US ECONOMIC UPDATE AUGUST 2016

National Australia Bank

NAB Group Economics

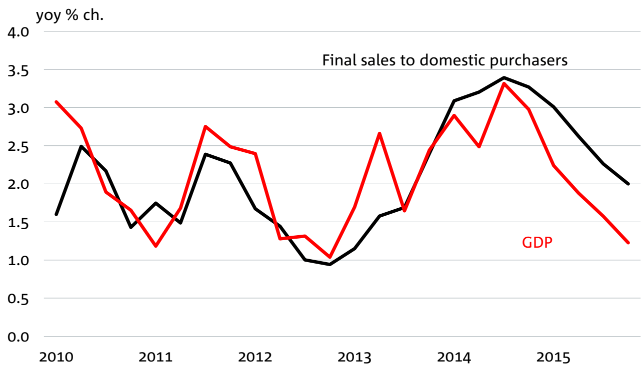
GDP growth was soft in the June quarter although the underlying pace of economic activity appears stronger. The labour market also continues to show improvement; a strong July employment report has allayed concerns of a major slowdown in jobs growth and wages growth is strengthening. We still expect the Fed to hike rates in December, but now only see two increases in 2017.

June quarter 2016 GDP

GDP growth was soft in the June quarter, growing by an annualised 1.2 % qoq. The composition of growth remained largely similar to recent trends, with consumption the main driver while business investment declined again and the drag on growth from inventories entered its fifth straight quarter. The exception was residential investment, which had been growing strongly but declined in the June quarter.

Excluding inventories and net exports to derive a measure of domestic demand ('final sales to domestic purchasers') suggests that the underlying pace of the US economy remains in line with that seen over recent years. Final sales to domestic purchasers grew by 2.0% yoy in the June quarter, compared to 1.2% yoy for GDP.

Economy appears stronger than GDP suggests



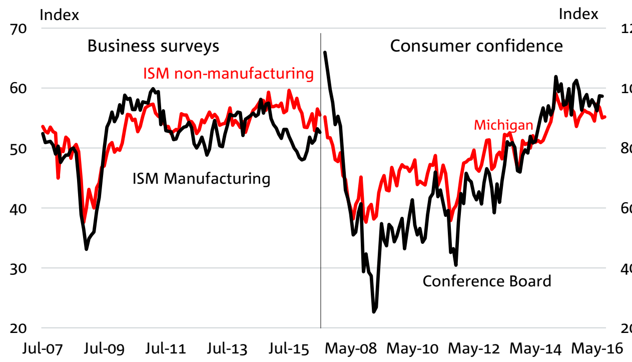
Sources: BEA, NAB

Other indicators point to a steady economy

This interpretation of a sounder economy than the headline GDP measure suggests is reinforced by various surveys which provide a guide to business conditions and household sentiment.

The ISM manufacturing and non-manufacturing surveys have both shown improvement in recent months. The latest readings on consumer confidence from the University of Michigan and The Conference Board point to household sentiment remaining solid.

Business conditions improving



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

There is relatively little activity data available for the September quarter. On the consumer side, after very rapid growth in the June quarter, some slowdown is to be expected. There are signs that this has occurred in July although the evidence is mixed at this point. Retail sales (including the 'control' category which excludes auto sales, gasoline, building materials and food services) were basically flat in July. However, auto sales jumped 6.8% in July.

Labour market continues to improve

While tending to lag activity historically, the labour market also continues to show improvement.

The July employment report further reinforced our view that the very weak May jobs report was an outlier and not indicative of a major slowdown in jobs growth.

Non-farm employment increased by 255,000 in July 2016. The average monthly job gain over the three

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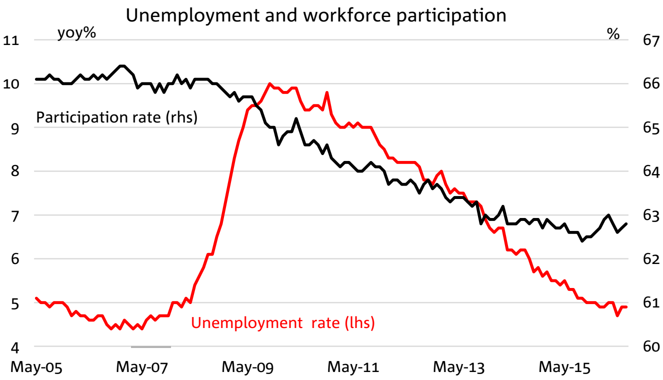
months to July was 190,000, basically unchanged from the prior three months average of 188,000.

That said, the annual growth rate has slowed to 1.7% yoy, after being 2% or higher for most of the period between mid-2014 and end 2015. However, this rate of growth remains well above the growth in the working age population which is 1.1% yoy.

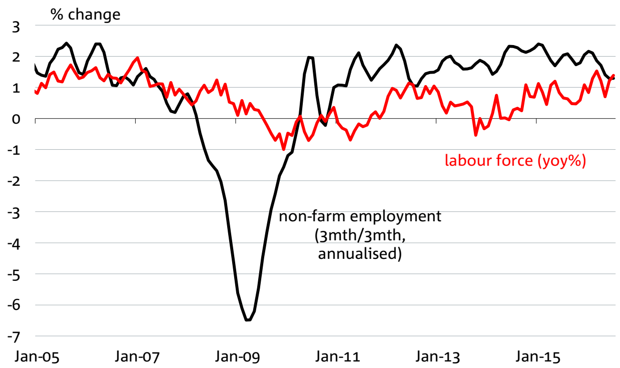
Despite this, the downward trend in the unemployment rate has slowed noticeably. The unemployment rate reached 5.0% in October 2015, a decline of 0.7ppt on October 2014. Since then it has only fallen a further 0.1ppt to 4.9%. The still strong jobs growth but largely unchanged unemployment rate reflects a couple of factors. Firstly, as noted above, employment growth, while still strong, has slowed modestly. Secondly, the downwards trend in the participation rate has not only stopped but has been partially reversed.

Pause in unemployment rate due to recovery in workforce participation…



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

…driving labour force higher as employment growth moderates



Sources: BLS, NAB

The participation rate measures the proportion of the working age population in work or looking for work. Due to demographic and other factors it is generally expected that the participation rate will trend down over time, but the falls in workforce participation post the Great Recession were larger than could be explained by these factors. This likely reflected the impact of the recession itself; for example, some people may have given up searching for work.

The low levels of participation were cited as one reason why the fall in the unemployment rate was overstating the improvement in labour market conditions. Given this perspective, the recent trends are still consistent with an improving labour market. Once the demographic factors reassert themselves, and the participation rate starts to ease down again, the current rate of jobs growth would be more than sufficient to further reduce the unemployment rate.

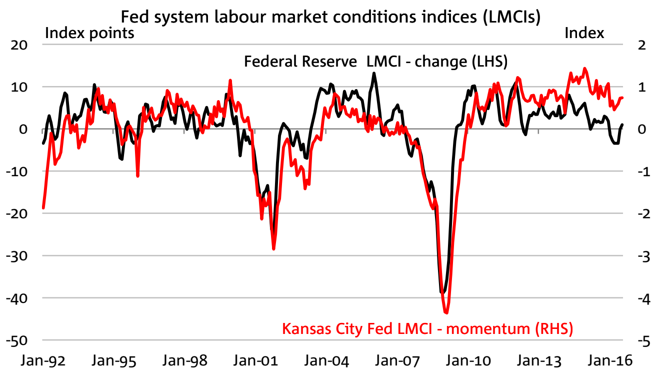
Nevertheless, while the recent stability in the unemployment rate can be seen as still consistent with a still improving labour market, it is often seen as an indicator that does a good job of smoothing out all the volatility in other indictors (jobs, participation) to provide a good guide to the labour market. This perspective suggests that the pause in the recent stabilization in the unemployment rate may be a concern

An alternative approach to using a single indicator, such as unemployment is to look at a measure that combines a range of labour market measures. A common factor model can be used to extract the overall signal coming out of the wide range of available, but often volatile, indicators.

One such indicator we have been asked about is the Federal Reserve's Labour Market Conditions Index (Fed LMCI). The Fed LMCI is constructed using 19 labour market indicators based around the "broad categories of unemployment and underemployment, employment, workweeks, wages, vacancies, hiring, layoffs, quits, and surveys of consumers' and businesses' perceptions"[1].

The Fed LMCI turned into negative territory in January this year and stayed below zero up to June. However, there are several concerns with the Fed LMCI.

LMCIs sending conflicting signals



Sources: Federal Reserve, Federal Reserve Bank of Kansas City

One issue concerns interpretation – it has been criticised on the grounds that it doesn't just show the change in conditions, but also whether the rate of

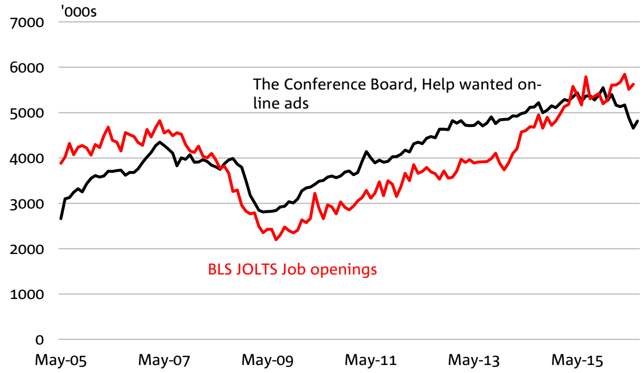
[1] Chung, Fallick, Nekarda, Ratner, Assessing the Change in Labor Market Conditions, Finance and Economics Discussion Series 17 December 2014

change is getting faster or slower. If correct, this would mean interpreting the LMCI is difficult.

Perhaps more importantly, a problem has been raised about one of the inputs to the indicator. According to the Fed, the indicators that most strongly influence the LMCI are the unemployment rate and private payroll employment. However, several other indicators, including the composite help-wanted index, are also "highly correlated with the index".

The Conference Board's help wanted on-line job ads measure (on which the composite measure used in the LMCI is based) started to level off in mid-2015 and then started falling in late 2015. However, this turnaround is not seen in the Bureau of Labor Statistics (BLS) measure of job openings, which continued to move higher. Separate research from the Federal Reserve has cast doubt on the help wanted measure. They found that rising prices at one of the larger on-line job ad boards (Craigslist) explained a large part of the divergence.

Conflicting signals on job indices



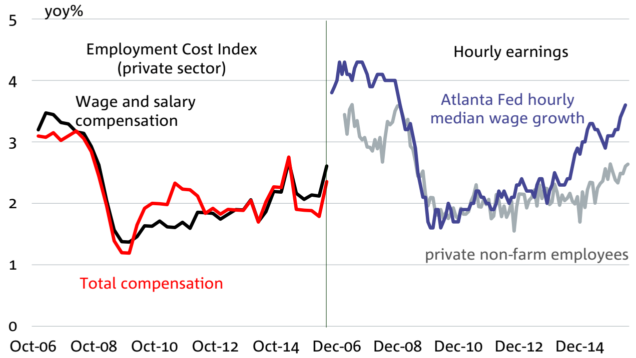
Sources: BLS, The Conference Board

Another way to test the Fed LMCI is to see if it is corroborated by other similar indicators. Fortunately, the Kansas City Federal Reserve has also constructed its own LMCI (Kansas Fed LMCI). The Kansas Fed LMCI has two indicators - the level and 'momentum'. The level indicates whether the labour market tight or has slack. The momentum indicator provides a guide as to whether the labour market is improving (positive reading) or softening (negative) or not.

The Kansas Fed indicator is estimated using 24 variables, but they do not use the on-line help data. The 'momentum' indicator is similar in concept to the Fed LMCI and indeed the two broadly track each other over time. However, since mid-2014 there has been a notable divergence, with the Kansas momentum indicator remaining well in positive in territory. It is, however, off its 2014 highs, consistent with the modest slowdown in employment growth noted previously. Not surprisingly, therefore, when asked in June about the Fed LMCI, the Fed Chair downplayed its importance by referring to it as 'experimental'.

Another way to assess labour market conditions is to look at wages growth. As the labour market tightens (that is, few available workers to fill all the available jobs) faster growth in wages can be expected. Consistent with the view that the labour market continues to improve, wage indicators are increasingly signalling an upturn in wages growth.

Wages growth improving



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

Monetary policy implications

The Fed's two main policy objectives are to maintain inflation at around 2% and to achieve the maximum level of employment consistent with stable inflation.

In terms of labour market objective, The Fed currently considers that this translates into a sustainable unemployment rate of 4.8%, very close to the current rate of 4.9%. Even allowing for the view of some Fed members that the unemployment rate currently may overstate the strength of the labour market, they are within touching distance of where they want to be.

For prices, their goal is annual inflation of 2% as measured by the Personal Consumption Expenditure price index (PCE inflation). Headline PCE inflation is still well below target, at just 0.9% yoy, although even this is above where it was last year when the Fed increased the fed funds rate. The low level is in part attributable to energy prices, and core PCE inflation, which excludes food and energy costs, is higher at 1.6% yoy. While this is also a bit below the Fed's target, as the impact of past US dollar appreciation fades and as the labour market tightens further (and wage/cost pressures rise) we expect this to pick up further.

As a result we expect the Fed will need to tighten policy further, but we don't see the next move happening until December. The Fed is in a very cautious mode right now. Reflecting this, and allowing for potential constraints arising from monetary easing by other central banks (most recently the Bank of England) we now expect only two rate hikes in 2017 (previously three). Beyond this period further rate hikes will be gradual, and while we expect a peak in this tightening cycle of 2.5%, it is unlikely to be achieved until 2019, and even that assumes no major economic shocks.

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					2016				2017			
	2014	2015	2016	2017	2018	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components													
Household consumption	2.9	3.2	2.5	2.2	1.9	0.4	1.0	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.5	4.0	0.6	3.0	3.2	-0.2	-0.8	**0.6**	**0.9**	**0.9**	**0.9**	**0.9**	**0.8**
Government spending	-0.9	1.8	1.1	1.3	1.6	0.4	-0.2	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**
Inventories*	-0.1	0.2	-0.4	0.1	0.0	-0.1	-0.3	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.1	-0.7	-0.2	-0.2	-0.1	0.0	0.1	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.4**	**2.6**	**1.5**	**2.1**	**1.9**	**0.2**	**0.3**	**0.6**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*0.8*	*1.2*	*2.5*	*2.1*	*2.2*	*2.1*	*2.1*	*2.0*
US Other Key Indicators (end of period)													
PCE deflator-headline													
Headline	1.2	0.4	1.4	2.2	2.3	0.1	0.5	**0.4**	**0.4**	**0.5**	**0.5**	**0.6**	**0.6**
Core	1.6	1.4	1.8	2.0	2.2	0.5	0.4	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.7	4.4	4.4	4.9	4.9	**4.8**	**4.7**	**4.6**	**4.5**	**4.4**	**4.4**
US Key Interest Rates (end of period)													
Fed funds rate (top of target range)	0.25	0.50	0.75	1.25	2.00	0.50	0.50	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**
10-year bond rate	2.17	2.27	1.75	2.25	2.25	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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