U.S. Economic Update, 2016Q1 GDP

by NAB Group Economics

29 April 2016

- **U.S. GDP growth slowed in the March quarter to 0.1% qoq (0.5% annualised), with softer consumption growth, and business investment and net trade again detracting from growth.**
- **We expect GDP growth of 1.8% in 2016 (previously 2.2%) and 2.1% in 2017 (previously 2.3%). The downward revisions include a lower expected productivity growth trend going forward and, as a result, we have lowered our expectation of the peak federal funds rate for this cycle to 2.5%.**

Quarterly U.S. Gross Domestic Product (GDP) growth slowed to a weak 0.1% qoq, or 0.5% annualised in the March quarter. As the same quarter last year was also weak, there was little change in the over-the-year growth rate which has been around 2% for the last three quarters.

The details were mixed, although the weaker growth was due to slower inventory accumulation, a factor that tends to wash out over time. The most noticeable strength was in residential investment, while public demand also picked up a bit. However, the drag on growth from business investment and net trade intensified.

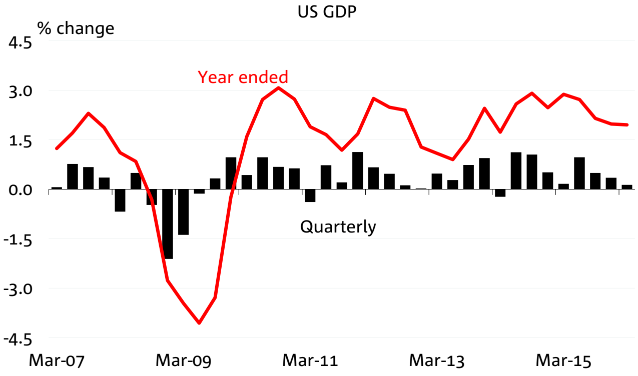
Real private consumption growth was 0.5% qoq – the slowest growth since the same time last year. Real (inflation adjusted) disposable personal income growth was stronger at 0.7% and, as a result, the savings rate rose. Goods consumption showed no growth at all (largely due to a fall in motor vehicle and parts consumption), but services consumption remained strong at 0.7% qoq. However, services looks to have been supported by a turn-around in utilities (power) consumption, swings in which tend to reflect weather conditions.

Business fixed investment declined for the second quarter in a row. Indeed, the 1.5% qoq fall was the largest decline recorded since (recession affected) 2009. The fall was concentrated in mining related investment – mining exploration, shafts and wells structures investment fell almost 40% qoq and is now 70% off its end 2014 high. However, even outside of this, there was a small decline in investment, including another fall in transport equipment which may also be mining related.

In contrast, residential investment grew very strongly; the 3.5% qoq growth in the quarter was the strongest since end 2012, and took the annual growth rate to over 10%. Growth was strong in both the 'permanent site' (new construction) and 'other structures' (which includes ownership transfer costs related to housing sales as well as home improvements) categories.

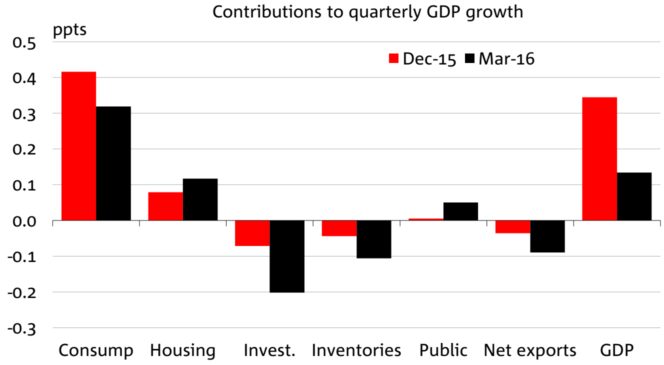
Inventory accumulation slowed for the third quarter in a row. Inventory movements have largely transitory affects, with little net impact over time, but it is not clear that this correction is yet over. The ratio of inventories to sales still

Weak start to the year…again



Sources: BEA, NAB

…with drags from business investment and trade while consumption growth slowed



Sources: BEA, NAB. Data not annualised

2016 Q1 GDP detail

	QoQ (%)	QoQ cont. (ppts)	YoY (%)
Consumption	0.5	0.3	2.7
Fixed investment	-0.4	-0.1	1.9
Structures	-2.8	-0.1	-4.4
Equipment	-2.2	-0.1	-0.3
Intellectual property	0.4	0.0	2.2
Residential	3.5	0.1	10.6
Ch. in inventories		-0.1	
Public Demand	0.3	0.1	1.4
Net exports		-0.1	
Exports	-0.6	-0.1	0.3
Imports	0.0	0.0	1.2
GDP	0.1	0.1	1.9

Source: BEA, NAB. Data not annualised.

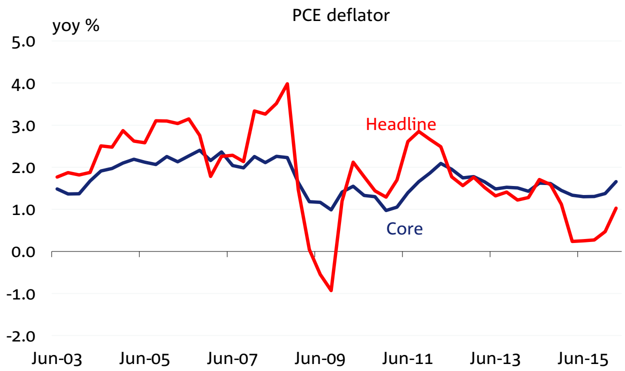
looks elevated. Stronger sales (which we expect) would help correct this but a further slowing in inventory accumulation would not be a surprise.

Trade flows were weak in the March quarter, with exports declining and imports basically flat. Exporters have been battling a significant appreciation of the U.S. dollar and a lacklustre global economy. The dollar has come off its highs recently, but it may be too soon for this to be materially affecting the trade data. Conversely imports should be supported by the strong dollar (and certainly this has been the case in travel), but the recent softness may reflect the ongoing inventory correction and weakness in business investment.

Government consumption and investment increased by a modest 0.3% qoq. The trend is one of gradual improvement; the annual growth rate is now at its highest level in six years.

Inflation picked up again the March quarter, although it still remains well below the Fed's long-term 2% target. The personal consumption expenditure (PCE) deflator grew by 1.0% yoy in the March quarter, well up from the 0.3% yoy recorded as recently as the September quarter 2015. The quarterly growth rate was soft (only 0.1%) and the rise reflects the large fall in the March quarter last year dropping out of the calculation. Similarly core (ex energy and food) PCE price growth has strengthened from 1.3% yoy in the September quarter to 1.7% in the March quarter; and the quarterly growth rate was also up (0.5% qoq).

Inflation on the up



Sources: BEA, NAB

Assessment

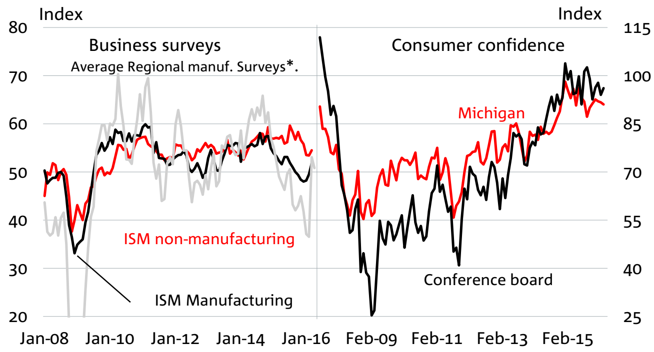
While the advance March quarter GDP estimate suggests a slowing economy, quarterly GDP is volatile and the initial estimate subject to considerable revision. Indeed, growth in the March quarter was very weak in both 2014 and 2015, yet did not signal a fundamental change in the economy.

However, it is risky to completely dismiss the slowdown as statistical 'noise', as it occurred against the back drop of a sharp deterioration in financial conditions early in the quarter, and was corroborated by declines in business survey indicators.

That said, the deterioration in financial conditions at the start of the year has largely been reversed, and business survey readings – including for the manufacturing sector – have shown some improvement.

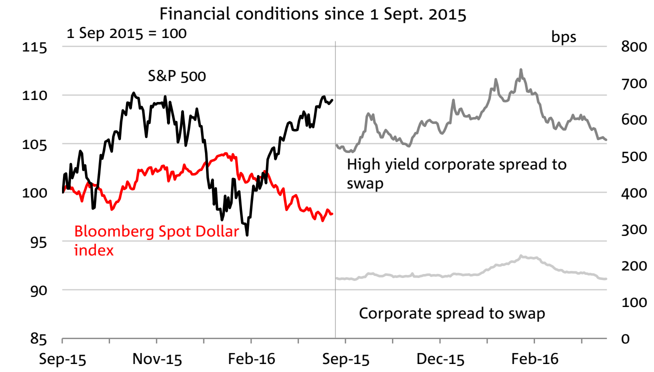
Moreover, the softer GDP data is yet to show any signs of impacting the labour market. While employment can often lag developments in GDP growth, data on initial jobless claims are available for most of April, and have actually fallen since early in the year to very low levels. Non-farm employment growth (data to March) has also remained strong.

Business indicators turning around, consumers steady...



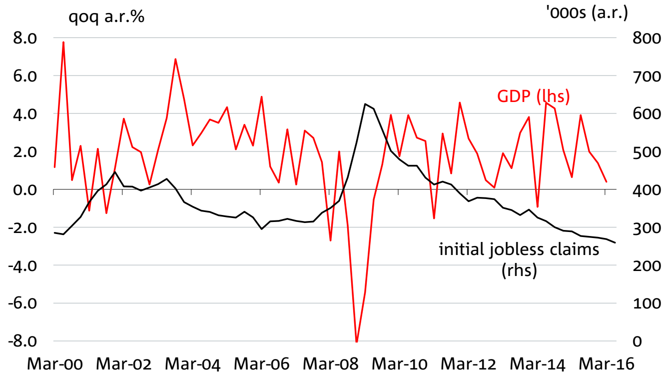
Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, Richmond, Dallas, Kansas City, Philadelphia & New York Federal Reserves (*simple average of survey results plus 50)

...as tightening in financial conditions at start of year continues to unwind



Sources: Bloomberg (LUCI), Fed. Reserve, Thomson Reuters Datastream. Data to 27/4/2016

...weakness in GDP not showing up in jobless claims



Sources: Dept of Labor, Bureau of Economic Analysis, NAB. June '16 qtr claims based on data to date

As a result, we don't consider that the weak March quarter outcome signals a marked, permanent, downshift in the economy. We maintain our view that the economy will grow at a moderate pace, and by enough to further bring down unemployment and contribute to gradual rises in inflation. The continuing relatively soft GDP but strong employment growth points to issues with productivity growth, which is stuck at a very low level.

Households continue to benefit from strong job gains and household balance sheets are in a good position. Given underlying population trends, non-farm employment growth can't continue at current levels indefinitely, but as the labour market tightens wages growth should strengthen.

Moreover, fiscal policy is also expansionary and the outlook for residential investment remains positive. Housing investment has plenty of scope to continue growing with the level of activity still relatively low. A strong labour market, low mortgage rates, easing bank lending standards, and low inventories make for a favourable environment for further residential investment growth.

Business investment is facing several headwinds, although they may fade a little. Corporate profits have declined, particularly in the energy sector but profits appear to have at least levelled out in other sectors. Manufacturing has had to contend with a large appreciation of the U.S. dollar and weak external demand. However, with oil prices recovering a little (and expected to continue to gradually trend up), and financial conditions improving, headwinds appear to be softening.

Net trade continues to feel the impact of past US dollar appreciation. While the dollar has fallen recently (against a basket of currencies) we expect that over time the currency will appreciate. However, it is likely to be at a more gradual rate than experienced between mid-2014 and end-2015. That said, global growth is likely to remain subdued. As a result, net exports will likely remain a drag on growth, although it should lessen over time.

Reflecting these various forces, we expect that the economy will continue to grow at a moderate rate. However, with the downside risk noted in our last update actually eventuating in the March quarter and the latest partials not yet signalling a rebound we have lowered our GDP growth forecast for 2016 from 2.2% to 1.8%. We have also lowered our economic growth expectation for 2017 from 2.3% to 2.1%. This is because we are now projecting a smaller productivity rebound given the ongoing sub-par productivity performance in the United States.

These changes have implications for our fed funds rate projections; we now expect the peak fed funds rate in this cycle to be 2.5% (3.0% previously).

Given the continued improvement in the labour market, and signs that inflation is starting to move back towards the Fed's target, we still expect gradual interest rate rises. We don't expect this process will re-start until the second half of the year. This is mainly because the Fed will want confirmation that the weak first quarter was only temporary. While this might be possible by the June meeting, the U.K. 'Brexit' vote will occur shortly after that meeting and if the polls remain close, this will give the Fed an added reason for caution.

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US Economic & Financial Forecasts

	Year Average Chng %					Quarterly Chng %									
						2015		2016				2017			
	2014	2015	2016	2017	2018	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	2.7	3.1	2.5	2.2	1.9	0.7	0.6	0.5	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.3	4.0	2.3	4.4	3.5	0.9	0.1	-0.4	**1.2**	**1.3**	**1.2**	**1.1**	**1.0**	**0.9**	**0.9**
Government spending	-0.6	0.7	1.3	1.6	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	-0.1	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	-0.3	-0.3	-0.1	-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**	**1.8**	**2.1**	**1.9**	**0.5**	**0.3**	**0.1**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*2.0*	*1.4*	*0.5*	*2.5*	*2.4*	*2.2*	*2.1*	*2.0*	*2.1*	*2.0*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.1	0.5	1.6	2.1	2.2	0.3	0.1	0.1	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**
Core	1.4	1.4	1.8	2.0	2.2	0.3	0.3	0.5	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	4.4	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	1.75	2.50	0.25	0.50	0.50	**0.50**	**0.75**	**1.00**	**1.00**	**1.25**	**1.50**	**1.75**
10-year bond rate	2.17	2.27	2.50	2.75	2.75	2.04	2.27	1.77	**2.00**	**2.25**	**2.50**	**2.75**	**2.75**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

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