US ECONOMIC UPDATE 7 APRIL 2017

National Australia Bank

NAB Group Economics

While March quarter GDP is likely to be weak, activity is expected to rebound over the rest of the year. The Fed is flagging that it will start unwinding its QE asset purchases later this year. We still expect two more fed fund rate hikes this year, most likely in June and September.

Overview of economy

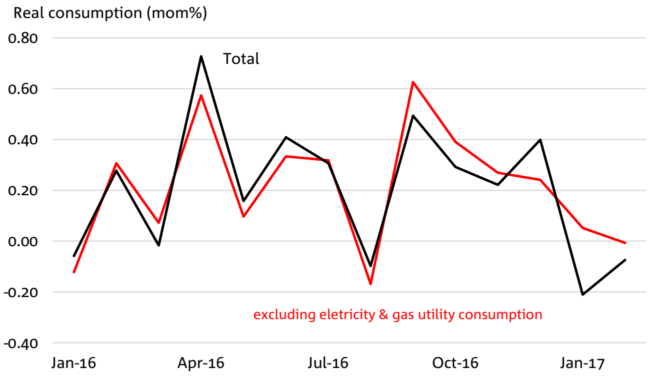
Taking the middle ground between the signals coming from direct measures of economic activity and from survey/sentiment indicators suggest that the U.S. economy is growing at a moderate pace.

Partial data continue to point to soft GDP growth in the first quarter. We are expecting growth of only around 0.2% or 0.9% on an annualised basis.

There has been a tendency in recent years for March quarters to be weaker, on average, than growth in the rest of the year. This could be a coincidence, but another theory has been that of 'residual seasonality'. Reported GDP data are seasonally adjusted by the statistician to remove regular, seasonal, swings in activity but the suggestion has been that this has been incomplete.

Research by the Cleveland Federal Reserve indicates this remains an issue, despite efforts to improve the seasonal analysis. It found that residual seasonality is mainly a problem for private investment and public demand. However, while public demand looks to have been soft in the March quarter, private investment appears to have strengthened.

Consumption weak even allowing for weather



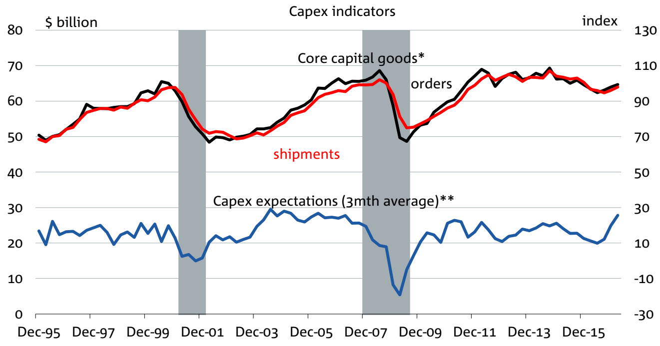
Sources: BEA, NAB

Rather, the weakness this time around is centred in household consumption. Part of this appears to be due to warmer than normal winter weather suppressing utility consumption. But even allowing for this, consumption was weak in January and February, and there was a large fall in auto sales in March. Possible explanations include tax refund delays as well as higher gasoline prices.

Government public demand is also looking soft for the March quarter. Construction investment and defence spending data for January and February are below their December quarter average, although government employment is up slightly. A slower pace of inventory accumulation also appears likely in the March quarter.

Not all activity indicators have been weak. Business investment indicators are looking more positive. This is particularly evident in equipment investment, and survey measures of future capital expenditure plans. Energy sector investment – as indicated by the rig count – has been growing strongly in line with the recovery in oil prices.

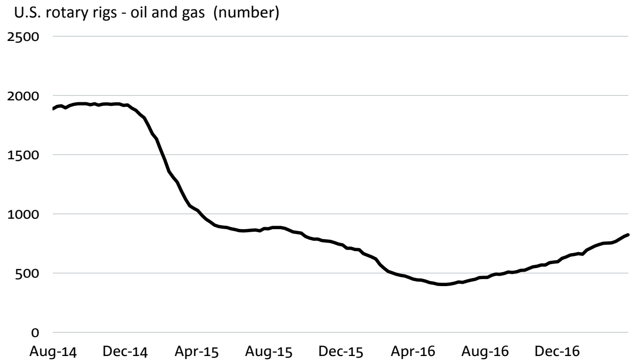
Investment indicators looking better



*Mar 17 qtr based on Jan & Feb data **Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys.

Housing investment is also holding up, despite the rise in mortgage rates since last November's elections. However, while mild weather might have dampened consumption readings, it has probably been a positive for housing construction, so the recent strength might be exaggerated.

Energy sector investment recovering

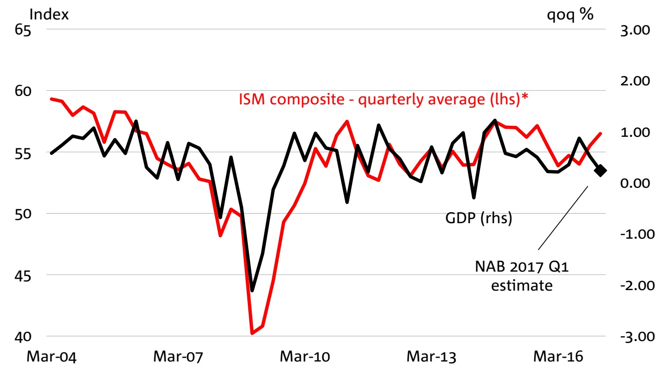


Sources: Baker Hughes Incorporated, Datastream

The ISM business survey readings (manufacturing and non-manufacturing), despite some moderation in March, are signalling that the economy is growing more strongly than the 'hard' activity measures suggest. A composite measure of the manufacturing and non-manufacturing ISM indices is consistent with GDP growth of 0.9% qoq (3.6% annualised). This is well above our estimate of what the statistician will reveal at the end of the month.

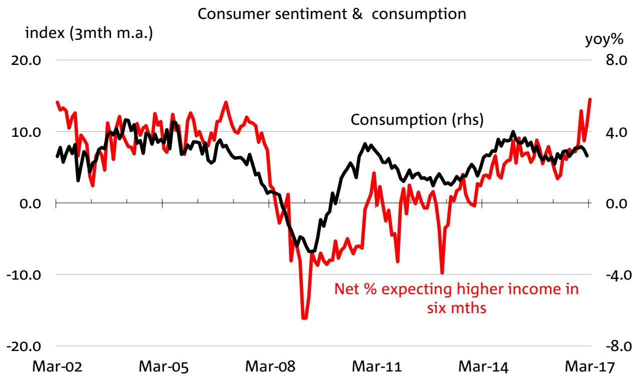
Of course, while broadly providing the same picture over time, GDP growth and ISM do diverge from quarter-to-quarter. That said, the ISM has, correctly, sent an opposite signal in other episodes of March quarter GDP weakness in recent years.

Business surveys more upbeat on the economy



Sources: BEA, ISM, NAB. *weighted average of manuf/non-manuf. ISM surveys based on GDP shares.

Consumer surveys positive for consumption outlook



Sources: BEA, The Conference Board, NAB

Similarly, the weakness in consumption is not being corroberated by consumer sentiment measures, which have moved back to pre-GFC, or higher, levels. These measures are signalling upwards momentum for consumption, if current sentiment is sustained.

Outlook

Our view is that the underlying pace of the economy is somewhere between the strength being signalled by the business and consumer sentiment surveys, and the weakness indicated by consumption and other activity measures.

Indeed some of the possible factors underpinning the expected March quarter GDP weakness represent temporary drags – mild weather pulling down on utility consumption, delays in tax refunds and an inventory slowdown.

With consumer sentiment positive, consumption over the rest of 2017 should continue to be supported by a strong labour market. Forward investment indicators are positive, consistent with business investment being supported by a recovery in profits over 2016 and improved confidence in the outlook. This will be reinforced by the upturn in the global economy which should also benefit US exporters.

Housing investment still has scope to grow after a long period of below trend investment, particularly given the support from a strong labour market and still low vacancy rates. However, as investment returns to more normal levels, and given the rise in mortgage rates since November 2016, we expect the growth rate to moderate over the course of this year and into the next.

A major uncertainty over the outlook remains the state of fiscal policy. Our forecasts assume a fiscal stimulus towards the end of this year, but the risk is that this will be delayed into the following year. Apart from timing, the amount of stimulus that might eventuate is unclear. There is also a short-term fiscal risk, as funding for government operations after 28 April has not yet been put in place. If a government shutdown were to eventuate the direct impact on the economy would be only temporary, but with the risk of a more sustained impact if it were to have a major, long lasting, impact on sentiment.

For 2017 we are expecting annual average growth of 2.1%, rising to 2.3% in 2018 on the assumption that fiscal stimulus kicks in.

Monetary policy

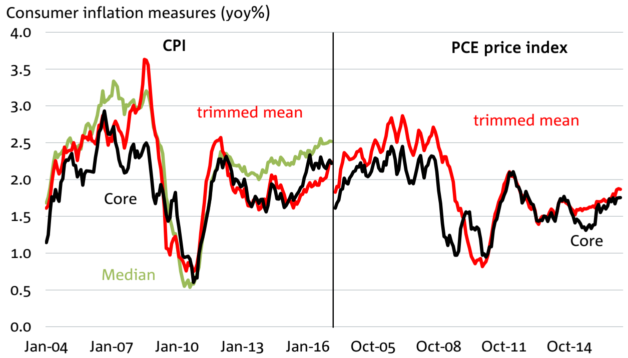
The Federal Reserve delivered another instalment of 'gradual' monetary tightening in its March meeting and flagged more is to come.

The tightening in monetary policy is a reflection of the fact that the Fed is closing in on its goals and does not see as much need to encourage above trend growth. The February unemployment rate of 4.7%

exactly matches the Fed's expectation of its long-run level consistent with stable inflation.

On the inflation front, the Fed's preferred measure of inflation is the personal consumption expenditure (PCE) price index. PCE inflation was 2.1% yoy, in February, moving above the Fed's 2% target for the first time in almost five years. Of course the Fed wants to achieve sustained inflation of 2% and considers core inflation measures as providing a better guide to the longer-term inflation rate. The standard core measure excludes volatile food and energy prices, and this has been moving up gradually, and is currently at 1.8% yoy. This is just shy of the Fed's target and other measures of underlying inflation confirm the upwards trend in inflation.

Core inflation measures moving higher



Sources: Cleveland Federal Reserve (median,core, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB

So far in tightening monetary policy the Fed has solely used increases in the federal funds rate. However, the minutes from its March policy meeting indicate that Fed members are increasingly focussing on when and how to start unwinding the stock of assets purchased through various QE programmes. The minutes indicate that most participants think QE unwinding should start 'later this year'.

However, there is no agreement as to how this will be done, nor what the end target – in terms of balance sheet size – should be. The minutes indicate that the 'how' will be announced well before any action, so we expect the process of unwinding QE to start in the December quarter 2017.

In line with the median Fed member expectation, we had been expecting two further rate rises over the rest of 2017. We had pencilled these in for September and December, while noting that the next hike could easily be earlier.

However, we think it is unlikely that the Fed will both raise rates and announce QE unwinding at the same time. So while we still only expect two further rate increases we are pulling forward our expectations of when they occur to the June and September meetings.

The major risks to a June hike are the weakness in the 'hard' activity measures – the Fed would want to see improvement before increasing rates – and the current fiscal uncertainty. However, since the March rate hike, while the stock market has declined slightly, 10 year bond yields have also fallen, as has the US dollar, and corporate credit spreads have remained stable. All this adds up to fairly benign financial conditions, leaving the door open for a June hike, assuming the economy remains on track.

CONTACT THE AUTHOR

Tony Kelly
Senior Economist – International
Antony.kelly@nab.com.au
+613 9208 5049

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %									
						2016		2017				2018			
	2015	2016	2017	2018	2019	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	3.2	2.7	2.6	2.5	2.0	0.7	0.9	**0.2**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**	**0.6**	**0.5**
Private fixed investment	4.0	0.7	3.3	3.5	2.5	0.0	0.7	**1.3**	**1.0**	**1.0**	**0.9**	**0.9**	**0.8**	**0.8**	**0.7**
Government spending	1.8	0.8	0.4	1.5	1.8	0.2	0.0	**0.1**	**0.2**	**0.2**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Inventories*	0.2	-0.4	0.1	0.0	0.0	0.1	0.3	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.1	-0.4	-0.2	-0.1	0.2	-0.5	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**	**0.0**
Real GDP	**2.6**	**1.6**	**2.1**	**2.3**	**2.0**	**0.9**	**0.5**	0.2	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Note: GDP (annualised rate)						*3.5*	*2.1*	*0.9*	*2.4*	*2.4*	*2.4*	*2.3*	*2.3*	*2.2*	*2.1*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	0.4	1.4	2.1	2.0	2.0	0.4	0.5	**0.7**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.4	1.7	2.0	2.1	2.1	0.4	0.3	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.0	4.7	4.5	4.3	4.3	4.9	4.7	**4.7**	**4.6**	**4.6**	**4.5**	**4.4**	**4.4**	**4.3**	**4.3**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	0.50	0.75	1.50	2.25	2.50	0.50	0.75	1.00	**1.25**	**1.50**	**1.50**	**1.75**	**2.00**	**2.00**	**2.25**
10-year bond rate	2.27	2.45	2.75	3.00	3.00	1.6	2.4	2.4	**2.5**	**2.8**	**2.8**	**3.0**	**3.0**	**3.0**	**3.0**

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 4)55 052 519

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

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

Behavioural & Industry Economics

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 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