U.S. Economic Update

by NAB Group Economics

4 April 2016

- **Recent partial data point to weak March quarter 2016 GDP growth. Labour market still strong.**
- **With business surveys starting to turnaround and financial conditions improving we have not changed our annual GDP forecasts (2.2% in 2016) but risks are to the downside.**
- **Corporate profits have been falling, mainly in the energy sector. Profit falls often – but not always - occur ahead of downturns. There are some important differences with past cycles – particularly Fed caution on lifting rates.**

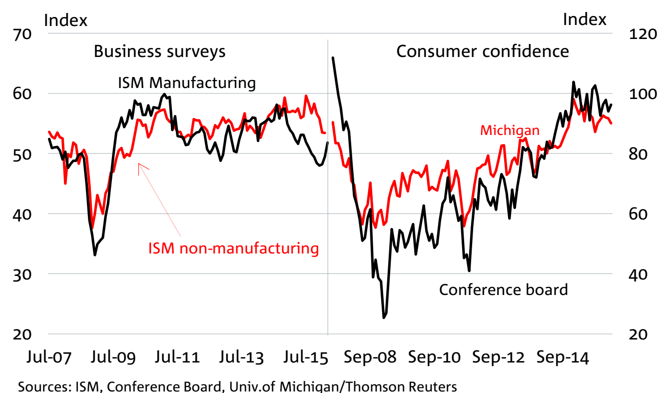
Overview

In last month's Update we noted that after a soft end to 2015, the partial indicators were pointing to a turnaround. Some new data (for February) and some hefty revisions to historical data later, March quarter 2016 GDP growth is now tracking at only 0.7% qoq (annualised) according to the Atlanta Fed's 'Nowcast'. This is lower than the still soft December quarter 2015 outcome, which has been revised upwards from an annualised 1.0% qoq to 1.4%.

At this stage we are maintaining our forecast for annual GDP growth of 2.2% in 2016. This is on the assumption that data for the March month will show improvement and that Q1 weakness is transitory and likely to be made up in subsequent quarters. However, the risks are now clearly on the downside. Beyond the next quarter, another risk is coming from the downturn in corporate profits.

However, a more positive signal is coming from business and consumer surveys. The manufacturing ISM moved back above 50 in March (the non-manufacturing survey for the month is yet to be released) and has improved in each of the last three months. Consumer sentiment remains solid.

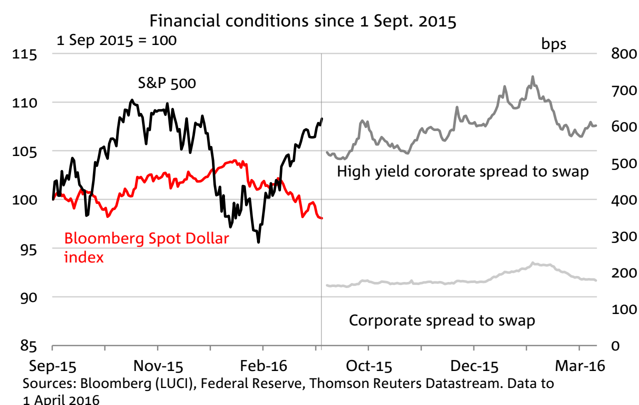
Consumer confidence stable, bus. conditions on the up



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

Moreover, financial conditions – which deteriorated markedly at the start of the year – generally continue to show improvement. The stock market has largely recovered its losses, the dollar has eased, and credit spreads are well down from their recent highs.

Financial conditions have improved

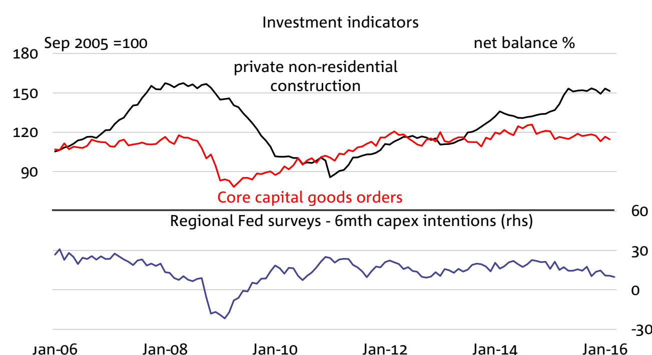


Sources: Bloomberg (LUCI), Federal Reserve, Thomson Reuters Datastream. Data to 1 April 2016

The weakness in partial indicators of activity has been most evident in investment and softer than expected household consumption.

After a pick-up in January core (ex defence and aircraft) capital goods orders fell back again in February. Private non-residential construction has not been as weak, but fell in February, partially reversing gains made in January. More broadly it has been tracking sideways since mid-2015 (in part due to a reversal in manufacturing sector investment, following a spike in Chemical sector investment triggered by low natural gas prices).

Investment indicators weak



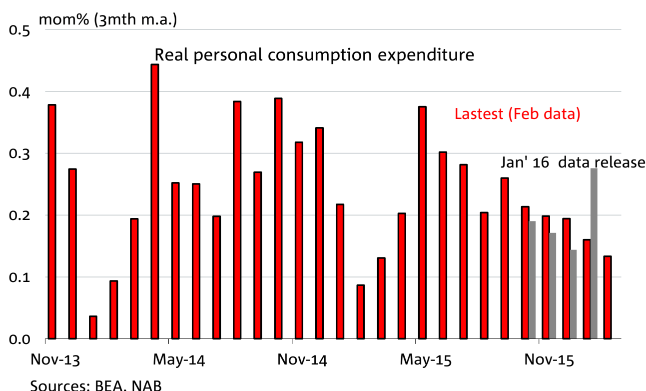
Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Business investment is facing several headwinds. The energy sector has cut back investment sharply due to the large fall in oil prices. Manufacturing has had to contend with a large appreciation of the U.S. dollar and weak external demand. However, with oil prices stabilising (and expected to gradually trend up), the US dollar falling back, and financial conditions improving, the headwinds appear to be softening. However, a not entirely unrelated concern is falling corporate profits (profit trends are discussed in more detail below) which are likely to mean investment growth remains modest over time.

One reason for the upwards revision to December quarter GDP were upwards revisions to estimated consumption over the quarter. However, January 2016 growth was marked down significantly from 0.4% mom to a small

negative, and while consumption grew solidly in February, on a trend (3 month) basis it continued to fall.

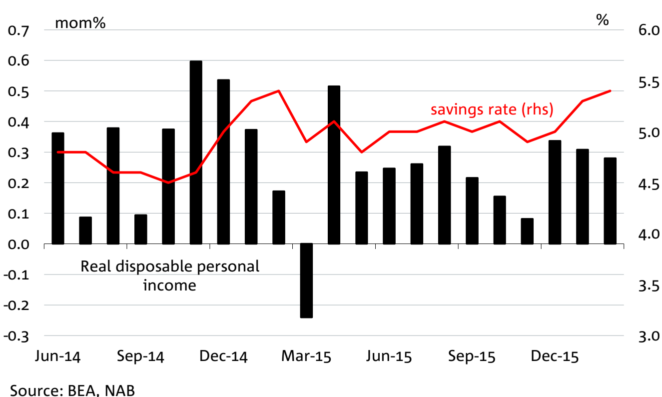
Rebound in consumption now a slowdown



Sources: BEA, NAB

The consumption slowdown is surprising given generally solid consumer confidence as well solid growth over time in real household incomes. Indeed, real household disposable income growth accelerated in early 2016, supported by further declines in gasoline prices early in the year and continuing strong employment growth. As a result, savings rates have risen, meaning that there is scope for a rebound in consumption, even with some pick up in gasoline prices in March.

...but income growth has picked-up, as has saving



Source: BEA, NAB

Looking ahead, solid consumption growth is expected. This reflects solid household confidence, the reversal of recent stock market losses and continuing house price gains supporting wealth, and the benefit to household incomes from strong employment growth and, we expect, in-time from stronger wages growth as the labour market tightens further.

Housing investment should also continue to be a positive. While it has been growing strongly, it is still at a relatively low level. Low unemployment and mortgage rates, easing bank lending standards, and low inventories make for a favourable environment for further residential investment growth. Fiscal policy is also acting as a gentle tailwind.

However, net trade continues to feel the impact of past US dollar appreciation. Despite the recent fall in the dollar, we expect that over time the currency will appreciate, although at more gradual rate than between mid-2014 and end-2015. External demand has also been weak, and we are not expecting any major improvement in global economic conditions. As a result, net exports will remain a drag on growth, although it should lessen over time.

Overall, reflecting these offsetting forces, we expect that the economy will grow in 2016 at a moderate rate, albeit somewhat down on the last two years. We are currently forecasting growth of 2.2% in 2017 and 2.3% in 2017. These forecasts are unchanged from last month, with a weaker expected March quarter 2016 offset by December quarter revisions and an assumption that growth will bounce back mid-year. As noted earlier, the run of recent weak data suggests risks are currently tilted to the downside.

While GDP growth appears to have weakened at the end of 2015 and early 2016, the labour market remains strong. As we noted in last month's Update, the sectors of the economy doing best are the labour intensive ones.

Non-farm employment recorded further strong gains in March, increasing by 215,000. Employment growth remains around double the level of population growth. As a result, the unemployment rate should decline over time. That said, the unemployment rate increased marginally to 5.0% in March, and has not improved since October 2015. However, the reason for this has been an increase in the labour force participation rate, itself a positive sign that the labour market continues to recover.

The other side of the Fed's mandate is inflation. It continues to show signs of moving back towards the Fed's 2% target. While headline inflation eased back in February to 1.0% yoy (on both the CPI and PCE price index basis), core – which excludes energy and food - inflation is running stronger. Core CPI inflation increased again to 2.3% yoy in February, while core PCE inflation held onto recent gains at 1.7% yoy. As the drags from past U.S. dollar appreciation and oil price falls fade, and as the labour market tightens further, inflation should continue to move back towards the Fed's target.

With unemployment at around the Fed's view of its long-term sustainable level, inflation moving back up, and concerns over broader financial conditions receding, the obvious question is when the Fed will tighten next.

While some Fed members have been floating the prospect of a rate hike as soon as the April meeting, The Fed Chair, Ms Yellen, was decidedly more cautious in her most recent speech. While financial conditions have improved, the Chair considers that is in part due to the more gradual path for Fed tightening now expected. She also raised concerns about inflation expectations and the global economy. The recent weakness in partial indicators will only serve to keep the Fed cautious. We expect there will be two fed fund rate hikes this year, the first in the September quarter (with the July meeting the most likely).

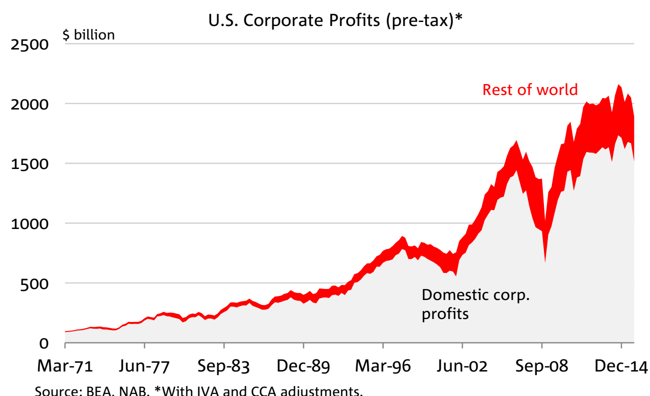
Corporate profit downturn

The third estimate of December quarter 2015 GDP also included the BEA's first estimate of profits for the quarter.

There was a large decline in (pre-tax) corporate profits of 7.8% (not annualised) on the previous quarter. While profits of domestic industries had been holding up better than those of overseas operations, this was not the case in

the December quarter. As a result, over the course of 2015, profits from both domestic and overseas operations fell by over 11%.

Profits down – both domestic & overseas operations



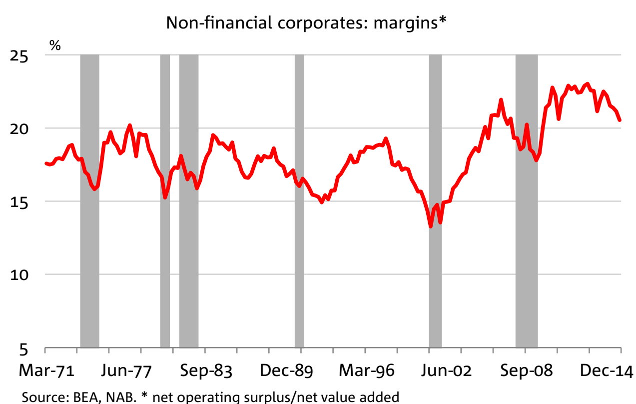
Source: BEA, NAB. *With IVA and CCA adjustments.

Around half of the fall in profits in the December quarter has been attributed to a one-off; BP's $20 billion settlement over a 2010 oil spill. Even allowing for this, there has been a large fall (around 8%) in profits over the past year.

Another way to look at this issue is through business margins. In the chart below these are measured by dividing the net operating surplus by net value added of the non-financial corporate sector. As the chart shows, business margins have been declining. Sometimes falling margins lead recessions, but not always (e.g. the mid-1980s, and the ups and downs already in the current recovery).

The fall in margins reflects both an increase in unit labour costs and falling output prices. While wage growth remains modest, unit labour costs are stronger relative to past standards reflecting weak productivity growth. Given the combination of soft GDP and strong employment growth this was likely also the case in the March quarter 2016. As the labour market tightens, some strengthening in wage pressures can also be expected, which will place further pressure on margins.

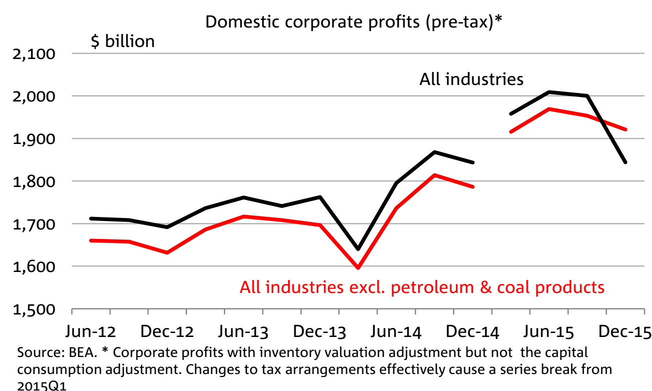
Business margins also falling



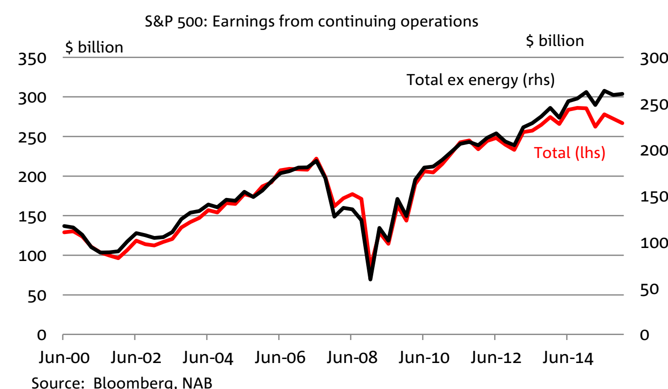
Source: BEA, NAB. * net operating surplus/net value added

One factor behind falling profitability is the large fall in energy prices that has been experienced. To assess whether the decline in profits is solely an energy story we have used two measures, shown in the charts below.

Profit downturn driven by energy, but growth in other industries has stalled



Source: BEA. * Corporate profits with inventory valuation adjustment but not the capital consumption adjustment. Changes to tax arrangements effectively cause a series break from 2015Q1

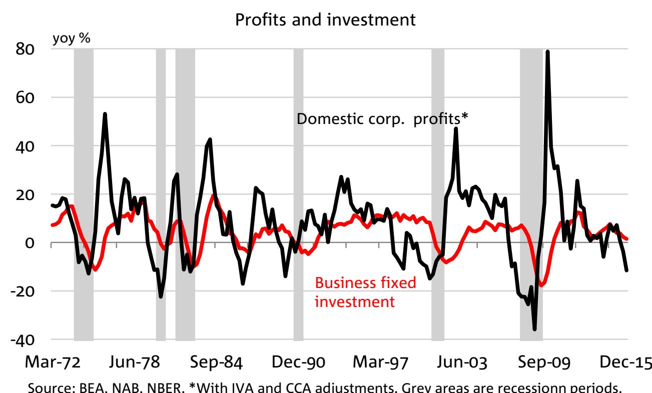


Source: Bloomberg, NAB

The first uses BEA data which is equivalent to the aggregate profit data shown earlier, except that the industry detail does not make the same capital consumption adjustment. Changes in tax (depreciation) laws early in 2015 causes a jump in industry level profits; effectively a series break. Nevertheless, it suggests that at least since early 2015 profits outside coal and petroleum have held up, although there has been downward pressure in the last two quarters.

The other measure is operating earnings of large (S&P500) corporates reported by Bloomberg. Excluding energy, earnings have been steady, with no obvious signs of downward pressure. While these measures have a mixed message on whether profits outside the energy sector have started to fall, what is clear is that the upturn in profits since the GFC has come to an end.

Profits typically lead investment



Source: BEA, NAB, NBER. *With IVA and CCA adjustments. Grey areas are recessionn periods.

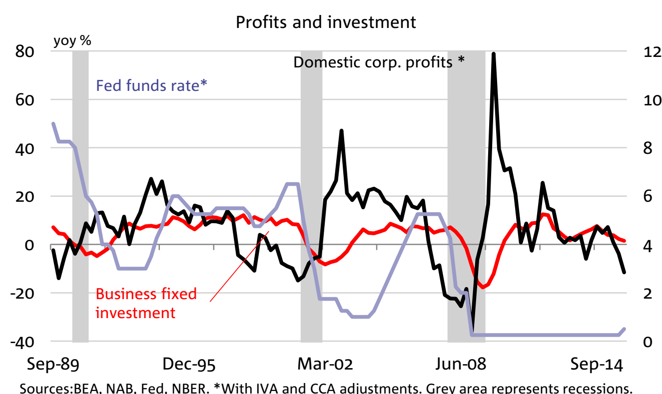
This needs to be watched because, as noted earlier, as changes in margins/profits can precede recessions. The

obvious link is that faced with declining returns, additional investment (in equipment/structures or labour) is less attractive. Even if the downturn is concentrated in one sector, this can spill over into the broader economy (as did the financial sector's problems in the GFC).

Of course, this is not the only factor in play – if margins are falling due to higher wages, then consumption may be expected to rise, offsetting any weakness in investment. Moreover, business investment prior to the last two recessions was reasonably steady right up to the point where the downturn started, suggesting an unexpected shock caused the recession rather than the trend decline in profits (although the two can be related).

One factor that is different this time around is monetary policy. In the past the Fed was well into a tightening cycle as profits were falling. This time around it has barely started, and it is signalling that any further tightening will be at a more gradual pace than in the past.

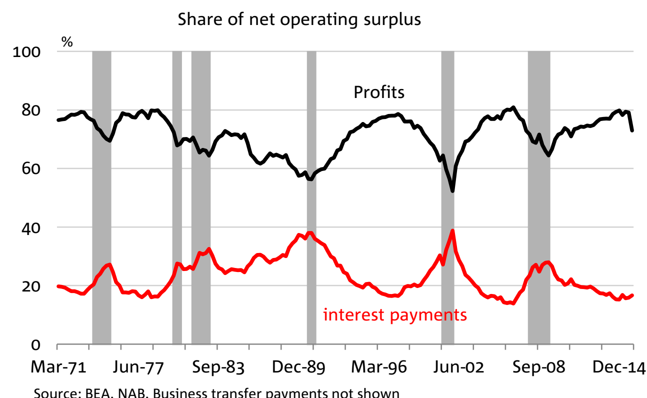
Fed caution a difference to past episodes…



Sources:BEA, NAB, Fed, NBER. *With IVA and CCA adjustments. Grey area represents recessions.

As a result, there is no squeeze on profits from rising interest payments, as has occurred prior to many previous downturns. The risk, highlighted by the recent upturn in core inflation indicators, is that inflation accelerates faster than the Fed expects, causing a rapid tightening in policy down the track.

… as a result interest not adding to squeeze on corporate profits - yet



Source: BEA, NAB. Business transfer payments not shown

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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	2.6	2.4	0.7	0.6	**0.5**	**0.7**	**0.7**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**
Private fixed investment	5.3	4.0	3.9	5.0	0.9	0.1	**0.8**	**1.5**	**1.5**	**1.3**	**1.2**	**1.1**	**1.0**	**1.0**
Government spending	-0.6	0.7	1.5	1.7	0.4	0.0	**0.4**	**0.5**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	0.0	0.2	-0.2	-0.1	-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	-0.3	-0.3	-0.1	0.0	**-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**	**0.4**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)					*2.0*	*1.4*	*1.6*	*2.7*	*2.6*	*2.4*	*2.2*	*2.2*	*2.0*	*2.0*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.1	0.5	1.4	2.3	0.3	0.1	**0.1**	**0.3**	**0.4**	**0.6**	**0.5**	**0.6**	**0.6**	**0.5**
Core	1.4	1.4	1.9	2.1	0.3	0.3	**0.5**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	4.4	5.1	5.0	4.9	**4.9**	**4.8**	**4.7**	**4.6**	**4.5**	**4.5**	**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	1.77	**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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