US ECONOMIC UPDATE - SEPTEMBER 2017

NAB Group Economics

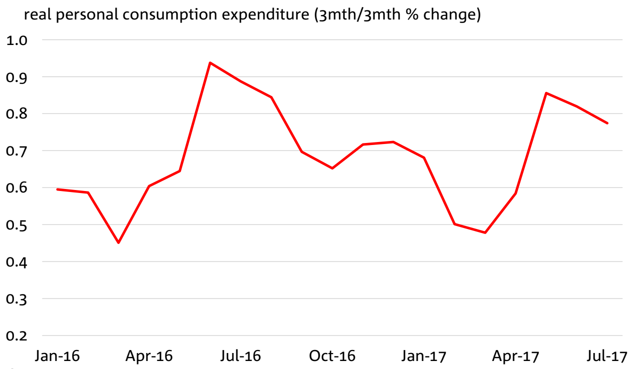
Initial data for the September quarter point to solid growth. Surveys of business conditions and consumer confidence support this outlook. Hurricane Harvey, despite the devastation it has caused, is unlikely to have a major effect on GDP but will affect some partial indicators; however, another major hurricane (Irma) appears set to make landfall in the US. The Fed is set to start balance sheet 'normalisation' in September, but inflation needs to strengthen soon for another rate hike to occur this year.

Data point to a solid start to H2 2017

GDP growth for the June quarter was revised up by the Bureau of Economic Analysis from 2.6% qoq (annualised rate) to 3.0%. The strong June quarter result followed a weak start to the year. The difference between the two quarters could reflect statistical noise as much as real changes in activity. For the first half of 2017 the average quarterly growth rate was 2.1% (annualised). This is in line with the post 2007-09 recession average growth rate, so essentially there was no major change in the economy's trajectory.

In terms of actual data, it is still early in the September quarter, but activity data are starting to come in. While somewhat mixed, overall they point to a continuation of solid US growth into the September quarter.

Consumption maintaining recent momentum



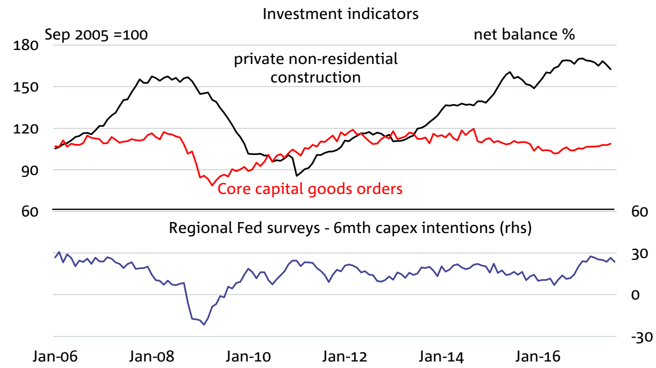
Source: BEA, NAB

This is certainly the case for private consumption, the major component of GDP. Consumption grew by 0.25% mom in July, in line with growth in the prior two months, continuing the bounce back from a soft patch earlier in the year. With the savings rate trending down in recent times we would expect to see consumption ease, but this is not evident yet.

Increasing household wealth (due to rising equity and house prices), as well as a high level of consumer confidence, remain tailwinds for consumer spending.

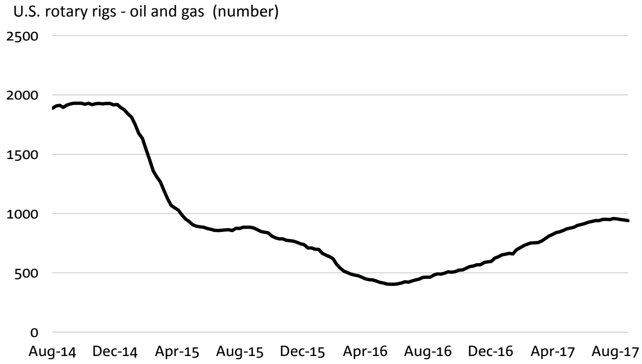
While investment indicators are mixed, overall business investment is on track to grow again in the September quarter. Core (ex defence and transport) capital goods shipments in July were 1.7% higher than their June quarter average, consistent with the upwards trend in orders over the course of 2017. Manufacturing sector forward looking investment intentions also remain reasonably high.

Investment indicators mixed



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

Mining investment recovery looks to have peaked

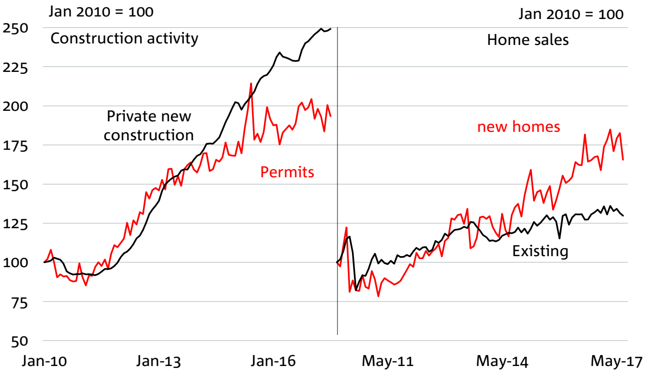


Sources: Baker Hughes Incorporated, Datastream

In contrast, monthly non-residential construction expenditure data fell again in July and are already over 2% below their June quarter average. These data do not include mining related construction, which has been supporting overall non-residential structures investment. However, support from the mining sector is starting to fade, although it should remain a positive in the September quarter. The oil and gas rig count eased over August, although the average so far in the quarter is still comfortably above the June quarter average.

Residential investment also looks weak early in the September quarter. Residential investment is being dragged down by weakness in home sales – commissions on sales and other sales expenses are recorded as investment spending. One factor behind the slower sales pace is a low level of supply of houses for sale (new and old) by historical standards; as a result house prices are growing by around an annualised 6%, well above the inflation rate. While construction expenditure on new dwellings is still rising it is at a slower rate than before.

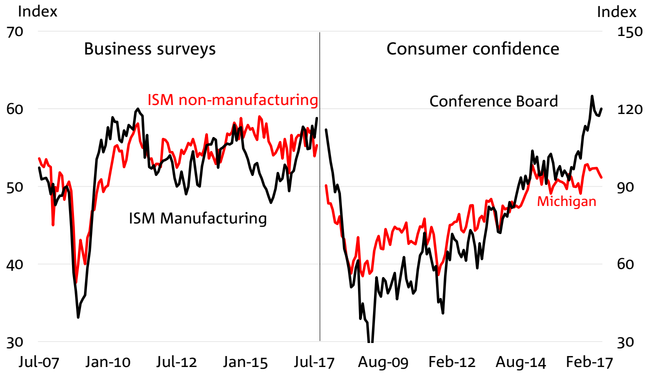
Weak sales weighing on residential investment



Sources: Census Bureau, National Association of Realtors, NAB

On the trade front, real goods exports fell in July while imports were unchanged, but relative to their June quarter average, export growth is stronger than import growth. The lack of a clear direction for net trade is not surprising – solid domestic activity – including the upturn in import intensive equipment investment – is supporting imports, while at the same time the improvement in the global economy and downturn in the dollar is a positive for exports.

Business and consumer confidence solid



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

Business surveys and consumer confidence measures are also painting a positive picture of the economy. In August, the manufacturing ISM headline measure reached its highest level in over six years. The non-manufacturing index also rose; while only partly reversing last month's large fall it is at a decent level.

At this stage we remain comfortable with our view that September quarter growth will be a little above 2% (annualised). We have revised up our estimate for 2017 as whole slightly to 2.1% for 2017 as a whole (from 2.0%) due to the revisions to the June quarter. We are currently projecting growth to pick up a little in 2018, based on our assumption that the Congress will pass a package of tax cuts which, at least in the short-term, are partly deficit financed.

However, this is still quite uncertain, as is what might happen on a range of other policy fronts such as trade and infrastructure. For our take on these issues see our note The Trump Economic Agenda: What Next?

More immediately the Federal government debt limit needs to be raised soon and funding for the Government will expire at the end of this month without Congressional action. An agreement has been reached between the President and the Democrats to suspend the debt limit, and extend Government funding, for three months. While alleviating immediate concerns it is a short-term fix.

Hurricane Harvey

Hurricane Harvey made landfall in Texas on 25 August and has caused loss of life and major damage to property including, according to news reports, around 200,000 homes damaged, and many people displaced. While most of the damage was in Texas, Louisiana has also been affected.

While the impact – both personal and economic – is greatest for people in the affected areas, it will also affect the rest of the country through supply chain disruptions (e.g. cars imported through ports in Texas) and energy disruption. At its peak around 20% of US oil refining capacity was shut-down, leading to an increase in gasoline prices across the US.

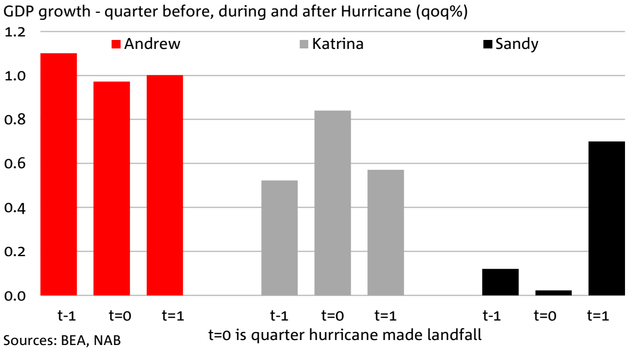
In terms of the majority of economic indicators that we track, the property damage has little direct effect. For example GDP focuses on new production or construction as well as service delivery. Costs involved in the transfer of existing assets (brokerage fees etc) are counted but the destruction of a physical asset does not affect GDP. Of course the loss of wealth caused by Hurricane is real and in turn can affect consumer and business behaviour.

Moreover, lost output (e.g. power production) or delays in activity (e.g. purchases put-off) have the potential to weaken measures of activity. Of course, as conditions return to normal there would be a bounce back in activity.

In terms of the size of its economy, Texas was the second largest state in the US in 2016. However not all of Texas was affected; reports indicate that the area around Houston was the worst affected. The Houston metropolitan area, while the fourth largest in the US, only made up around 3% of the US economy in 2015.

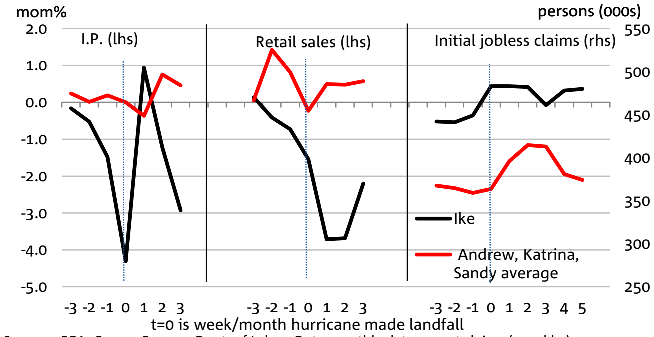
While it is possible that there will be some impact on national GDP growth (possibly negative in Q3, positive in Q4), we do not expect it to be large. Other major hurricanes have not had a significant discernible impact, particularly when account is taken of the normal quarter-to-quarter volatility.

GDP impact of hurricanes tends to be small

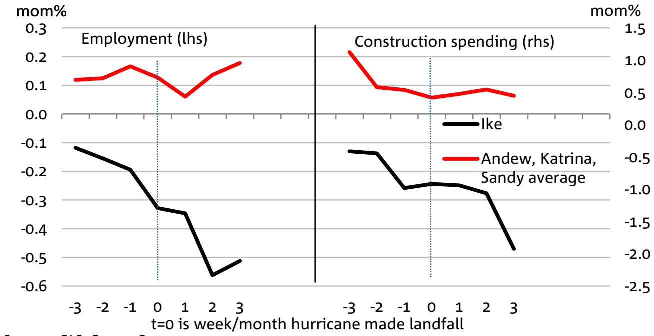


Sources: BEA, NAB

Some economic indicators are likely to be affected



Sources: BEA, Census Bureau, Dept. of Labor. Data monthly data except claims (weekly.)



Sources: BLS, Census Bureau

However, some of the higher frequency data are likely to be affected. The above chart shows several indicators and how they tracked before and after Hurricanes Andrew, Katrina and Sandy. Hurricane Ike is also shown separately as, like Harvey, it was centred on Texas and also because it occurred as the GFC was unfolding, making assessment of how activity was affected (particularly after the event) more problematic.

Sales are likely to be affected temporarily as will the weekly jobless claims data. Related to jobless claims, monthly employment growth has typically slowed the following monthly but by no more than the normal monthly variation seen for this report.

Industrial Production (IP) has not normally been affected but in the case of Hurricane Ike there was a noticeable dip and strong bounce back the next month. This probably reflects Texas large industrial base (including its energy sector) and so the IP data may also be affected this time around. Measured construction spending (not shown in chart) does not seem to be affected by Hurricanes.

The White House has requested additional funding for disaster relief of $7.85 billion (0.04% of GDP). . This is likely to be just the first request, with additional requests expected; the Texas Governor has flagged that an amount well over $100 billion may be required.

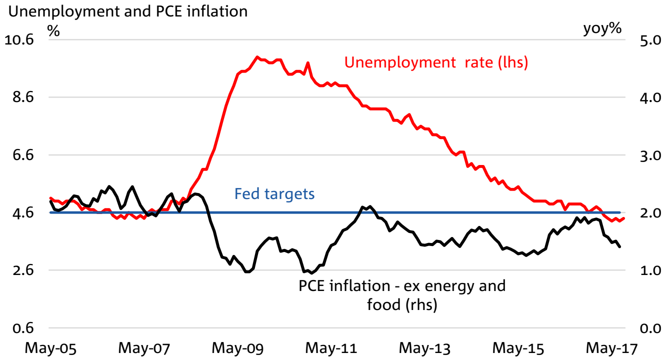
At the time of writing, there is a risk that another major Hurricane – Irma – will make landfall, this time centred on Florida.

Labour market, inflation & monetary policy

Despite a slightly weaker August Employment Report, the labour market remains in good shape. The increase in non-farm jobs was 156,000, only slightly below the average increase of around 180,000 in the prior three months. The unemployment rate ticked up to 4.4%. While the unemployment rate has been in the 4.3 to 4.4% range since May, this followed a large fall earlier in the year, and the recent pace of jobs growth is more than enough to reduce the unemployment rate over time.

What the Employment Report did not show was any upturn in wages growth, with non-farm employee average hourly earnings up 2.5% on a year earlier, unchanged from the previous four months.

Below target inflation and unemployment



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

The Fed's preferred inflation measure was also on the soft side in July, as had been expected given the July CPI result. Both the headline and core (ex energy and food) measures increased by 0.1% mom. As a result annual core inflation fell to 1.4% yoy - well down on where it had been at the start of the year when it was seemingly within touching distance of the Fed's 2% inflation target. The fall can only be partly explained by special factors such as changes in mobile phone data pricing.

Below target and decelerating inflation would not normally mean further rate increases. However, an unemployment rate below target is consistent with rate hikes. Some Fed members of the Fed – including its Chair – consider that the low unemployment rate will translate into higher inflation down the track, and that to delay rate hikes would mean risking falling behind the curve. Another case being made for further rate hikes is that broader financial conditions (e.g. the dollar, credit spreads, stock market prices) have been easing even as the Fed has raised rates, so rate hikes are needed just to keep financial conditions from easing.

However, there is a limit to how far these arguments can go. If inflation remains subdued the Fed will perceive little risk of falling behind the curve. Some Fed members are sounding increasingly cautious about further rate hikes. As a result while we still are projecting a further rate hike in December, it would not surprise if the Fed took it off the table; at the very least, inflation will need to show some strengthening in September for this to occur. The potential for tax reform and government funding to all be on the table around December only adds to the uncertainty.

Meanwhile, the Fed appears almost certain to start the process of balance sheet 'normalisation' at its September meeting. This refers to a reduction in the size of the Fed's balance sheet – built up through its QE programs - gradually over time by not fully reinvesting principal repayments of its current asset holdings.

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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	3.6	2.7	2.7	2.4	2.0	0.7	0.7	0.5	0.8	**0.6**	**0.5**	**0.5**	**0.6**	**0.6**	**0.5**
Private fixed investment	3.9	0.7	3.9	3.4	2.6	0.4	0.4	2.0	0.9	**0.8**	**0.9**	**0.8**	**0.8**	**0.8**	**0.7**
Government spending	1.4	0.8	-0.1	1.0	1.5	0.1	0.0	-0.2	-0.1	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Inventories*	0.2	-0.4	-0.2	0.1	0.0	0.0	0.3	-0.4	0.0	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.7	-0.2	-0.2	-0.1	-0.1	0.1	-0.4	0.1	0.1	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**1.5**	**2.1**	**2.3**	**2.0**	**0.7**	**0.4**	**0.3**	**0.8**	**0.6**	**0.6**	**0.5**	**0.6**	**0.6**	**0.5**
Note: GDP (annualised rate)						*2.8*	*1.8*	*1.2*	*3.0*	*2.2*	*2.2*	*2.2*	*2.4*	*2.4*	*2.1*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	0.4	1.6	1.4	1.9	2.0	0.4	0.5	0.6	0.1	**0.3**	**0.5**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.3	1.9	1.5	1.9	2.0	0.5	0.3	0.5	0.2	**0.3**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	5.0	4.7	4.2	4.0	4.0	4.9	4.7	4.7	4.4	**4.3**	**4.2**	**4.1**	**4.1**	**4.0**	**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	**1.25**	**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	2.3	**2.4**	**2.8**	**3.0**	**3.0**	**3.0**	**3.0**

Source: NAB Group Economics

*Contribution to real GDP growth

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