US ECONOMIC UPDATE NOV. 2016

Economy is solid although election result increases uncertainty

NAB Group Economics

The election result increases uncertainty around the economic outlook as we wait to see what parts of the election platform are delivered and when. However, markets recovered quickly post-election and with the economic data remaining solid we expect the Fed to lift the fed funds rate in December.

US election implications

Economic data have been overshadowed by the unexpected (going by the opinion polls) win by Mr Trump in the US Presidential election.

The Republicans also retained control of the Congress raising the prospect for less gridlock than experienced recently. However, with some Republicans critical of the new President's policies during the election campaign it should not automatically be assumed that the new President will get his way.

Apart from how the President elect will interact with the Congress, it remains to be seen how he will flesh out and prioritise the implementation of the various parts of his platform, deal with other nations and fill the senior posts in his administration (including vacancies in the Supreme Court and Federal Reserve).

Financial markets experienced large moves during the election count but then quickly reversed course; the S&P 500 share market index is now above pre-election levels. Persistent bouts of volatility could have implications for Federal Reserve monetary policy as the Fed typically pushes back any planned rate hikes in such an environment.

Uncertainty can also affect business investment decisions and consumer confidence. Of course, how significant these affects will be is unclear. There is always a degree of uncertainty following an election. Businesses wondering whether they will get a corporate tax cut or what regulations might get cut will hardly put-off investment, but investments based around supply chains in Mexico or China might.

With markets quickly settling post the election and the economic data remaining supportive for a hike (see discussion in Overview of the Economy below) we are leaving our call for a Fed rate hike in December unchanged.

Looking beyond the short-term, the chance of greater fiscal stimulus (and public debt) from promised tax cuts and public spending, offset by only limited budgetary savings, will have implications for the economy and Fed policy. How the Republican Congress – which has in the past tried to curb spending – will react is unclear, although tax cuts would have strong appeal and infrastructure spending may receive bi-partisan support.

Fiscal stimulus in an economy close to full employment, while it may give some extra support to growth, is more likely to be inflationary and suggests a risk that the Fed may have to increase rates more aggressively. This, coupled with higher public debt, could see long-term bond yields move higher and strengthen the US dollar.

In terms of their potential effect on growth, going in the opposite (negative) direction are possible measures to curb what the President-elect sees as "unfair" trade, and to reduce illegal immigration. In relation to trade, actions that have been flagged include declaring China to be a "currency manipulator", a 45% tariff on US imports of Chinese goods, and seeking to renegotiate or even pull out of NAFTA (a US-Canada-Mexican trade agreement). The risk is that such actions could trigger trade tensions.

Such trade and migration policies are also potentially inflationary with flow on implications for Federal Reserve policy.

Clearly, given this new environment, uncertainty around the forecasts has increased. However, the risks for growth are not one-sided and with a lack of clarity around what will actually be implemented and when, we have left our forecasts unchanged for now.

Overview of the Economy

The new President and administration will take office at a time when the economy is in reasonably solid condition at the macro level.

US GDP growth accelerated in the September quarter 2016 to 0.7% qoq (or 2.9% on an annualised basis), its fastest pace in two years. While the details were less

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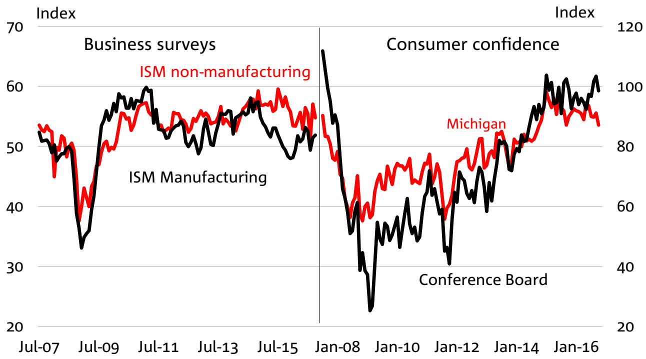
positive the result is consistent with the view that the economy remains on a solid footing.

This is also the message from other indicators. While measures of consumer confidence have diverged somewhat recently, overall they point to still solid consumer confidence.

Business conditions on the up; consumers solid



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

The ISM business surveys for October were mixed with the manufacturing survey rising, while the non-manufacturing index gave up some of its large September gain. Nevertheless, the surveys still indicate that the business conditions have improved from the subdued levels seen earlier in the year. Moreover, while the non-manufacturing ISM is still at a higher level, the narrowing of the gap to the manufacturing survey is consistent with the fading impact of the large falls in oil prices and appreciation of the dollar between mid-2014 and early-2016.

A key support to the economy in recent times has been consumption. While the boost to household budgets from gasoline price falls and US dollar appreciation are in large part behind us and despite banks no longer indicating they are lowering lending standards on consumer loans, consumption should still remain solid. Support will come from solid labour market conditions and consumer confidence, as well as strong household balance sheets.

Similarly, the drag on business investment from low oil prices and the high dollar is fading. Excluding mining investment, business investment rose in the last two quarters, and a rising rig count points to mining investment also turning around. Banks also appear to have largely stopped the tightening in commercial & industrial loan lending standards that commenced in late 2015 (although for commercial real estate loans the process is still underway). While we see some turnaround in business investment, pressure on business sector profits is likely to limit the extent of any business investment pick-up.

Net exports have also improved as the headwind from past US dollar appreciation has lessened. However, we still expect the dollar to trend higher and with the global economy still lacklustre, this will continue to put pressure on net exports.

While investment in residential housing has fallen recently, the outlook is still positive. Vacancy rates and interest rates are low, employment is growing, banks are easing lending standards on mortgages and new home sales are growing strongly.

As noted above, while the outlook for fiscal policy is clouded by the election it looks to be moving in a more stimulatory direction. Other policies, particularly around trade and migration, however, may detract from growth. So there are upside and downside risks to the forecasts.

With this caveat in mind, we currently expect that the US economy will continue to grow at a moderate pace. With productivity growth subdued, employment growth is expected to remain solid leading to further declines in unemployment over time, putting upward pressure on inflation.

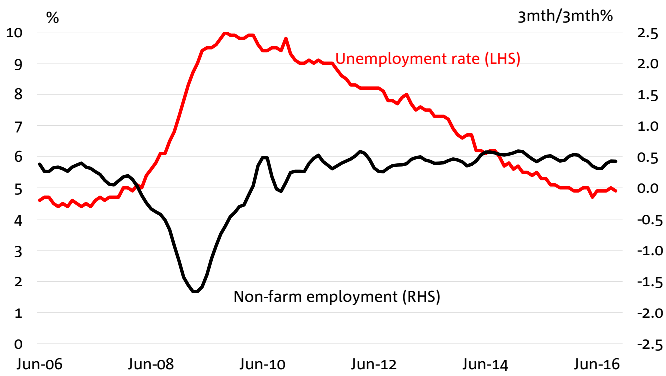
The improved GDP data will give the Fed confidence about the underlying state of the economy. That said, the Fed's targets are centred on inflation and the labour market and progress is being made on both fronts; a more detailed discussion is below.

With Fed members considering there was a reasonable case for policy tightening at their September meeting, the November decision indicating the case had strengthened and, since then, a solid October employment report, a December Fed funds rate hike is likely. It is not set in stone and could be derailed by poor economic data or a bout of financial market volatility (either due to domestic events or externally from events such as the Italian constitutional referendum in early December).

Labour market

Total non-farm employment increased by 161,000 in October and there was also a fall in the unemployment rate to 4.9%. The solid jobs growth is despite what looks to have been a negative impact from Hurricane Matthew.

Unemployment rate flat despite solid jobs growth



Sources: BLS, NAB

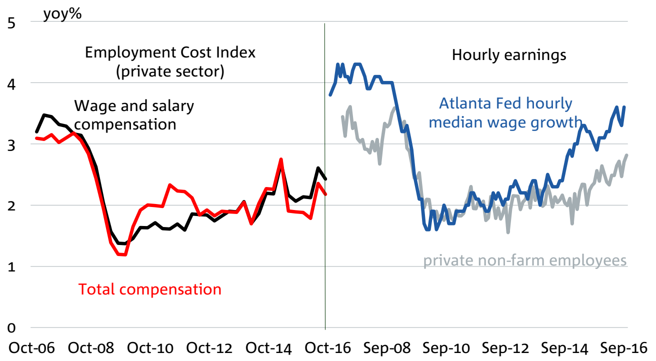
Employment growth appears to have slowed down from the 200,000 plus monthly pace achieved over much of 2014 and 2015. Moreover, the fall in the unemployment rate simply reversed the rise in

September and it has been essentially unchanged since the start 2016. However, this is in part due to an increase in the workforce participation rate, despite demographic and other trends which are exerting downward pressure on participation over time.

The Fed is well aware of this. A recent note from the Federal Reserve Bank of San Francisco estimates that, due to demographic and other factors affecting workforce participation, monthly jobs growth of only between 50,000 to 110,000 jobs is required to maintain a steady unemployment rate. Current jobs growth is still well above this and so signals continued improvement in the labour market.

The strength of the labour market is increasingly being reflected in wage growth measures. Growth in average hourly earnings for private non-farm employees reached 2.8% in yoy in October, the highest it has been since the GFC. While wages growth is still low relative to pre-GFC levels, productivity growth is also low, so unit labour cost growth – more relevant to the Fed from an inflation perspective – is at more 'normal' levels.

Wage growth strengthening



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

Inflation

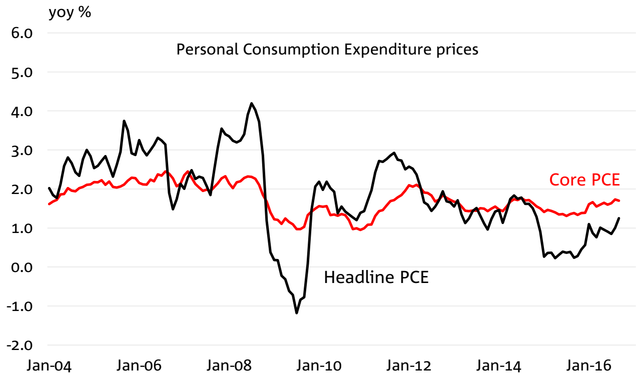
Annual personal consumption expenditure (PCE) price index growth rose to 1.2% yoy in September 2016, its highest level since late 2014. The rise in large part reflects the fading impact of low gasoline prices. 'Gasoline and other energy goods' prices declined by 6% over the year to September, compared to a 17% fall over the year to August.

Excluding volatile food and energy prices, core PCE inflation has been edging up and was 1.7% yoy in September; similar to its August rate but up from 1.4% a year ago. The rise in core inflation reflects in part a fading impact on prices from past US dollar appreciation. Other measures of core inflation (CPI ex food and energy, trimmed mean or median inflation measures) have also been trending up.

The core measure is therefore not too far away from the Fed's long-term PCE inflation target of 2% and heading in the right direction.

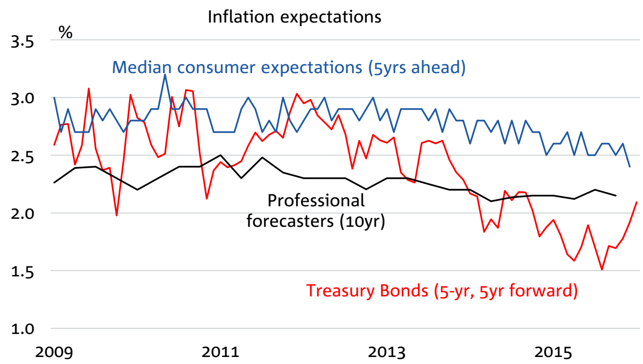
A lingering concern for the Fed has been inflation expectations, with survey based measures continuing to drift down. Market based measures have picked up recently – particularly post the election given the perceived inflationary consequences of some of Mr Trump's platform. While many Fed members have largely discounted the significance of financial market derived measures of inflation 'compensation', it will still provide some comfort to the Fed to see them moving back up.

Inflation trending higher…



Sources: Bureau or Economic Analysis, NAB

…but survey measures of inflation expectations are soft



Sources: Bloomberg (November 2016 reading is as at 11 November), Philadelphia Fed. Reserve, Thomson Reuters/Michigan University

We are forecasting that inflation will continue to rise over time, although we expect that the increase in core inflation will only be gradual. Our forecasts allow for some further US dollar appreciation; while we don't see it as being as significant as occurred between mid-2014 and early-2016 it will still provide a mild constraint on inflation. The forecast rise in inflation is underpinned by an expected gradual rise in oil price, an end to recent to food price deflation, a recovery in inflation expectations as headline inflation rises and declining slack in the economy creating some pricing pressures.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly 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	1.1	0.5	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	5.5	4.0	0.6	2.6	3.1	-0.2	-0.3	-0.2	**0.7**	**0.9**	**0.9**	**0.8**	**0.8**
Government spending	-0.9	1.8	0.8	1.0	1.5	0.4	-0.4	0.1	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**
Inventories*	-0.1	0.2	-0.4	0.1	0.0	-0.1	-0.3	0.1	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.1	-0.7	0.0	0.0	-0.1	0.0	0.0	0.2	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.4**	**2.6**	**1.5**	**2.1**	**1.9**	**0.2**	**0.4**	**0.7**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)						*0.8*	*1.4*	*2.9*	*2.0*	*2.1*	*2.2*	*2.0*	*1.9*
US Other Key Indicators (end of period)													
PCE deflator-headline	Change on year earlier %												
Headline	1.2	0.4	1.4	1.9	2.1	0.1	0.5	0.4	**0.5**	**0.5**	**0.4**	**0.5**	**0.5**
Core	1.6	1.4	1.8	1.9	2.1	0.5	0.4	0.4	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.7	5.0	4.9	4.5	4.5	4.9	4.9	4.9	**4.9**	**4.8**	**4.6**	**4.6**	**4.5**
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	1.60	**1.75**	**1.75**	**2.00**	**2.00**	**2.25**

Source: NAB Group Economics

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