US ECONOMIC UPDATE - OCTOBER 2017

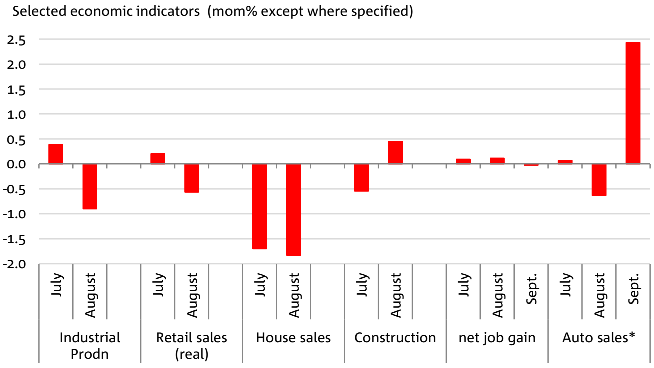
NAB Group Economics

Some US activity indicators have been clearly affected by recent hurricanes – the impact is likely to be transitory and the economy remains on track. The Administration and congressional Republicans took a step forward on tax cuts, consistent with a small fiscal stimulus, although it is not certain that it will be passed by Congress. Inflation is expected to trend back up towards the Fed's 2% over target, leading to further fed funds rate increases, but risks are to the downside.

Hurricane affects evident

Not unexpectedly, the effects of the recent major Hurricanes affecting the US are clearly evident in some of the economic data.

Some hurricane impacts on activity data



Sources: Census Bureau, BLS, Federal Reserve. * change on previous month , millions

Industrial production fell in August, its largest monthly decline since 2009, as did retail sales. There was a decline in house sales but it was similar to that seen in July. In contrast – as has been the case with past Hurricanes – there was no obvious impact on the construction data, and core capital goods shipments and orders also appeared unaffected.

In a sign that reported activity might bounce back strongly, auto sales more than made up their August loss in September. This was despite Hurricane Irma that hit Florida that month.

The labour market report was little affected in August as the survey week fell before the first major hurricane. However, September's report was eye catching with a decline in non-farm employment of 33,000; the first monthly fall since late 2010. However, the household survey employment measure (which is more volatile) went in the opposite direction – rising by over 900,000 and the unemployment rate fell 0.2ppts to 4.2%.

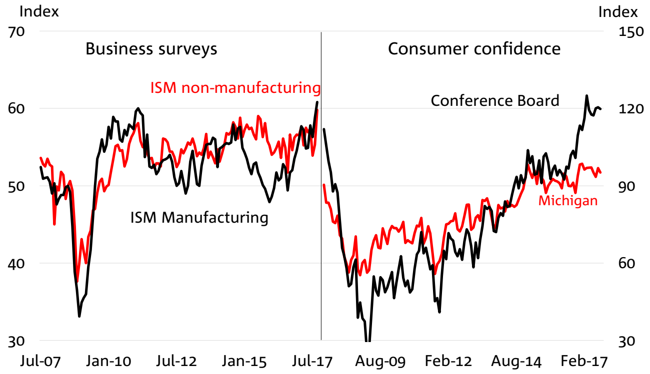
According to the Bureau of Labor Statistics (BLS) analysis, the non-farm employment numbers were affected by the hurricanes, but there was no discernible effect on the unemployment rate.

Hourly wages growth also accelerated in September. Most of the job losses were in the low paying leisure & hospitality sector. However, after adjusting for this, wages still grew above 0.40% mom for the second time in three months, a strong growth rate.

Initial jobless claims are another measure of the labour market. They spiked post Hurricane Harvey and, while they have come off their post Hurricane Harvey peak, they remain above recent lows, with a fall in Texas claims being partially offset by a rise in Florida (Hurricane Irma). With the rise in claims centred in states affected by hurricanes and continuing claims being little changed (suggesting job impacts are not long lasting) these data also suggest a noticeable, but temporary, impact from the hurricanes.

Overall, we continue to expect the hurricanes will have only a temporary impact on US data indicators. At this stage we have not made any major changes to our September quarter GDP forecast.

Surveys point to a solid underlying economy



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

Business and consumer surveys also suggest that the economy remains on track. Consumer confidence remains solid and the ISM manufacturing surveys moved to high levels in September. There were hurricane affects evident in the ISM surveys, as the 'supplier deliveries' component rose strongly - likely due to supply chain disruption rather than strong demand. However, intuitively, other components could have been negatively affected (e.g. production) and even abstracting from the supplier deliveries component, the surveys point to a solid economy.

Fiscal update – movement on tax

On 27 September, the "Big 6" – senior Republican Congressional leaders and administration officials – released a framework for tax reform.

Details included: reducing the number of income tax brackets from seven to three (but with an option of an additional top rate for high income earners), an increase in the child tax credit, almost doubling of the standard income tax deduction, lowering business tax rates (a maximum 25% tax rate for small/family businesses and a corporate tax rate of 20%), and an immediate expensing of capital investment for the next five years. It also proposed changes to the taxation of US companies overseas earnings, including moving to a territorial system. To help 'pay' for this, the plan proposes removing 'most' itemized deductions and limiting interest expense deductibility.

The Committee For a Responsible Federal Budget estimates that the plan would have a direct budgetary cost of $2.2 trillion over ten years.

The announcement is just the start of the process as almost all Republicans will have to come on board to get tax cuts passed through Congress using the budget reconciliation process. The proposed Senate budget resolution reconciliation instructions include allowance for a $1.5 trillion net tax cut over ten years (around 0.6% of GDP), which might provide a better idea of the likely magnitude of any package that is agreed to.

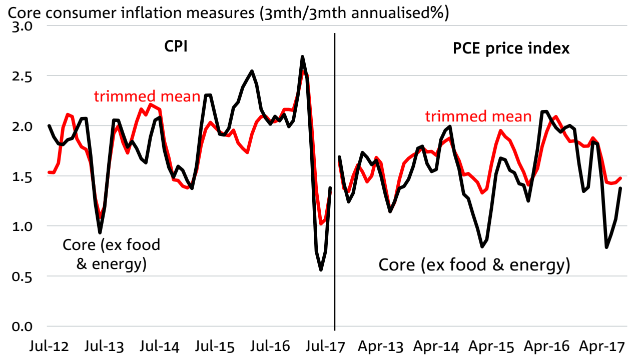
As the difficulties in replacing 'Obamacare' illustrate, it is by no means certain that Congressional Republicans will reach agreement. Nevertheless, the announcement represents a step forward and we continue to allow for a modest fiscal stimulus in 2018 in our forecasts.

Inflation revisited

In late June we took a close look at inflation in the US. Our conclusion then was that the weakness in inflation was likely to dissipate and it would slowly head back towards the Fed's 2% target.

Since then there has been some improvement in core inflation measures. Core (ex food and energy) CPI in August posted its highest monthly gain since the start of the year although the core personal consumption expenditure (PCE) price index – the Fed's favoured measure - for that month was more muted.

Inflation slowdown arrested but not yet reversed

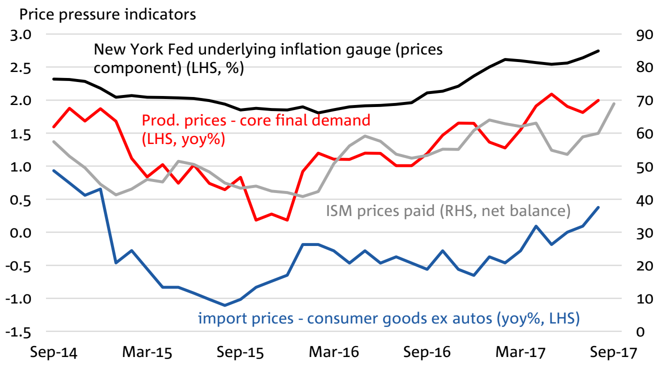


Sources: Cleveland Federal Reserve (trimmed mean CPI), Dallas Federal Reserve (Trimmed mean PCE), BEA, NAB.

The Fed's September meeting projections included one more fed funds rate increase this year and three more next year. We still expect the evolution of actual inflation and wages will be crucial to what the Fed actually does. With this in mind we have taken another look at the inflation outlook.

There is no shortage of analysis looking at the detailed CPI components and concluding the inflation slowdown is due to a few items and that it will be transitory. The risk is that such analysis leads to cherry picking – finding reasons why the prices for some items may be temporarily low, but ignoring temporary factors lifting other components. While the standard core inflation measure excludes food and energy, an alternative measure is the trimmed mean which excludes not just the slowest growing components but also the fastest. As can be seen in the above chart, while the trimmed mean core measure did not decline by as much as the standard core measure, there was still a noticeable slowdown.

Other price indicators have not weakened



Sources: BLS, Census Bureau, ISM (average of manuf./non-manuf. surveys), NY Fed

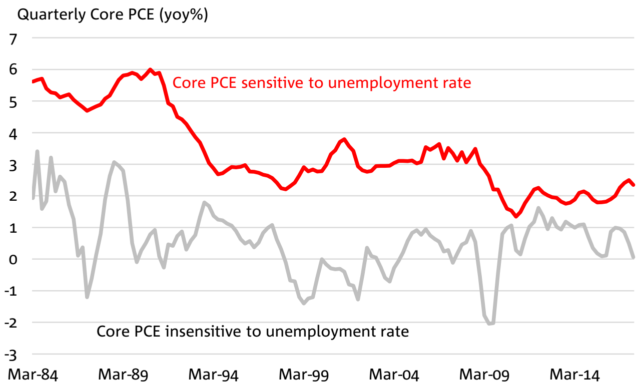
Perhaps more importantly, other measures of prices have not shown the slowdown seen in the consumer inflation measures. This can be seen in producer prices, imported consumer goods prices and the ISM surveys prices paid indicators. As noted earlier, when discussing the Employment Report, the hourly wages data has shown some acceleration recently.

The New York Fed's underlying inflation gauge, also included in the chart above, is based on a detailed breakdown of the CPI and uses statistical analysis to isolate a 'common factor' that will show up in future inflation. In this sense it is another 'core' measure but unlike the other core measures it does not exclude any consumer prices. The NY Fed also has a gauge which includes other, non-price, information which help predict inflation and it is running even stronger.

The weakness in inflation in the face of a declining unemployment rate has led to questioning of the whether the Phillips Curve relationship is still alive. The Phillips Curve describes the relationship between wages or inflation and the unemployment rate, with a lower unemployment rate expected to be associated with higher wages/inflation.

However, we think that the Phillip's curve is still alive. Using econometric analysis, it is possible to find a relationship between unemployment and core inflation. However, it is not strong – a one ppt reduction in the unemployment rate would normally lead to a rise in annual core inflation of 0.1 ppt – and so can easily be swamped by other factors.

Inflation slowdown caused by prices insensitive to economic slack

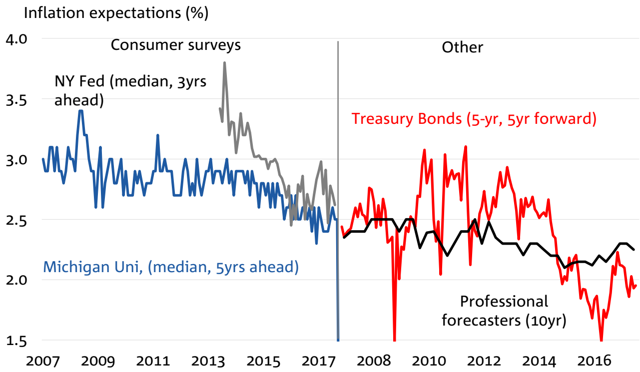


Instead of looking at aggregate inflation, another way to look at this is to see which components of the CPI are sensitive to the level of the unemployment rate and which are not. This is illustrated in the chart above, and shows there has been little downturn in the unemployment sensitive CPI components. Rather, weakness in the non-unemployment sensitive components have caused the inflation slowdown; these components also tend to be more volatile.

In addition to measures of slack in the economy – such as the unemployment rate – inflation is also seen as being determined by inflation expectations. This is certainly the Fed's view and their various communications stress the importance of expectations. Not everyone agrees, arguing that in recent decades it is difficult to detect a relationship between expectations measures and future inflation. Instead, inflation is seen as settling at a particular level (for whatever reason), and that this level can be approximated using past inflation.

In either case, this poses a risk to the Fed achieving its inflation target. Most inflation expectations measures have fallen at least somewhat since the GFC. Similarly, the Fed has been undershooting on its inflation target for over 5 years. These developments raise the risk that inflation is now anchored at a lower level and raises the question as to what could pull inflation back up.

Is inflation anchored at a new, lower, level?



Sources: Bloomberg, Philadelphia & New York Fed. reserves, Thomson Reuters/Michigan Uni.

In this context, it is worth taking a look at past periods to get a sense of what factors have been associated with rising inflation.

The two most recent periods in which the unemployment rate was around current levels were in the late 1990s and the mid-2000s. Only in the second period did core inflation rise reasonably smoothly as unemployment fell. However, this was also a period in which there was modest US dollar depreciation and there were large rises in oil (and other) commodity prices.

In contrast, for a period in the mid-to-late 1990s both core inflation and the unemployment rate were falling. Between November 1996 and June 1998, the unemployment rate fell from 5.4% to 4.5%; at the same time core PCE inflation halved from 2% to 1%. As the unemployment rate continued to fall core inflation finally started to rise, reaching 1.8% yoy by mid-2000. This period is one piece of evidence that the Phillip's curve relationship may strengthen when the unemployment rate becomes very low.

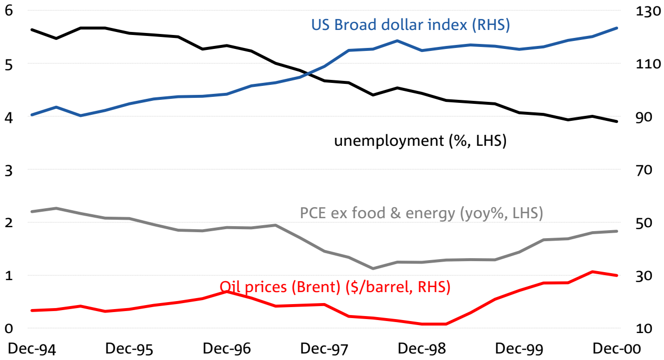
However, it is worth noting that the initial fall in inflation was accompanied by falling oil prices and a rising dollar. Dollar appreciation largely stopped prior to inflation turning around, and only after oil prices started to rise did the upwards move in core inflation gather pace.

While the common view has been that oil prices do not have much impact on core inflation, a recent Federal Reserve research paper has found that the large fall in oil prices of recent years is still a drag on core inflation, currently in the order of 0.2ppts.

All these three elements are currently in play – the unemployment rate is moving down to a very low level, dollar appreciation has been partly reversed and there has been some recovery in oil as well as other commodity prices.

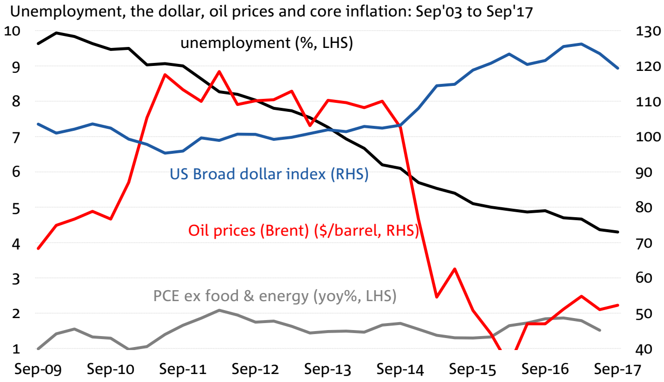
Some similarities to late 1990s inflation story

Unemployment, the dollar, oil prices and core inflation: Dec '94 to Dec'00



Sources: BEA, Federal lReserve, BLS, ICIS Pricing

Unemployment, the dollar, oil prices and core inflation: Sep'03 to Sep'17



Sources: BEA, Federal lReserve, BLS, ICIS Pricing

Given this, we are retaining our forecast that inflation will gradually rise over time towards the Fed's 2% target. However, there is a risk that inflation is now anchored at a low level which could see inflation remain clearly below the Fed's target. If the latter scenario does come to fruition – then it would cause the Fed to put on hold rate hikes at some stage.

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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	2.6	2.3	2.0	0.7	0.7	0.5	0.8	**0.4**	**0.6**	**0.5**	**0.6**	**0.6**	**0.5**
Private fixed investment	3.9	0.7	3.8	3.3	2.6	0.4	0.4	2.0	0.8	**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	0.0	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**
Inventories*	0.2	-0.4	-0.1	0.1	0.0	0.0	0.3	-0.4	0.0	**0.1**	**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*	*3.1*	*2.3*	*2.2*	*2.0*	*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	1.9	0.4	0.5	0.6	0.1	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Core	1.3	1.9	1.4	1.9	1.9	0.5	0.3	0.5	0.2	**0.3**	**0.4**	**0.5**	**0.5**	**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	2.60	3.00	3.00	1.6	2.4	2.4	2.3	2.3	**2.6**	**2.8**	**2.8**	**3.0**	**3.0**

Source: NAB Group Economics

*Contribution to real GDP growth

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