US ECONOMIC UPDATE 17 MARCH 2017

National Australia Bank

NAB Group Economics

Jobs growth, business surveys and consumer sentiment all point to an economy in good shape. March quarter GDP growth is looking soft but a weak start to the year has not been unusual in recent times. The Fed obviously thinks so, raising the fed funds rate in its March meeting with more 'gradual' rate rises to come.

Overview of economy

Another solid jobs report, signs inflation – and wages – are rising as well as positive consumer sentiment and strong business survey readings all point to an economy in good shape.

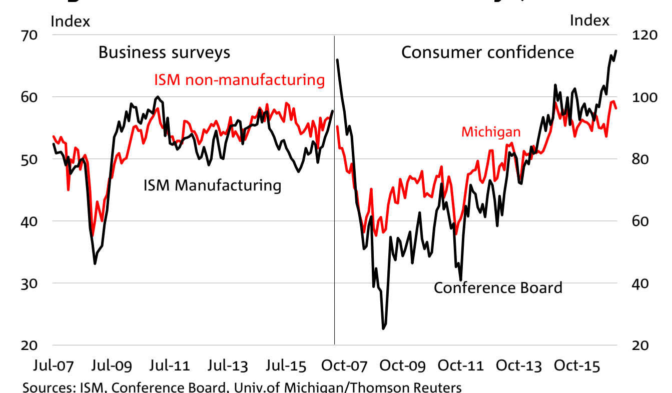
However, the actual 'hard' data that will be used to put together the estimate of March quarter GDP is looking weak, and we have revised down our expectation for growth at the start of the year. We think this slowdown will be temporary. The Fed obviously also thinks so as it increased the fed funds target rate by 25bps in its meeting this week and continues to signal further, 'gradual', rate rises.

In February, the ISM surveys moved higher – the manufacturing survey reached its highest level since August 2014 and the non-manufacturing survey its highest level since late 2015. Consumer sentiment has improved noticeably since the Presidential election, and is back around pre-GFC levels.

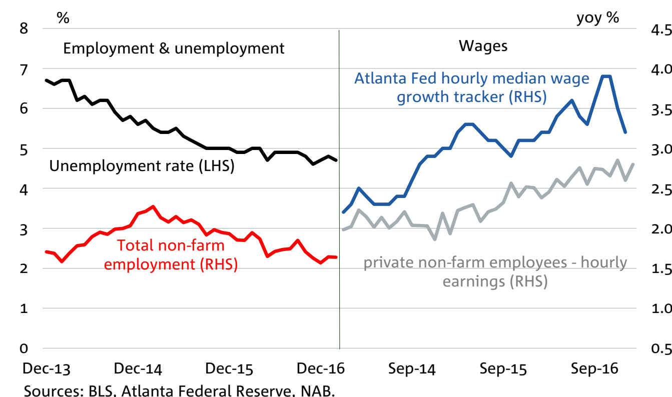
There was also another solid jobs report for February, with a net gain of over 200,000 jobs for the second month in a row. This pace of jobs growth should be more than enough to reduce the unemployment rate over time. However, the decline in the unemployment rate has slowed recently due to a pick up in workforce participation – against the long term, mainly demographic driven, trend decline. Consistent with a tightening labour market, wages growth appears to be strengthening.

At the same time, however, indicators of economic activity have softened. Consumption growth – which represents around 70% of GDP – actually went backwards in January. This was partly due to warmer than normal weather leading to reduced power consumption but even excluding this consumption fell. In February, temperatures remained above average, retail sales growth was soft (although

The good…business & consumer surveys, labour mkt

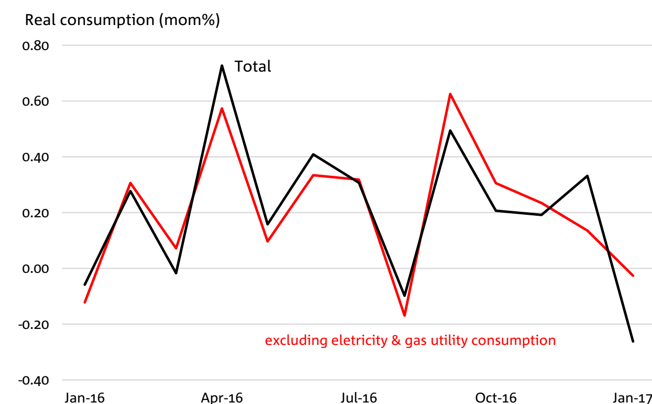


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters



Sources: BLS, Atlanta Federal Reserve, NAB.

The bad…consumption & other indicators weak



January was revised up pointing to upwards revisions to the January consumption numbers) and there was no rebound in auto sales - so there is little sign of an upturn in February.

Trade data for the start of 2017 also point to another negative contribution from net exports in the March quarter. Government demand also looks subdued.

However, weakness at the start of the year in activity measures – as reflected in GDP – has not been unusual. Average growth in the March quarter has been well below that of other quarters in recent years.

Nor are all components of GDP look weak. Business investment indicators have improved, with equipment orders picking up and manufacturing capex intentions at their highest levels since the GFC. Early indicators also suggest that residential investment will record another solid quarter of growth. On the trade front, business survey measures suggest that the underlying trend is stronger for exports, and weaker for imports, than the volatile monthly trade data are showing.

As a result of the weakness in March quarter GDP indicators, we have lowered our expectation of growth in the quarter to 1.3% (annualised). However, as we expect this is essentially temporary, with some rebound likely in subsequent quarters, we have not lowered our expectation of growth for 2017 as a whole, which we still expect to be 2.1% and likely to move higher to 2.3% in 2018.

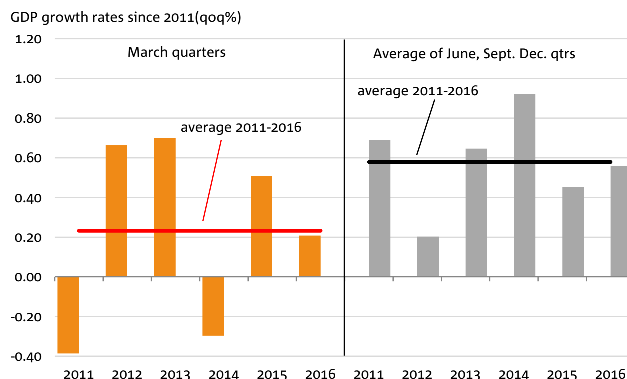
The forecast of higher growth in 2018 is driven by our expectation that there will be fiscal stimulus kicking in towards the end of 2017 and into 2018.

However, there is still considerable uncertainty about the size and timing of any fiscal stimulus. The President's budget blueprint released this week does not shed much light.

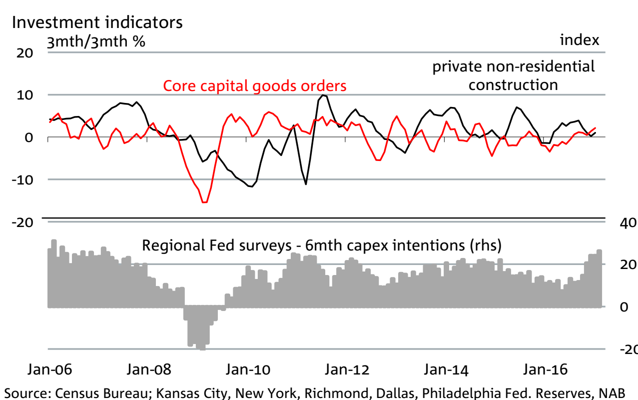
The blueprint only covers discretionary spending, which makes up around 30% of total federal government spending. The main element of the blueprint is an increase in the defence spending authority cap for fiscal 2018 by $54 billion funded by an equivalent reduction in other non-defence discretionary spending. The blueprint also proposes a net $10 billion of supplemental budget authority for the current fiscal (2017) year; this represents only 0.1% of GDP.

A full budget – including the big ticket promises around taxation and infrastructure – is currently expected in May. In any event a President's budget is only the starting point in the process given the significant role played by Congress.

But not so ugly… a weak March quarter not unusual



…and investment looking better

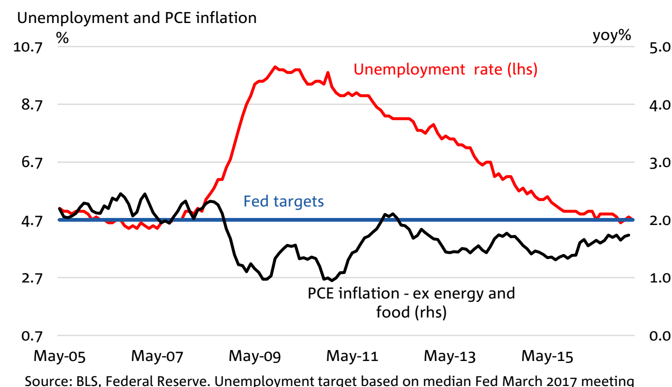


Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Monetary policy

As expected, the Fed raised its target range for the fed funds rate by 25 bps, taking it to 0.75-1.00%, at its March meeting. The Chair, Janet Yellen, said the increase reflected further progress towards the Fed's objectives and did not "represent a reassessment of the economic outlook or of the appropriate course for monetary policy." The Fed is either at its targets – the unemployment rate – or close and moving in right direction – inflation – and so will continue to unwind its loose policy settings, barring unexpected developments.

Rate increases the outcome of a Fed close to target

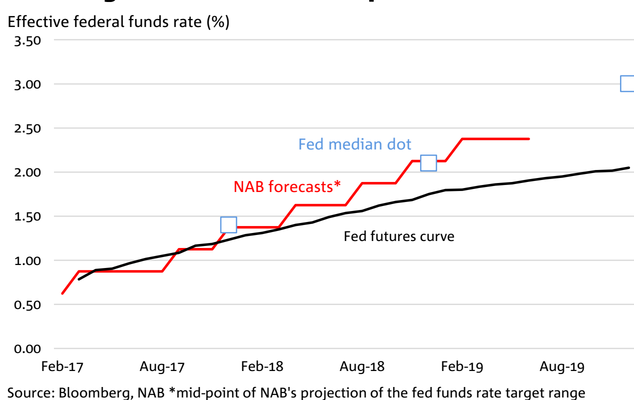


Source: BLS, Federal Reserve. Unemployment target based on median Fed March 2017 meeting

Updated Fed member economic projections, including for the Fed funds rate, were also released following the Fed's meeting.

The Fed is continuing to indicate that, if the economy develops as expected, rate rises will be gradual. In the March meeting projections there were no changes to the median estimate of the appropriate fed funds rate at end 2017 and 2018 of 1.375% and 2.125% respectively, which amounts to three rate hikes in each year.[1] This is also our expectation, although market pricing for 2018 is more muted. For 2017, we have pencilled in the likely dates as September and December, but the next hike could easily come earlier in June.

Further 'gradual' rate rises expected



Source: Bloomberg, NAB *mid-point of NAB's projection of the fed funds rate target range

However, the lack of change in the median Fed projection hides some upward shift particularly in 2018. For both end 2017 and end 2018 there are now more members with projections above the median than below it. Indeed to raise the median end-2018 projection would only take one member moving his/her dot from or below the current median (2.125%) to above it.

This suggests some upside risk to these rate expectations, particularly in the light of the prospect of future fiscal stimulus. The Fed Chair indicated that the possibility of fiscal stimulus was not a factor in the March rate increase and that they would wait until the fiscal outlook was clearer before making decisions about the appropriate monetary policy response. if and when it becomes clear that there will be a noticable fiscal boost, Fed members may build in a more aggressive tightening of monetary policy into their projections. That said, despite the Chair's comments fiscal policy propects are clearly already having some influence on the Fed - the Chair acknowledged that some members have 'pencilled in' some fiscal stimulus in their projections already, and the fiscal outlook is a factor already affecting financial markets – particularly the rise in equity markets – which the Fed closely tracks in determing monetary policy.

Debt limit & government shutdown – back on the horizon?

The Bipartisan Budget Act of 2015 suspended the debt ceiling from November 2, 2015, through March 15, 2017. So the debt ceiling came into force again on 16 March 2017 (set at the level of debt at that date), and the Treasury is now undertaking 'extraordinary measures' to allow the Government to keep running and meet its obligations. According to the most recent estimates of the Congressional Budget Office, these measures will likely be sufficient until sometime in the US fall (autumn).

With Republicans controlling the Presidency and Congress, the impediments to a debt ceiling increase or suspension should be smaller than normal. Moreover, at least some senior Democrats – such as Nancy Pelosi – have been making the right noises indicating that they would support a clear (no strings attached) increase in the ceiling.

A government shutdown is a greater risk. The current funding bill ends towards the end of April and will need to be replaced. While Republicans hold 52 of 100 Senate positions, 60 votes are required to get around any use of filibuster, and Democrats are already warning of a shutdown if certain measures (such as funding for the border wall with Mexico) are included.

There is a lot going on in the budget and legislative sphere – e.g. the budget blueprint, mooted tax cuts, infrastructure spending, and 'Obamacare' replacement. Both the debt ceiling and government funding will be caught up in that broader process.

Given the far greater potential negative consequence of not passing an increase in the debt ceiling – default on US debt – we expect the debt ceiling limit will be lifted in time. A Government shutdown cannot be ruled out, although it would likely only be temporary (the shutdown in 2013 lasted a bit over two weeks).

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[1] These represent the mid-point of the target band; so e.g., 1.375% is consistent with a target range of 1.25 to 1.50%. In our table of projections we show the upper end of the target range.

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %									
					2016		2017				2018			
	2015	2016	2017	2018	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	3.2	2.7	2.5	2.6	0.7	0.7	0.3	0.6	0.7	0.7	0.7	0.6	0.6	0.5
Private fixed investment	4.0	0.7	3.3	3.5	0.0	0.8	1.3	0.9	0.9	0.9	0.9	0.8	0.8	0.7
Government spending	1.8	0.8	0.7	1.8	0.2	0.1	0.2	0.3	0.3	0.4	0.5	0.5	0.6	0.6
Inventories*	0.2	-0.4	0.2	0.0	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.7	-0.1	-0.5	-0.3	0.2	-0.5	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
Real GDP	**2.6**	**1.6**	**2.1**	**2.3**	**0.9**	**0.5**	**0.3**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)					*3.5*	*1.9*	*1.3*	*2.2*	*2.4*	*2.4*	*2.4*	*2.4*	*2.3*	*2.2*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	0.4	1.4	2.1	2.1	0.4	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.5
Core	1.4	1.7	2.0	2.1	0.4	0.3	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	5.0	4.7	4.5	4.2	4.9	4.7	4.7	4.6	4.6	4.5	4.4	4.4	4.3	4.2
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	0.50	0.75	1.50	2.25	0.50	0.75	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.25
10-year bond rate	2.27	2.45	2.75	3.00	1.60	2.45	2.50	2.50	2.75	2.75	3.00	3.00	3.00	3.00

Source: NAB Group Economics

*Contribution to real GDP

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