# US ECONOMIC UPDATE DECEMBER 2017

NAB Group Economics

2017 has proved to be another year of solid US economic growth and more of the same is expected in 2018, helped along by fiscal stimulus. Business survey readings are at high levels, as is consumer confidence and employment gains are strong enough to reduce the unemployment rate over time. Even inflation, surprisingly subdued this year, is showing signs of life; this will need to continue for our expectation of three more rate hikes in 2018 to be met.

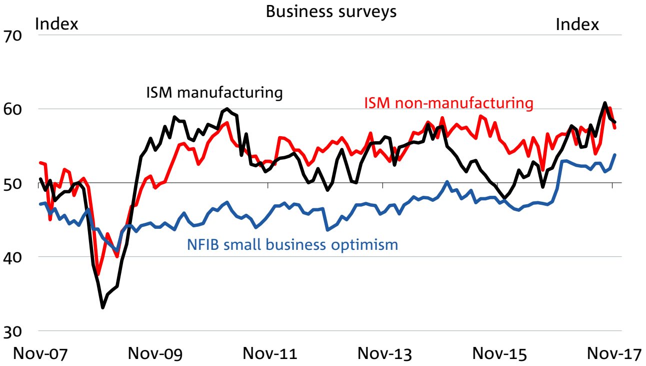
## Overview

The US economy continues to perform solidly. After a slow start to 2017, quarterly GDP growth was above 3% (annualised) in both the June and September quarters. Trend employment growth remains at a level which will continue to bring the already low unemployment rate down further over time.

We expect a more modest but still solid result for December quarter GDP growth of around 2½% qoq. The Atlanta Fed's GDP nowcast is currently running at around 3% so there may be upside to our forecast.

The strength of the economy is also reflected in business surveys. The ISM surveys, despite easing in November, remain at reasonably high levels. Small business optimism, which bounced after last year's presidential election, also remains elevated.

**Business surveys point to a robust economy**




Sources: ISM, NFIB (index divided by 2), NAB

We expect 2018 will be another year of solid growth.

This is despite a number of moderating factors that might be expected to moderate growth. The run down in the household savings rate, which has supported consumer spending over the last two years, won't continue indefinitely. The boost to investment from mining structures investment following the rise in oil prices since early 2016 should also moderate.

Moreover, monetary conditions are set to tighten. We expect that the Fed will further increase the fed funds rate given the downwards trend in unemployment and based on our expectation that inflation will shift modestly higher over the next year. We expect to see a further three rate hikes in 2018. While the hikes to-date haven't translated into much tightening of broader indicators of financial conditions, we expect longer-term yields to move higher from their current levels and for there to be a modest appreciation of the dollar.

More fundamentally, the unemployment rate is at a very low level suggesting diminishing spare capacity in the economy.

However, against this it is looking likely that the US Congress will pass a major tax cuts package, which will provide a fiscal stimulus to the economy.

As with 2017 a key focus will be on signs of a pick-up in wages growth. We do expect some strengthening, reflecting our expectation of some improvement in the weak post-GFC productivity trend, and the increasingly tight labour market. However, the growth implications of this are mixed. While supportive of consumer spending, the tight labour market also means that employment growth is likely to slow. Higher wages, except where supported by productivity improvement, will also eat into businesses profit margins, a negative for investment.

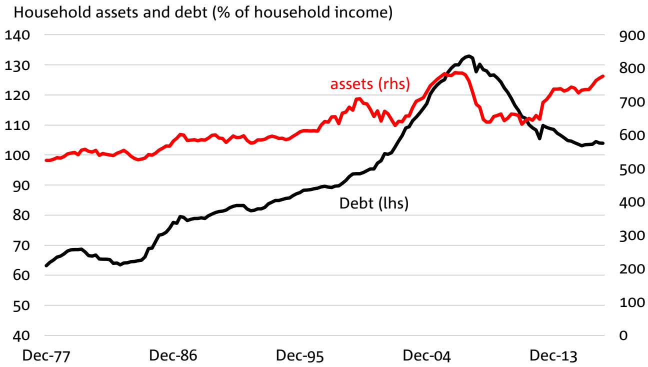
We are forecasting GDP growth of 2.3% for 2017 (revised up from 2.2%) and 2.4% in 2018 (revised from 2.3%). The forecast changes reflect the statistician's upwards revisions to Q3 GDP growth, and the strength of recent of activity and survey indicators which feed into modestly stronger forecasts for end 2017/early 2018 GDP growth.

## Q4 off to a solid start, setting up 2018

Real consumption growth was only a modest 0.1% mom in October. The result was probably in part a correction to September's post-hurricane spike in consumption. Hurricane distortions are clear in the auto sales data, which increased 15% mom in September and fell by around 3% mom in each of October and November. The rise in gasoline prices since July is also weighing on consumer budgets.

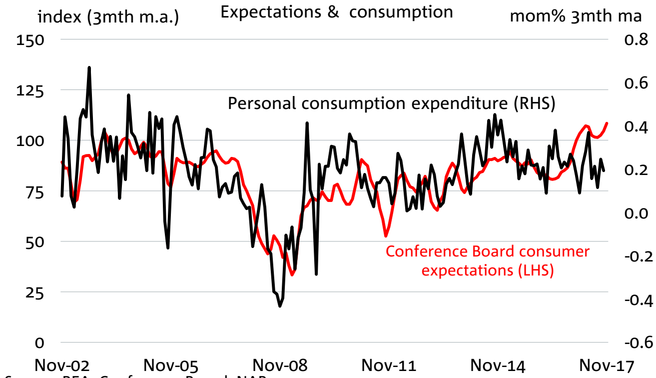
The outlook for consumption still appears reasonably solid. Employment continues to rise (even if the pace is slowing over time), the tightening labour market should lead to gradual increases in wages, and household balance sheets are in good shape with assets rising and debt under control. Consumer confidence is also high, and historically would signal a lift in consumer spending from current levels.

**Solid balance sheets supporting spending**




Sources: Federal Reserve, NAB

**Confidence suggests some upside risk**



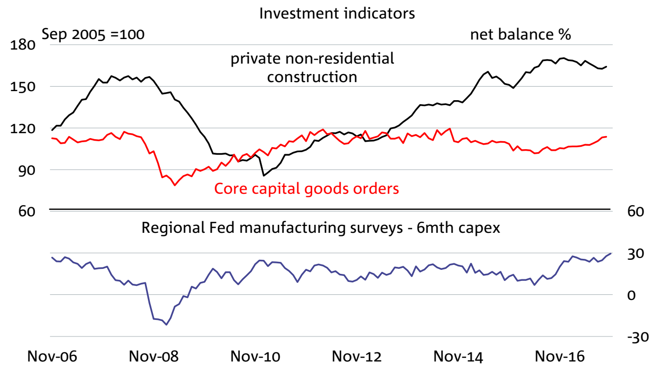

Source: BEA, Conference Board, NAB.

Overall business investment grew at a solid rate over the first three quarters of 2017 and this looks to have continued into the final quarter. Core (ex defence and aircraft) capital goods orders are trending up strongly. Construction (outside of the mining sector) has been a weak point, but the monthly private non-residential construction data recorded their first increase in five months in October.

However, the tailwind from mining investment is set to fade. While at the end of 2016 mining investment made up only around two per cent of total investment, it accounted for 40% of the increase in total investment over the first three quarters of 2017.

However, a decline in oil prices from March 2017 led to a declining rig count between August and early November. Oil prices have again recently picked up, and the rig count has recently stabilised and started to push higher, but we expect only modest growth in oil prices from here so a more moderate boost from oil industry investment looks likely.

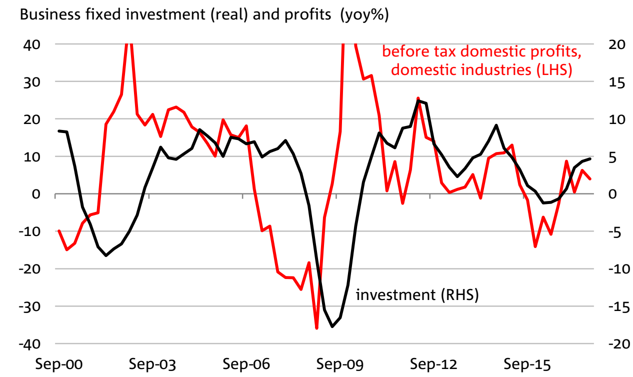
**Positive indicators for business investment**




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

The turnaround in business investment reflects a recovery in corporate profits. This is also in part a mining sector story. With only gradual further oil price increases expected, and a tighter labour market likely to lead to stronger growth in wages in time, the outlook is for modest profit growth at best. This points to a moderation in the pace of business investment growth, although the changes to business taxation likely to be made by Congress may provide a boost.

**Investment recovery helped by increased profits**

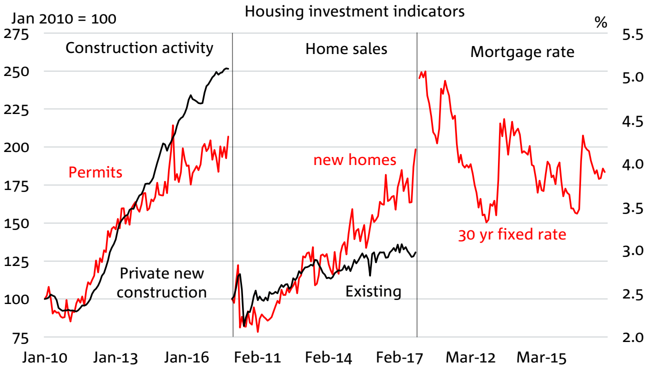



Source: BEA, NAB

In contrast, residential investment has been weak, falling in the last two quarters. There are signs that this might turnaround in Q4 due to increases in new and existing sales. Actual monthly construction fell a little in October, but building permits are still trending up. The strength of new home sales should also encourage new construction, although with vacancy rates having bottomed out and reports indicating supply constraints, future growth is likely to be modest.

The decline in housing investment may have been influenced by a delayed impact from the spike in mortgage interest rates at the end of 2016. The turnaround that looks to be underway in Q4 may reflect rates moving down this year. However, as we expect the Fed to keep gradually tightening monetary policy, mortgage rates should rise, reinforcing the modest growth outlook for residential investment.

**Rebound in home sales**

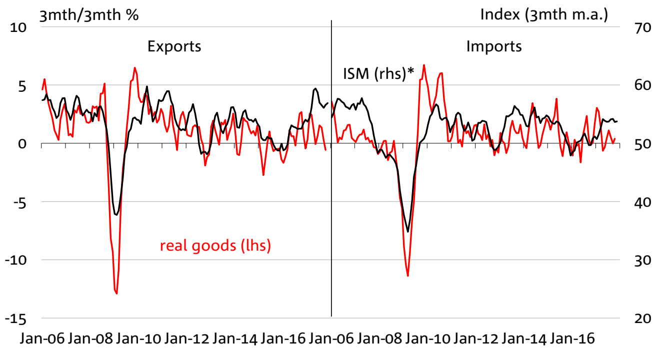



Sources: Census Bureau, Freddie Mac/Bloomberg,NAB

A headwind to Q4 growth may come from net exports. Real goods exports fell 0.2% mom in October while imports grew by a rapid 1.5% mom. Trade data can be volatile they are still probably being affected by the after effects of the August/September hurricanes. The fall in exports is likely exaggerated as it appears to mainly reflect a couple of factors – a large decline in soybean exports (which on a nominal basis reduced exports by around 1ppt) and a large decline in the very volatile aircraft category.

The broader story is that the trade data have been surprisingly muted recently. The ISM trade indicators – which typically do a good job tracking the underlying trend – are pointing to stronger trade growth, particularly for exports, but it is yet to materialise. Exporters experienced a large jolt to their competitiveness from the over 20% appreciation of the currency from mid-2016 through to end 2016. The repercussions of this large currency shift may still be flowing through, but the modest decline in the dollar over 2017 should provide some respite, as should the strengthening in the global economy. For imports, the currency effects work in reverse, but the strength in import intensive equipment investment should be supporting import growth.

**Trade flows surprisingly sluggish**




Sources: ISM, Census Bureau. *Average of ISM manuf./non-manuf. export/import indicators using goods/services trade shares.

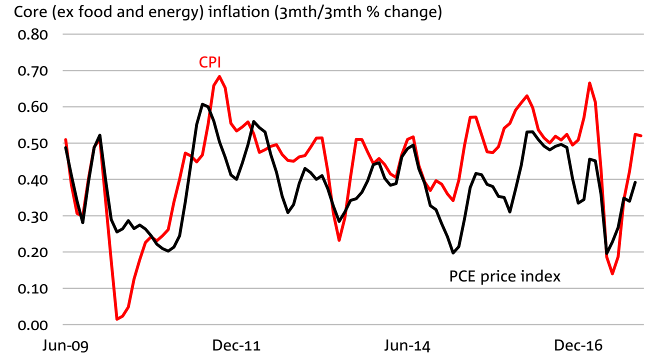
We expect further Fed tightening to lead to renewed US dollar appreciation over 2018. However, it should only be modest and with both foreign and domestic demand solid, the net export contribution to growth is likely to be only small over 2018.

## Inflation shows signs of life

A major issue over 2017 has been the slowdown in US consumer price inflation. Headline inflation, as measured by the personal consumption expenditure (PCE) price index, slowed from 2.2% yoy in February 2017 to 1.4% yoy over June to August. This partly reflects oil price movements, but even core (ex food and energy) slowed noticeably from 1.9% yoy at the start of the year to a low of 1.3% yoy in August.

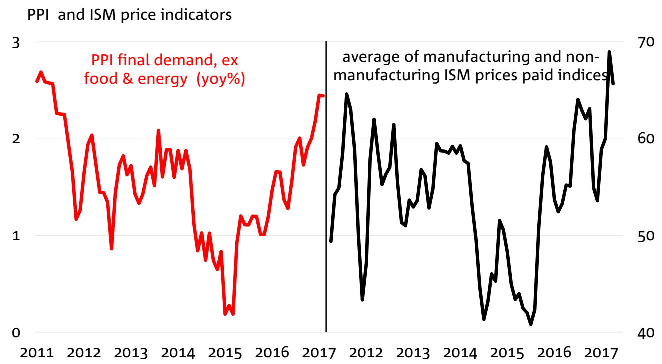
However, in recent months there has been some strengthening in inflation. This partly reflects movements in energy prices but even on a core basis there has been some acceleration. While November's core CPI was on the soft side, on a 3mth/3mth basis – which strips out some of the volatility – there has clearly been a rise from low rates recorded earlier in the year. Moreover, business survey price measures are relatively high and upstream price growth, as measured by the producer price index has picked up.

**Consumer inflation shows signs of life...**




Sources: BLS, BEA, NAB. CPI data to Nov. 2017, PCE data to Oct. 2017.

**...consistent with other price pressure indicators**




Source: BLS, ISM, NAB

While still early days, the recent data are consistent with our view that the slowdown would prove transitory and that inflation will gradually track back towards the Fed's 2% target.

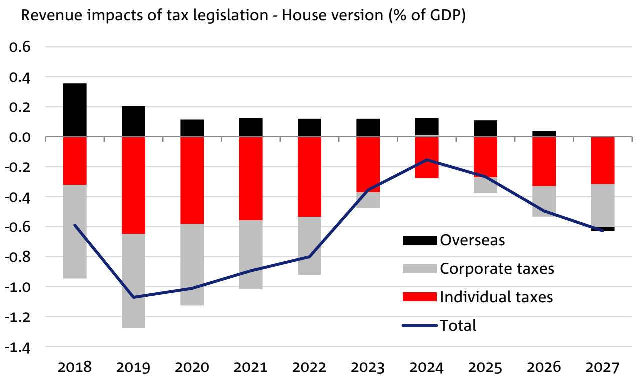
## Fiscal stimulus looming

Both the US House of Representatives and the Senate recently passed bills to cut US taxes by around $1.4 trillion over a ten year period. At their peak, both the House and Senate versions incorporate tax changes that would lead to a decline in revenue of just over 1% of GDP.

There are differences between the two sets of legislation that need to be reconciled through a committee process. House and Senate Republicans appear to have agreed on a compromise bill and the intention, at the time of writing, is for a vote on the legislation next week. Passage appears likely but not certain as it would take only a few defections of Republican senators to prevent passage.

Both the Senate and House packages were projected to lead to lower revenue from individual and domestic business operations, and increased revenue from international tax changes. In terms of the fiscal impact a major difference between the two versions was the timing of the corporate tax cut which the House had starting in January 2018 and the Senate version a year later. Reports indicate that under the compromise version the corporate cuts will start from January 2018, so we have illustrated the magnitudes of the changes in the chart below using the House plan.

**Broad composition of tax changes (f.y. basis)**



Sources: CBO, Joint Committee on Taxation, NAB. Years in chart are financial years.

Our assumption has been that there would be a fiscal stimulus of around 1% of GDP in calendar 2018. The House version has an approximate calendar year fiscal impact of around 0.8% GDP in 2018 (rising to 1.1% in 2019) so we look like we are in the right ball park. Given this, we have not changed our assumption for the amount of fiscal stimulus but will review it when more details of the reported compromise version, including cost estimates, become available

## Fed to further tighten the screws

This week the Fed lifted its fed funds rate target range by 25bp to 1.25-1.50%, making it three increases for the year.

Next year, we expect that the combination of an economy growing solidly enough to reduce the already low unemployment rate even further and a gradual rise in inflation will lead to a further three fed fund rate hikes. The median Fed member projection is also for three rate hikes.

The main risk around this call is that, despite some recent improvement, the downward surprise in inflation this year could persist into 2018. If this were to occur than at some stage the Fed would likely pause the rate tightening process.

There is also upside risk to the rate track, as our projections essentially call for a slowing in policy tightening. In each of the last five quarters the Fed has tightened policy in some way (four rate hikes and, in September, it started unwinding its balance sheet). Balance sheet policy, barring some major shift in the economy, is essentially now on auto-pilot so if the Fed were to maintain this pace there would be four rate hikes. Moreover, the injection of fiscal stimulus into an economy with an already low unemployment rate may feed the fears of some Fed members about falling behind the curve.

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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 | **0.6** | **0.5** | **0.6** | **0.6** | **0.5** |
| Private fixed investment | 3.9 | 0.7 | 3.8 | 4.0 | 3.0 | 0.4 | 0.4 | 2.0 | 0.8 | 0.6 | **1.3** | **1.0** | **1.1** | **1.0** | **0.8** |
| Government spending | 1.4 | 0.8 | -0.1 | 0.6 | 1.1 | 0.1 | 0.0 | -0.2 | 0.0 | 0.1 | **0.2** | **0.2** | **0.2** | **0.2** | **0.3** |
| Inventories* | 0.2 | -0.4 | -0.1 | 0.1 | 0.0 | 0.0 | 0.3 | -0.4 | 0.0 | 0.2 | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| Net exports* | -0.7 | -0.2 | -0.1 | 0.0 | -0.1 | 0.1 | -0.4 | 0.1 | 0.1 | 0.1 | **-0.1** | **0.0** | **0.0** | **0.0** | **0.0** |
| **Real GDP** | **2.9** | **1.5** | **2.3** | **2.4** | **2.0** | **0.7** | **0.4** | **0.3** | **0.8** | **0.8** | **0.6** | **0.5** | **0.6** | **0.6** | **0.5** |
| *Note: GDP (annualised rate)* | | | | | | *2.8* | *1.8* | *1.2* | *3.1* | *3.3* | *2.4* | *2.1* | *2.4* | *2.4* | *2.1* |
| **US Other Key Indicators (end of period)** | | | | | | | | | | | | | | | |
| PCE deflator-headline | | | | | | | | | | | | | | | |
| Headline | 0.4 | 1.6 | 1.7 | 1.9 | 1.9 | 0.4 | 0.5 | 0.6 | 0.1 | 0.4 | **0.7** | **0.6** | **0.5** | **0.5** | **0.4** |
| Core | 1.3 | 1.9 | 1.5 | 1.9 | 2.0 | 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 | 4.1 | 3.7 | 3.7 | 4.9 | 4.7 | 4.7 | 4.4 | 4.3 | **4.1** | **3.9** | **3.8** | **3.8** | **3.7** |
| **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 | 2.50 | 3.00 | 3.00 | 1.6 | 2.4 | 2.4 | 2.3 | 2.3 | **2.5** | **2.6** | **2.8** | **3.0** | **3.0** |

**Source: NAB Group Economics**

*Contribution to real GDP growth

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