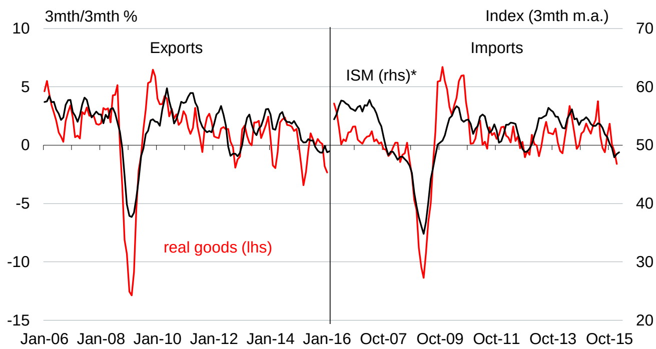
Trends in housing indicators generally positive



Sources: Census Bureau, NAB

Net trade flows continue to remain a drag on growth reflecting the appreciating trend in the US dollar since mid-2014 and weak external demand. Import growth has also weakened recently possibly as part of an inventory correction.

Exports remain under pressure, import growth has also weakened

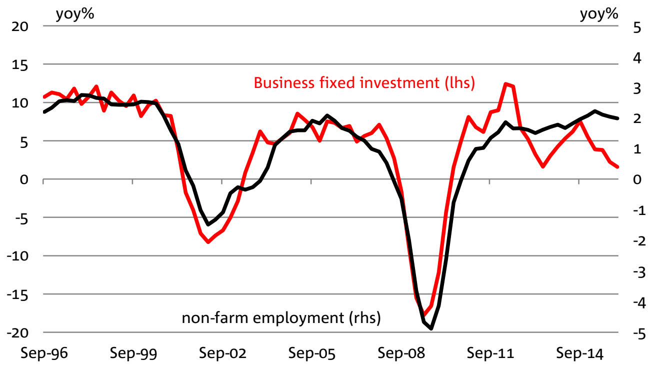


Sources: ISM, Census Bureau. *Average of ISM manuf./non-manuf. export/import indicators using goods/services trade shares.

While growth remains on a moderate track, the labour market continues to show strong gains. Non-farm employment growth rebounded in February, with net job creation of 242,000. The annual growth rate was unchanged at 1.9%, a level which is not far off double growth in the working age population (16 years and over).

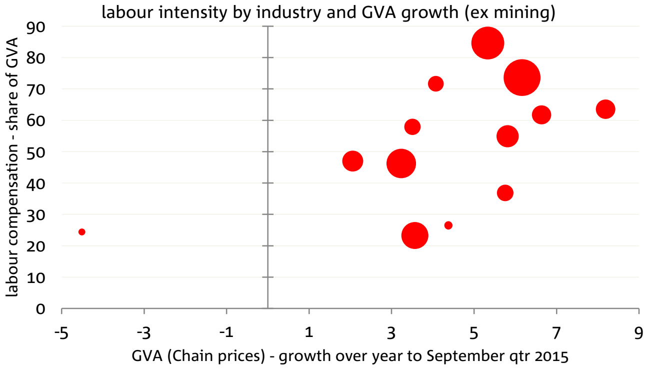
The strength of the labour market stands in contrast to the weakness in business investment. Historically, while business investment tends to have bigger swings, the two have tended to move together. This is not unexpected; as employing additional labour is, like buying extra equipment, also an investment in additional capacity. However, a divergence has opened up recently between employment and business investment trends (see chart below). This can be reconciled by noting that the industry sectors that are recording the stronger growth rates in gross valued added (GVA) are generally more labour intensive (second chart below).

Labour market improving



Sources: BLS, BEA, NAB

...with labour intensive sectors generally doing better



Sources: BEA, NAB. Bubble size indicates share of total labour compensation.

Note: mining is not included because it is such an extreme outlier it distorts the chart. Allowing for it does not change the picture as it is (currently) a poor performing, capital intensive sector.

As a result, the unemployment rate is likely to continue its downward trend. A factor that might slow the decline in the unemployment rate is rising workforce participation. Workforce participation has increased noticeably since September 2015, and is now slightly higher than a year ago. This is despite the longer term trend (for demographic and other reasons) being one of declining participation. This suggests that the tightening labour market is starting to encourage greater participation.

Monetary policy outlook

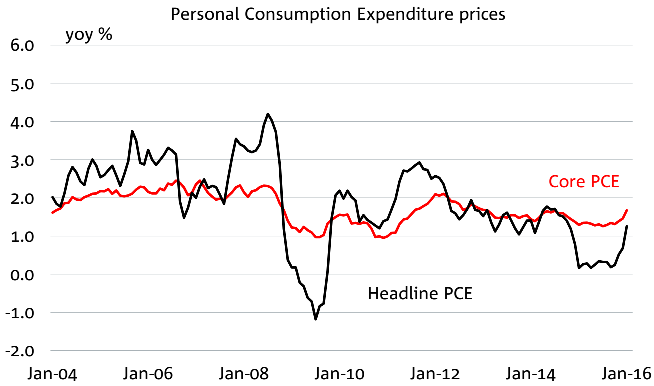
We recently changed our view on the likely timing of the next fed funds rate, moving it to the September quarter 2016. The rationale was the tightening in financial conditions, an expectation that bouts of financial volatility are unlikely to go away soon, and further indications that inflation expectations are falling, all of which would induce Fed caution.

However, we did not rule out a move in the June quarter (we see little chance of a move in the March meeting). Since then, the chance of June quarter rate hike has increased. This reflects several factors: signs that the economy remains on track and the recovery in financial conditions (i.e. less downside risk), as well as stronger than expected inflation.

On both a headline and core (which excludes energy and food) basis, annual growth in the personal consumption expenditure (PCE) price index has been below the Fed's 2% longer-term target since April 2012. The headline measure has been particularly weak of late given the steep falls in energy prices. While it jumped to 1.3% yoy in January, falls in gasoline prices in February are likely to see it move back down in the short-term.

More telling is the recent upwards move in core PCE inflation, which arguably provides a better signal of underlying or trend inflationary pressures. In January 2016 it moved back to 1.7% yoy following the largest monthly growth rate in four years. But for an estimated 0.4-0.5ppt drag coming from US dollar appreciation, core PCE inflation would be above the Fed's long-term 2% inflation target.

Inflation moving back up



In other words, the Fed currently has its policy rate at a near historical low despite being close to, or at, both its inflation and labour market goals.

However, we expect the Fed will be cautious, and still think the September quarter is the most likely timing for the next hike. The Fed will want to see confirmation that the tightening in financial conditions in January and February did not affect the economy. On the inflation side it will be concerned about the downwards trend in measures of inflation expectations. Moreover, we would not be surprised if annual core inflation gave up some of its gains in coming months due to base effects (relatively strong core PCE inflation in the February to June 2015 months dropping out of the calculation). Perhaps more importantly, the factors that produced the recent bout of financial market turbulence have not gone away, including uncertainty about the strength of the global economy, suggesting that financial markets will remain volatile.

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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	Q3	Q4
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**	**0.6**	**0.5**
Private fixed investment	5.3	4.0	4.2	5.0	0.9	0.0	**1.2**	**1.4**	**1.5**	**1.3**	**1.2**	**1.1**	**1.1**	**1.0**
Government spending	-0.6	0.7	1.2	1.6	0.4	0.0	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.2	-0.3	0.0	-0.2	0.0	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	-0.4	-0.3	-0.1	-0.1	**-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**	**0.3**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**
Note: GDP (annualised rate)					*2.0*	*1.0*	*2.2*	*2.5*	*2.5*	*2.4*	*2.3*	*2.2*	*2.2*	*2.2*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.1	0.5	1.3	2.3	0.3	0.1	**-0.1**	**0.3**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**
Core	1.4	1.4	1.8	2.0	0.3	0.3	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**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**	**4.4**	**4.4**
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	0.25	0.50	1.00	2.00	0.25	0.50	**0.50**	**0.50**	**0.75**	**1.00**	**1.00**	**1.25**	**1.75**	**2.00**
10-year bond rate	2.17	2.27	2.50	2.75	2.04	2.27	**2.00**	**2.25**	**2.50**	**2.50**	**2.75**	**2.75**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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