U.S. ECONOMIC UPDATE
by NAB Group Economics

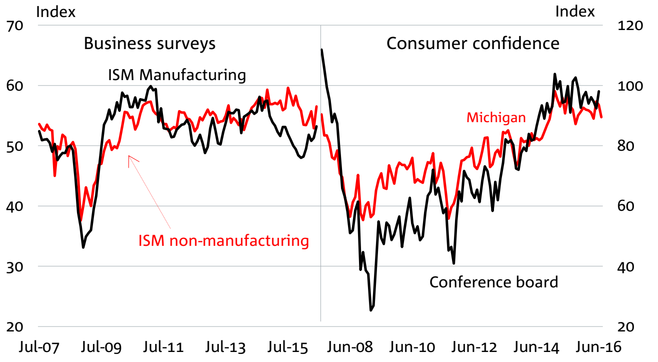
18 July 2016

- **Activity indicators point to stronger GDP growth in the June quarter.**
- **Concerns over the labour market have subsided after the June employment report.**
- **Brexit is not expected to have a significant impact on the US. However, it adds to risks and uncertainty and so the Fed is likely to stay on hold until December.**

Primarily driven by very strong consumption growth, activity looks to have picked up in the June quarter, after a sluggish start to the year. Moreover, concerns over the health of the labour market have diminished after the June employment report.

This turnaround is also reflected in the ISM business surveys. The manufacturing ISM rose for the second consecutive month in June (taking it to its highest level since early 2015), and the non-manufacturing survey also bounced back from its May lull, reaching its highest level since November last year. At the same time, consumer confidence remains solid.

Business surveys turning around; consumers still solid



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

Most of these surveys would at best only partially reflect any impact on activity or sentiment from the UK vote to leave the EU. The exception is the preliminary Michigan confidence measure for July. While this measure fell it remained within its recent (solid) range. At this stage, the fall out through financial markets also appears limited. The share market declined initially but has since moved to new highs, spreads did not widen significantly, the 'VIX' fear index did spike but quickly moved down, and the appreciation of the USD (on a trade-weighted basis) has not been particularly large, and it remains below the peaks seen earlier in the year.

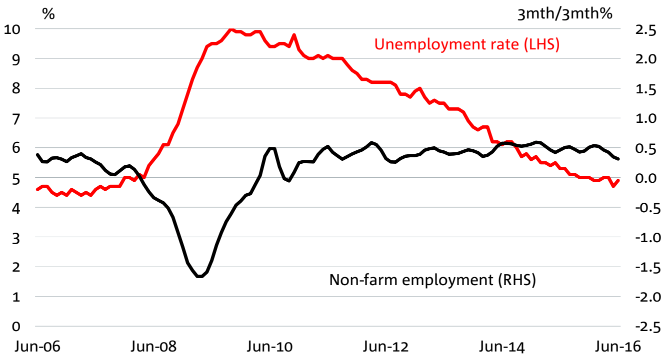
While in our latest global forecast update we revised down our forecasts for the UK economy to include a shallow technical recession in the UK, exports to the UK are a very small part of the US economy (less than 1% of GDP in 2015). The main risks from the 'Brexit' vote comes from financial market disturbances – which are relatively muted at this stage – and from any contagion to the rest of Europe, with which the US has much larger ties. Our recent publication, Brexit and World Growth discusses the implications of the referendum for the world economy.

Labour market worries subside

Concerns over the US labour market which had arisen after a very low jobs growth number in May were alleviated by June employment report. While May employment growth was revised down to only 11,000, the gain in non-farm jobs of 287,000 far exceeded expectations. While the unemployment rate rose from 4.7% to 4.9%, this was partially due to a rise in workforce participation and did not fully reverse the fall in May. Over the last two months the unemployment rate fell 0.1 ppt and is close to what the Federal Reserve considers its long run sustainable level.

Over the last three months, non-farm employment grew by an average of 147,000 per month, down on 196,000 in the previous three months. While some indicators do not suggest any change in labour market conditions – initial jobless claims remain very low – it is likely that some slowdown has occurred. This is not unexpected; as unemployment declines to relatively low levels the available pool of workers begins to diminish.

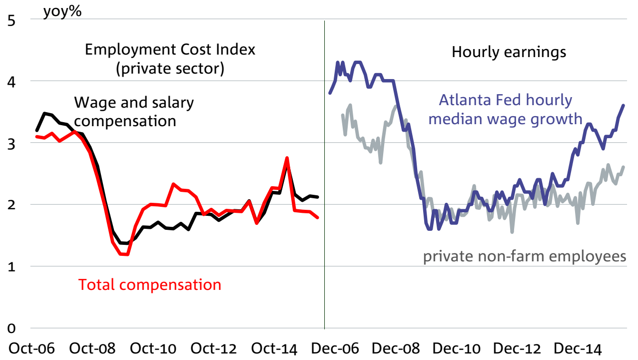
Labour market continues to improve



Sources: BLS, NAB

A tighter labour market should give rise to stronger wages growth. Of course it is not the only factor; relatively subdued inflation and weak productivity growth are headwinds to wages. Nevertheless, several indicators suggest wages are strengthening, with annual growth in private non-farm hourly earnings and the Atlanta Fed's wage tracker ticking higher in June. The Employment Cost Index total compensation measure, however, shows no acceleration, although data are only available through to the March quarter.

Signs wages growth continues to strengthen

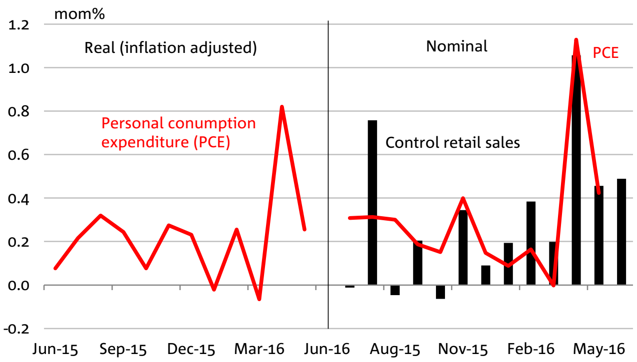


Sources: BLS, Atlanta Federal Reserve, NAB. Employ. Cost Index growth rates based on seasonally adjusted data

Review of Q2 Activity – Consumption leads the way

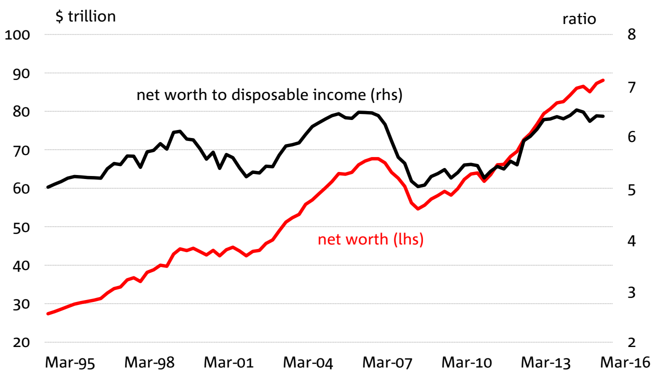
After, only growing 0.4% qoq in the March quarter, the slowest quarterly growth rate in two years, consumption has bounced back in the June quarter. Data on real (inflation adjusted) consumption growth are only available to May, but indicate that consumption was running 1% higher than in the March quarter. June looks likely to add to this, despite a fall in auto sales, as nominal retail sales grew strongly in the month.

Strong pick-up in consumption



Source: BEA, Census Bureau, NAB. Control sales exclude gasoline, auto dealers & building materials & food services

Healthy h'hold balance sheets a plus for consumption

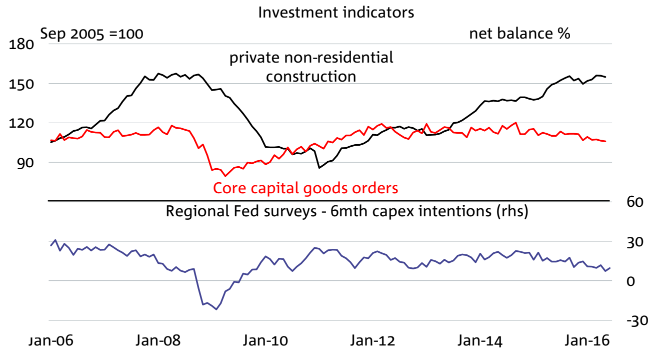


Source: Federal Reserve, NAB

The strong growth in consumption in the June quarter is despite a rise in inflation, including higher gasoline prices. It looks unsustainably strong. Nevertheless, there are reasons to expect solid consumption growth including a strong labour market, solid confidence levels, and healthy balance sheets. Household net worth in the March quarter was at relatively high levels. Household assets are growing and, while liabilities are rising in absolute terms, relative to income they continue to drift down. Net worth likely has improved since March due to rises in housing and equity prices.

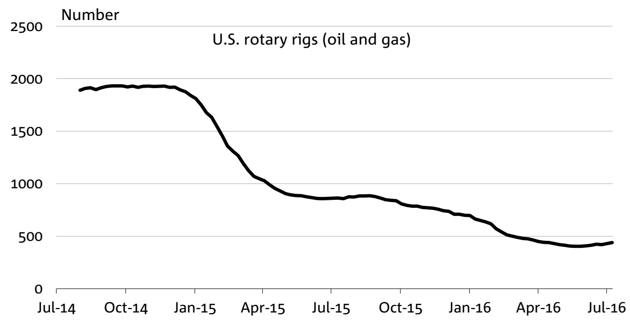
In contrast indicators for business investment remain weak and do not yet signal any clear turnaround, although energy related investment appears to be stabilising. Core capital goods orders (which exclude defence and aircraft) are still drifting down. Private non-residential construction is slowly trending up although this series does not include energy related investment. Energy related investment looks to have had another large fall in the June quarter, but towards the end of the quarter the number of rigs bottomed out and have even moved above their lows in July so far. This is consistent with some recovery in oil prices, which we expect to continue, albeit gradually.

Business investment indicators remain weak…



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

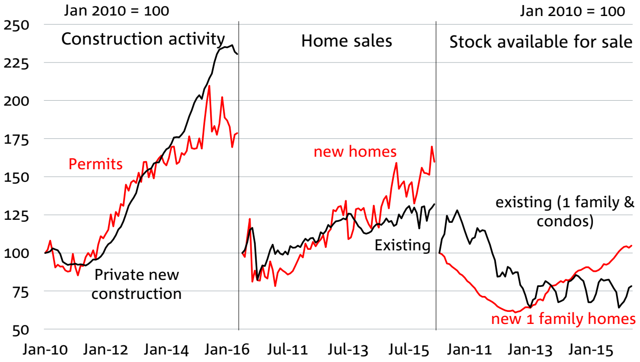
…but energy drag abating as rig count bottoms out



Sources: Baker Hughes Incorporated, Datastream

Previously strong residential investment also looks to have slowed (if not fallen) in the June quarter, although it is likely to be only temporary. Private new residential construction in April and May was below its March quarter level. The permits data, which tend to lead construction, are still trending up but have been particularly volatile of late. More importantly, new home sales have risen, which will support further building down the track. Existing home sales have also risen; with sales commissions (and other ownership transfer costs) part of residential investment, this should offset the weakness in construction activity in the June quarter.

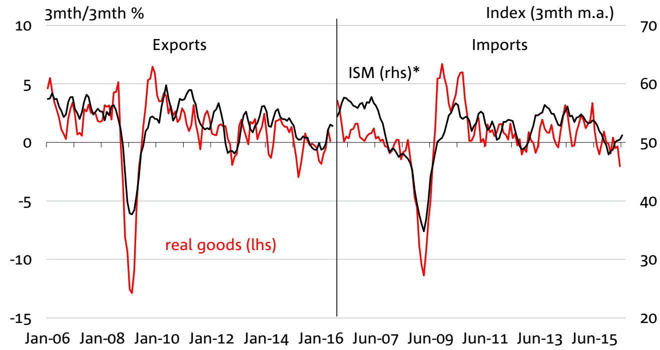
Housing construction softened in the June quarter



Sources: Census Bureau, NAB

Despite some ups and downs, the US dollar, on a trade-weighted basis, is around where it was in late 2015. As a result, the headwind from USD appreciation on exporters should be fading. Real goods exports have improved marginally, but a stronger positive signal is coming from the ISM surveys export orders measures. This is despite still lacklustre world growth. Real goods imports have declined recently although the ISM surveys are pointing to a turnaround here as well.

Exports showing signs of life



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

Outlook and Monetary Policy

We expect that the economy will continue to grow at a moderate pace. The recent experience has been one of growth driven by consumption and residential investment, while investment and trade have been weak. This should broadly continue although it is likely that there will be some convergence. The economy should also continue to benefit from a mild fiscal policy tailwind.

Consumption growth is expected to remain solid (but down on our estimate of the rapid June quarter pace). Consumption will be supported by strong household balance sheets and a healthy labour market. While jobs growth is likely to slow over time, although (at least to some extent) this should be offset by stronger wages growth. At the same time, rising oil prices, and inflation in general, will exert some downwards pressure on household purchasing power.

Healthy balance sheets and labour markets, as well as as low mortgage rates, easing bank lending standards and low inventories for sale, also suggest that residential investment will remain strong, and any weakness in the June quarter should prove short lived. However, we don't see a resumption of the 11% growth seen over the year to the March quarter 2016. Existing home sales, for example, while still off pre-GFC levels (which were part of a boom, possibly not to be repeated in this cycle), are starting to get to a reasonably solid level by historical standards, from which rapid growth might be difficult.

However, we are allowing for somewhat stronger business investment as the headwinds on the capital intensive energy and manufacturing sectors from past oil price declines and strong US dollar appreciation fade. 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 end to rapid US dollar appreciation 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 over time, although by a smaller amount than during 2015.

Despite the unemployment rate being close to the Fed's estimate of the longer-run unemployment rate, and inflation moving in the right direction towards the Fed's 2% target, we expect the Fed will remain on hold until December.

It was not so long ago that the Fed was strongly signalling a June or July rate hike. However, the very weak May employment report and then the uncertainty caused by the UK referendum has put paid to that. Fed officials have indicated that they are monitoring any fall out from Brexit, and it will take several months of data before they can assess this. Moreover, they appear very risk averse both to market developments but also to fluctuations in activity indicators (which are volatile in the best of times). We are also discounting the change of a rate hike in the November meeting as it occurs just before the US Presidential election.

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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	2.6	2.2	1.9	0.7	0.6	0.4	**1.1**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.3	4.0	1.5	3.7	3.3	0.9	0.1	-0.1	**0.1**	**0.9**	**1.0**	**1.0**	**0.9**	**0.9**	**0.9**
Government spending	-0.6	0.7	0.8	1.4	1.6	0.4	0.0	0.3	**-0.2**	**0.3**	**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	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.2	-0.6	0.0	-0.2	-0.1	-0.1	0.0	0.0	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.4**	**2.4**	**1.8**	**2.1**	**1.9**	**0.5**	**0.3**	**0.3**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*2.0*	*1.4*	*1.1*	*2.4*	*2.0*	*2.1*	*2.1*	*2.1*	*2.1*	*2.0*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.1	0.5	1.7	2.2	2.1	0.3	0.1	0.1	0.5	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**	**0.6**
Core	1.4	1.4	1.8	1.9	2.2	0.3	0.3	0.5	0.4	**0.4**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	4.5	4.4	5.1	5.0	4.9	4.9	**4.8**	**4.7**	**4.6**	**4.6**	**4.5**	**4.5**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	0.25	0.50	0.75	1.50	2.25	0.25	0.50	0.50	0.50	**0.50**	**0.75**	**0.75**	**1.00**	**1.25**	**1.50**
10-year bond rate	2.17	2.27	1.75	2.25	2.25	2.04	2.27	1.77	1.47	**1.50**	**1.75**	**1.75**	**2.00**	**2.00**	**2.25**

Source: NAB Group Economics

*Contribution to real GDP

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