US ECONOMIC UPDATE 8 JUNE 2017

National Australia Bank

NAB Group Economics

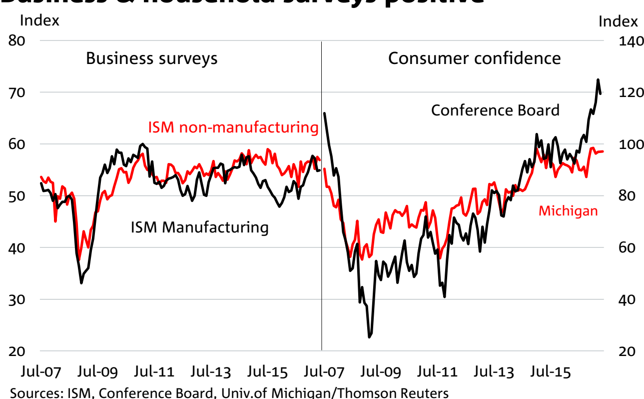
Early indications suggest that GDP growth is on track to rebound in the June quarter. The ongoing decline in the unemployment rate is consistent with an economy growing above its longer-term trend level, and we expect this to continue over the rest of this year. The Fed is expected to increase the fed funds rate at its June meeting.

Overview of economy

After a slow start to the year, early indications for June quarter GDP are pointing to an acceleration in growth. At the same time, the unemployment rate continues to decline despite some slowdown in jobs growth, consistent with an economy growing above its longer-term trend level.

March quarter GDP growth was revised up to 1.2% qoq (annualised) from the advance estimate of 0.7%. This still represents a slow rate of growth and is in stark contrast to the more positive business survey and consumer sentiment measures, which have been solid so far in 2017.

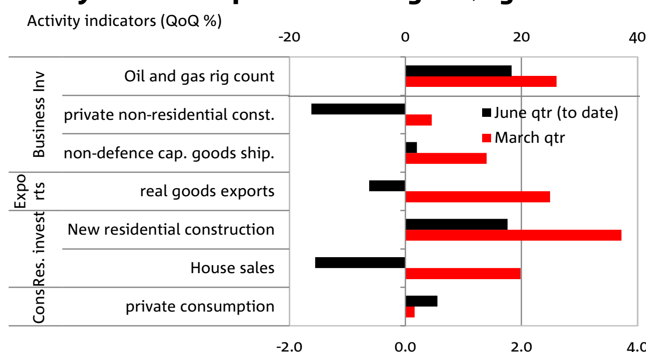
Business & household surveys positive



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

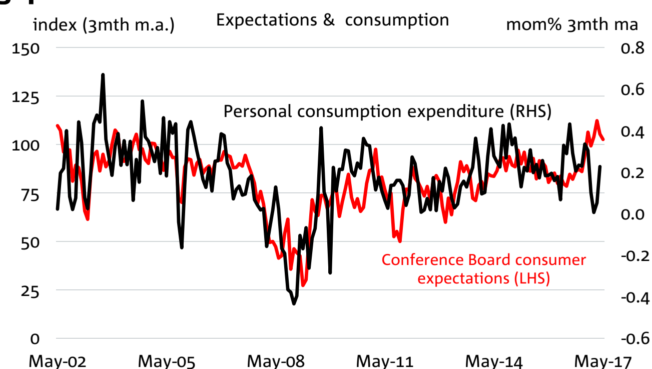
However, these surveys are not part of the GDP calculations. For the most part, data that are part of GDP calculations are only available to April, so it is still early days in terms of getting a handle on where growth for the quarter will fall. Nevertheless, there has been a clear strengthening in consumption growth. As a result, the large gap between what consumer sentiment was signalling and actual reported spending has narrowed.

Activity indicators point to stronger Q2 growth...



Sources: BEA, Census Bureau, National Association of Realtors, Baker Hughes Incorporated. June qtr set equal to April month data except for Rigs which is average for qtr to early June. Bottom scale applies for all indciators other than Rigs (top scale)

...as consumption growth rebounds, narrowing the gap to sentiment indicators



Source: BEA, NAB.

Other indicators of activity have been more mixed. Business and residential investment were reasonably strong in the March quarter, but look set to record a slower rate of growth in the June quarter. While new residential construction remains sold, lower house sales so far in the quarter are a drag. Non-residential construction spending is also down in the quarter so far, but this does not include the energy sector construction, which continues to show robust growth.

Despite weakness in some indicators for the June quarter, with consumption strengthening, and making up almost 70% of GDP, overall they are signalling stronger GDP growth.

We are currently expecting growth in the June quarter of around 2¾% qoq (annualised). However, even if this eventuates, it would likely overstate the strength of the economy just as the March quarter outcome under represented it. For the second half of the year we expect moderate, but still above long-term trend, growth.

Over the rest of 2017, support for growth will come from a variety of sources. Consumption growth should benefit from the tightening labour market and rising wealth, particularly given that the overall household balance sheet is in good shape. These factors are also positive for housing investment, although we expect some slowdown from the recent rapid growth.

Business investment indicators are positive, probably reflecting a recovery in profits, and improved confidence in the outlook. Energy investment is also likely to keep growing given our expectation for a gradual rise in oil prices over the rest of the year, although we expect the pace to slow.

One possible negative for investment is some tightening in bank lending conditions, although this has been centred on the commercial real estate sector (including multi-family residential properties).

The improvement in the global economy has also been a positive for US businesses. The ISM business surveys export orders indicators have been trending up since late 2016.

While monetary policy is being gradually tightened, it will still be relatively 'loose' for a while to come. Moreover, other indicators of financial conditions, such as credit spreads, remain favourable. Similarly, the unwinding of post-election dollar appreciation means that the currency is now close to where it was a year ago; as a result any currency drag on trade and business investment is receding.

Expectations of the timing of Federal fiscal stimulus have been slipping. While previously looking for a stimulus to start in the second half of 2017, 2018 is looking more likely. It remains the case that the timing and size of any stimulus is highly uncertain. Moreover, any impact on growth is likely to be muted by the fact that unemployment is already very low, providing a practical constraint on how fast the economy can grow.

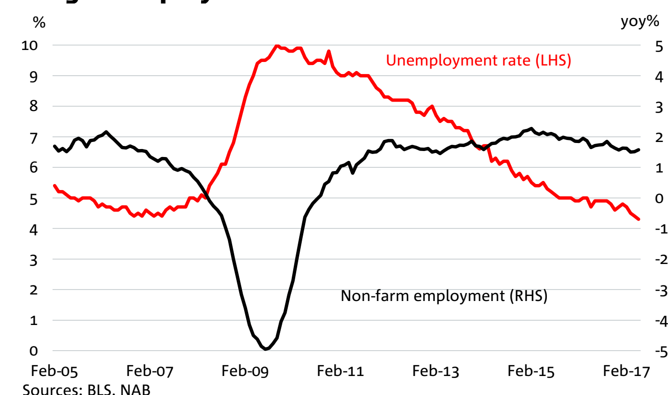
Overall we expect growth of 2.1% in 2017. If fiscal stimulus kicks in by early 2018 we see this rising modestly to 2.3%, before slowing in 2019.

Labour market, inflation and the Fed

The continued above trend growth in the economy is being reflected in the labour market. The unemployment rate fell again in May and now stands at 4.3%. This was despite a softening in jobs growth in the month. Non-farm employment increased by 138,000, below its monthly average over January and April 2017 of 168,000.

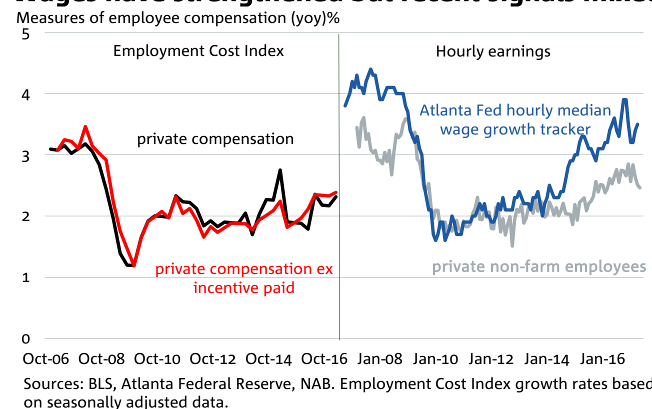
While any one month's result has to be viewed with caution, it is clear that employment growth has been slowing for a while. This was to be expected, as the fall in the unemployment rate to a low level means that unused labour is in short supply and growth is increasingly constrained by population growth and trends in workforce participation. Monthly employment growth of around 140k per month represents an annualised growth rate of 1.2%, which is above the recent 0.8% annualised growth rate in the working age population, and demographic changes suggest that, over time, the labour force will grow even more slowly.

Employment growth slowing…but still enough to bring unemployment down



Sources: BLS, NAB

Wages have strengthened but recent signals mixed



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

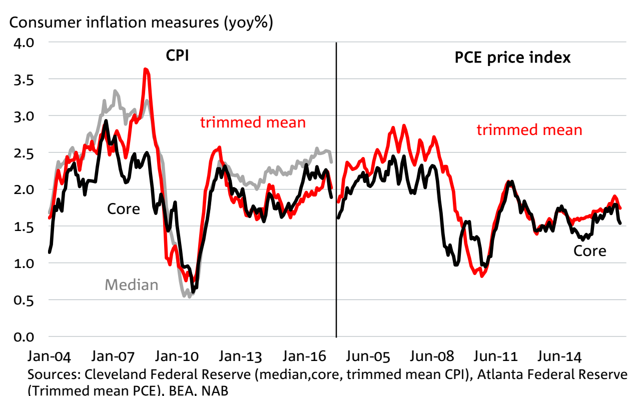
Despite this, the extent to which the tightening labour market is feeding into stronger wages growth remains unclear. Growth in non-farm average hourly earnings, after accelerating from mid-2015 to end 2016, has slowed down this year, although it remains well above its mid-2015 level. Other measures of wages point to a strengthening in wages growth over time, but it has not been a smooth process. While the

extent of upwards momentum in wages growth is uncertain, what is more clear is that wages growth remains below pre-GFC levels. This may be in part due to a slowdown in productivity growth and, possibly, the relatively subdued inflation experienced since then, as well as other factors such as changing technology.

While the unemployment rate has fallen further below what the Federal Reserve regards as its likely long-term level – a development conducive to further rate hikes - the other objective of the Fed, inflation, has recently gone in the opposite direction.

The Fed's favoured inflation measure is the personal consumption expenditure (PCE) price index, with the core measures (ex energy and food) seen as providing a better guide to underlying inflationary pressures. Core PCE inflation had clearly been trending up until the index actually fell in March. A large decline in mobile phone service prices has been cited as one factor behind the fall but other measures of core inflation – such as the trimmed mean or median – which would remove a single outlier like this have also softened, albeit by less.

Core inflation measures have softened recently



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

It looks likely that the Fed's median projection for both core inflation and the unemployment rate will be revised down in its June meeting, resulting in roughly neutral implications for monetary policy. Moreover, at this stage the Fed appears to be inclined to see the recent fall in core inflation as temporary. As a result, we expect that the Fed will again increase the federal funds rate in this month's meeting. This is also the financial market expectation, with a June hike more than 90% priced in.

Our current forecasts are also for further monetary tightening in both September and December. These are expected to be in the form of another increase in the Fed funds rate and the start of balance sheet 'normalisation'.

Balance sheet 'normalisation' refers to a reduction in the Fed's balance sheet, which increased significantly on the back of the three 'QE' (asset purchase) programs post the GFC.

We think the most likely order is the additional rate hike first, but it would not be a major surprise to see the order reversed. However, the recent softening in inflation raises the prospect of these actions being delayed, particularly if inflation readings in coming months show further weakness.

From the details provided of Fed discussions so far, it looks like 'normalisation' will include a run-down over time in the Fed's holdings of both US Treasuries and mortgage backed securities. The Fed will not actively sell any securities, but rather rely on principal repayments to gradually reduce its holdings over time – a so called 'passive' approach. However, the amount that the balance sheet can fall in any one month will be capped - to the extent that principal repayments exceed the cap then the Fed will undertake asset purchases ('reinvestments'). The Fed is considering an approach in which the size of the cap will increase over time, possibly by pre-announced amounts at quarterly intervals.

At this stage, however, no definitive decisions have been taken about how the balance sheet will be reduced, and there have been no indications of the size of the caps or what the end point (in terms of balance sheet size) is.

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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	2.4	2.4	2.0	0.7	0.9	0.2	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**
Private fixed investment	4.0	0.7	4.7	3.4	2.5	0.0	0.7	2.9	**0.9**	**0.9**	**0.8**	**0.9**	**0.8**	**0.8**	**0.7**
Government spending	1.8	0.8	0.0	1.3	1.6	0.2	0.0	-0.3	**0.2**	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**
Inventories*	0.2	-0.4	0.0	0.1	0.0	0.1	0.3	-0.3	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.1	-0.3	-0.1	-0.1	0.2	-0.5	0.0	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.6**	**1.6**	**2.1**	**2.3**	**2.0**	**0.9**	**0.5**	**0.3**	**0.7**	**0.6**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)						*3.5*	*2.1*	*1.2*	*2.7*	*2.3*	*2.2*	*2.4*	*2.4*	*2.3*	*2.1*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	0.4	1.4	1.7	2.1	2.0	0.4	0.5	0.6	**0.1**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
Core	1.4	1.7	1.7	2.1	2.1	0.4	0.3	0.5	**0.2**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.0	4.7	4.2	4.0	4.1	4.9	4.7	4.7	**4.3**	**4.3**	**4.2**	**4.1**	**4.1**	**4.1**	**4.0**
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

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