U.S. Economic Update

by NAB Group Economics

9 June 2016

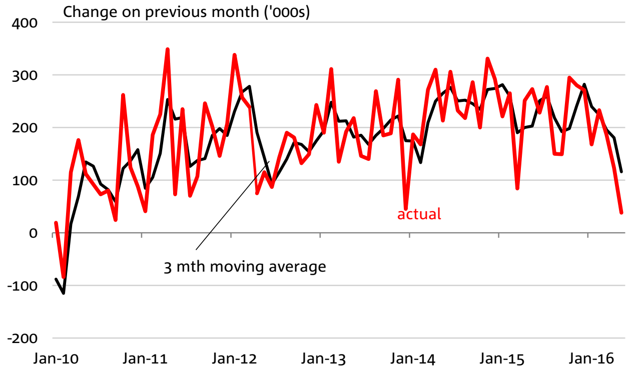
- **The dramatic slowdown in jobs growth in May casts doubt on the labour market.**
- **However, partial indicators suggest GDP growth has strengthened in the June quarter.**
- **We expect that the May employment report is an outlier. If this proves to be the case then Fed rate hikes are still likely; with July or September the most likely dates.**

Labour market clouds

Through the weakness in March quarter GDP, one of the reassuring trends was the strength in jobs growth. However, even as June quarter GDP is showing signs of accelerating, confidence in the labour market outlook has plunged following the May employment report.

Total non-farm employment increased by only 38,000 in May, its smallest monthly increase since late 2010, and April was also below expectations. A strike by around 35,000 Verizon workers only partially explained the weak result, although adjusting for this factor puts the May result in the same ball park of other weak months seen in recent years.

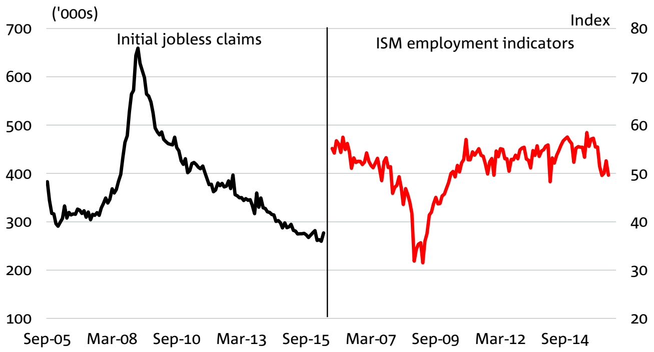
Jobs growth slows dramatically in May



Sources: BLS, NAB. Excludes Census workers.

This raises the issue as to whether it is simply 'noise' and coming months will be stronger or whether it points to a more fundamental slowing in the economy.

Other labour market indicators are mixed

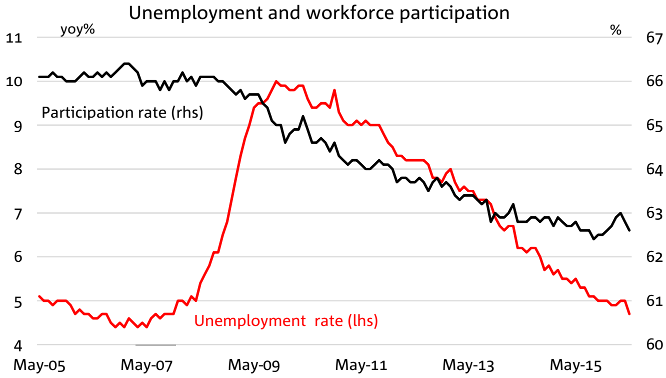


Source: ISM, Dept of Labor, NAB. ISM composite based on manufacturing/non-manufacturing shares of private employment.

Other labour market indicators do not fully resolve this issue although, on balance, suggest that the slowdown reported in the May employment report is exaggerated. The employment indicators in the ISM business surveys have clearly fallen this year. However, initial jobless claims have remained at very low levels by historical standards. Moreover, the ADP employment report, which tends to fluctuate less than the official series, estimates employment growth of around 170,000 in each of the last two months.

There was good news in the employment report but even this had a cloud hanging over it. The unemployment rate fell to 4.7% (from 5.0% in April) but largely due a sharp reversal of much of the recent gains in workforce participation. Looking through the monthly fluctuations, participation now appears to have been tracking sideways, although given the longer term trend, due to demographics, is for it to fall, this is not a bad outcome.

Large fall in unemployment rate due to lower workforce participation



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

Regardless of the reason, an unemployment rate of 4.7% points to an increasingly tight labour market, consistent with recent signs of strengthening wages growth.

Our view is that while there may be been some slowdown in jobs growth, the May employment report is probably significantly exaggerating the extent.

Underpinning our forecasts has been an expectation that employment growth would slow as the pool of unemployed workers diminished. Similarly, in a recent speech, the head of the Boston Federal Reserve stated that "…as we approach full employment, we expect employment growth to moderate toward its long-run sustainable growth rate – a rate that will neither raise nor lower the unemployment rate. Federal Reserve economists currently estimate that rate…to be about 80,000 to 100,000 jobs per month." A recent estimate by the Chicago Federal Reserve estimates that jobs growth of above 50,000 a month would still lead to a tightening in the labour market. [1]

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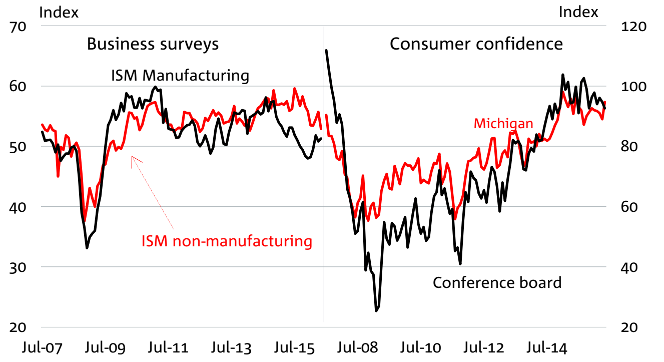
1 http://www.bostonfed.org/news/speeches/rosengren/2016/051216/index.htm & Is There Still Slack in the Labour Market , Letter No. 359

Q2 GDP showing some acceleration

One possible expectation for a slowdown in jobs growth is the weakness in activity earlier in the year. March quarter GDP growth was only 0.8% qoq annualised. However, at this stage it looks like GDP growth has strengthened in the June quarter.

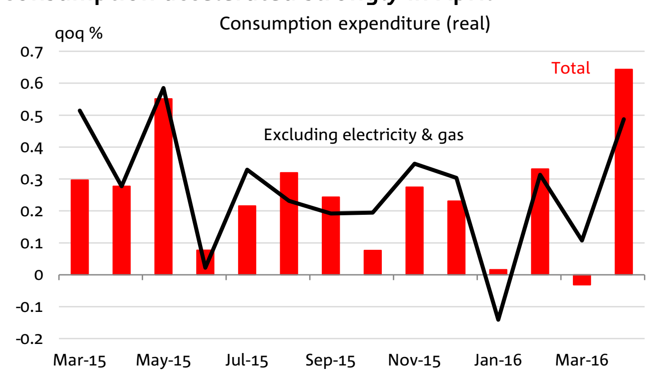
Business conditions have softened, but consumer confidence remains solid



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

On a more cautionary note, however, is the recent weakness in business surveys. While the manufacturing ISM survey has shown some improvement, the non-manufacturing ISM, which covers a much larger part of the economy, has clearly weakened.

Consumption accelerated strongly in April

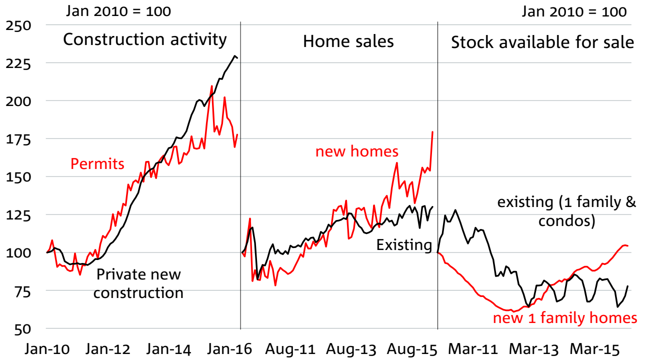


Sources: BEA, NAB

Against that, consumer confidence remains at a reasonably solid level. While consumption growth was on the soft side in the March quarter, it is estimated to have got off to a strong start early in the June quarter, with growth in real consumption of 0.6% mom in April alone. This partly reflects a rebound from weather related weakness in electricity and gas consumption in March, but even excluding this impact, growth in April was strong.

Even in the face of the first quarter GDP slowdown, residential fixed investment remained strong. Over the year to the March quarter 2016 it grew by over 10%. Partial data for the sector, are often very volatile, highlighted most recently by the April new home sales data. While the spike in new homes sales probably is exaggerated, even so it suggests that new homes sales are trending up, which should continue to support building activity in the near future. Pending home sales also grew strongly in April, pointing to stronger existing sales data in coming months, which again is a positive for residential investment as it includes sales costs such as real estate commissions.

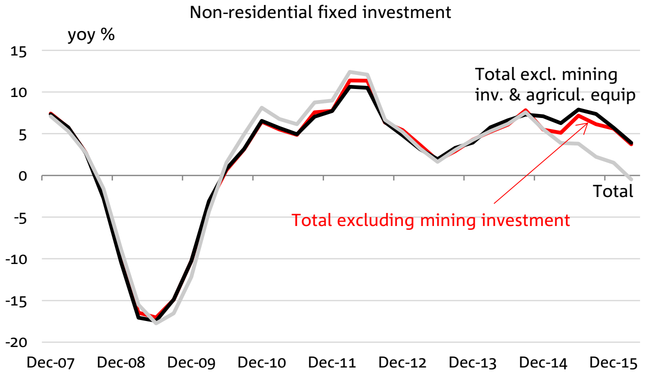
Large spike in new home sales in April



Sources: Census Bureau, NAB

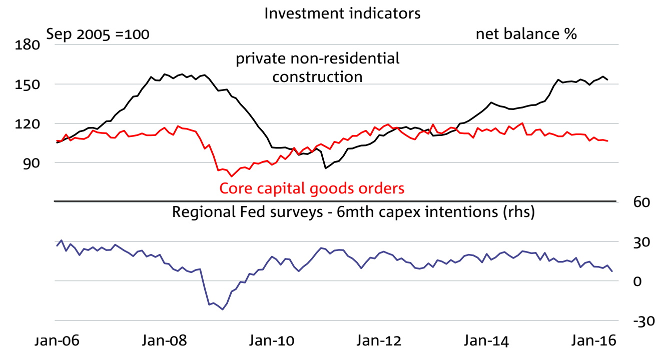
In contrast, partial indicators point to continuing weakness in business investment. Business fixed investment fell by 0.5% over the year to the March quarter 2016. This mainly reflected weakness in mining sector investment, although the ill winds caused by falling commodity prices also affected other sectors including agricultural investment. However, the weakness has become more general recently; in the last two quarters investment excluding mining fell.

Business investment has been falling



Sources: BEA, NAB

Partial data show no upturn in investment



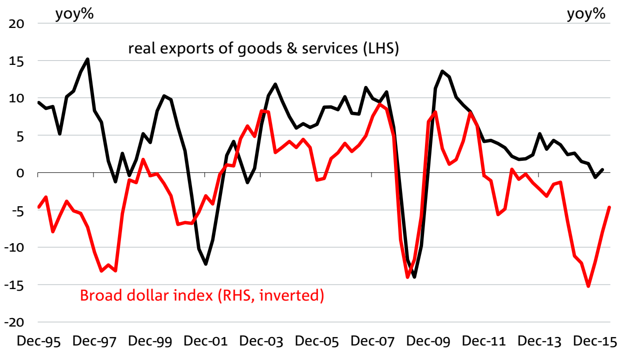
Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Partial data for April do not point to a turnaround yet. Capital goods orders and manufacturing investment intentions if anything have softened further. Construction investment has been stronger, but gave up some of its recent gains in April. However, with oil prices now well off their lows seen earlier in the year, there are tentative signs

(https://chicagofed.org/publications/chicago-fed-letter/index) that the fall in mining investment may be bottoming out, as the rig count has stopped falling.

The fall in the U.S. dollar since January 2016 should provide some relief to U.S. exporters, who had been battling the twin headwinds of U.S. dollar appreciation and a lack lustre global economy for a while. In line with this, there has been some improvement in the monthly data (to April) and the ISM export indicators have been trending up since January.

Dollar drag on exporters softening



Sources: BEA, Federal Reserve. June 16 qtr BDI based on April & May average

We expect that the economy will continue to grow at a moderate pace. This is predicated on our expectation that the significant slowdown in jobs growth reported for May is a 'one-off' and that a faster pace of jobs growth will resume.

Consumption growth is expected to remain solid. While rising oil prices will exert some downwards pressure, consumption will still be supported by strong household balance sheets, rising wealth (particularly from house price growth), and a tight labour market. While jobs growth is likely to slow over time this should be offset by stronger wages growth. These same factors, as well as low mortgage rates, easing bank lending standards and low inventories for sale, also suggest that residential investment will remain strong.

The economy is also continuing to benefit from a fiscal policy tailwind, albeit only a modest one. Government consumption and investment grew by 1.4% over the year to the March quarter – its fastest pace since the stimulus put in place post the 2007-09 recession. Broader measures of government activity also suggest a modest fiscal stimulus, and monthly partial indicators are generally increasing.

We are also factoring some improvement in business investment, as oil prices continue their gradual recovery and as the headwind from past rapid U.S. dollar appreciation fades. However, we are not expecting rapid growth, as rising wage costs are likely to mean pressure on profit margins will continue, and banks have been tightening lending standards for business loans.

Similarly, the recent fall in the dollar should alleviate some of the pressure on the traded sector. However, global growth is likely to stay subdued. As a result, net exports are likely to remain a drag on growth, although it should lessen over time.

Monetary policy

The Fed's two principle objectives are to maintain price stability and promote maximum employment. It currently defines these goals as Personal Consumption Expenditure price index growth of 2% a year over the long-run and an unemployment rate of 4.7-5.0% (the 'central tendency' Fed member view of the longer-run unemployment rate).

After its fall in May, the unemployment rate is now at the bottom end of Fed members' view of the longer-run unemployment rate.

Headline inflation remains low at 1.1% yoy, but it has been rising, as has core inflation (ex energy and food) which is now at 1.6% yoy and so is not that far off the Fed's target. With oil prices rising and the drag on prices from U.S. dollar appreciation fading, inflation is likely to move higher.

Despite this the Fed has been on hold since its single rate increase in last December's meeting. Expectations had been high that the Fed would raise rates again at its June or July meetings.

However, any chance of rate hike at the June meeting has been derailed by the May employment report.

If, as we expect, the May employment report is an aberration then a July hike is still a possibility. This would require a strong rebound in jobs growth in June and generally positive other data on the economy. Even if this were to occur it is easy to see the Fed being cautious and wanting more data before moving, which opens up September as another likely date. Our call for a while has been for a Q3 rate hike, with July the most likely date; clearly, however, the chance of this being delayed till the September meeting has increased significantly.

The other possibility – not our central call – is that the May report signifies a permanent, significant, slowdown in jobs growth. If this were to be the case, then the implication for Fed monetary policy would be that any short-term rate hikes would be taken off the radar.

For more information, please contact

Tony Kelly +613 9208 5049
antony.kelly@nab.com.au

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	2.6	2.2	1.9	0.7	0.6	0.5	**0.8**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.3	4.0	2.1	4.3	3.5	0.9	0.1	-0.4	**0.9**	**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	-0.2	-0.1	0.0	-0.2	0.0	-0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	-0.2	-0.3	-0.1	-0.1	0.0	-0.1	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**
Real GDP	**2.4**	**2.4**	**1.8**	**2.1**	**1.9**	**0.5**	**0.3**	**0.2**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*2.0*	*1.4*	*0.8*	*2.5*	*2.3*	*2.1*	*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	2.2	2.3	0.3	0.1	0.1	**0.5**	**0.6**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**
Core	1.4	1.4	1.8	2.0	2.2	0.3	0.3	0.5	**0.4**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.5	4.3	4.3	5.1	5.0	4.9	**4.8**	**4.6**	**4.5**	**4.5**	**4.4**	**4.4**	**4.3**
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	2.25	2.75	2.50	2.04	2.27	1.77	**2.00**	**2.25**	**2.25**	**2.25**	**2.50**	**2.75**	**2.75**

Source: NAB Group Economics

*Contribution to real GDP

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 2) 9237 8017

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Behavioural & Industry Economics

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(61 3) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Jason Wong
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055