US ECONOMIC UPDATE AUGUST 2018

NAB Group Economics

The US economy grew strongly in Q2 2018, driven by a rebound in consumption and further solid business investment growth. We continue to expect GDP growth of 2.8% in 2018, and for the economy to slow in 2019 (2.4%, previously 2.3%) and 2020 (1.7%) as this year's fiscal stimulus wanes, monetary policy tightens and supply constraints kick-in. The yield curve is not (yet) pointing to a recession in the immediate future. A more immediate concern is the escalation of the US/China trade dispute, although EU/US trade tensions have settled down.

Rapid growth in Q2

US GDP grew by a strong 1.0% q/q (or 4.1% annualised) in Q2 2018. This is the strongest quarterly growth rate in almost four years. The composition of growth was good, with solid or better consumption and business investment, while big moves in net exports and inventories cancelled each other out.

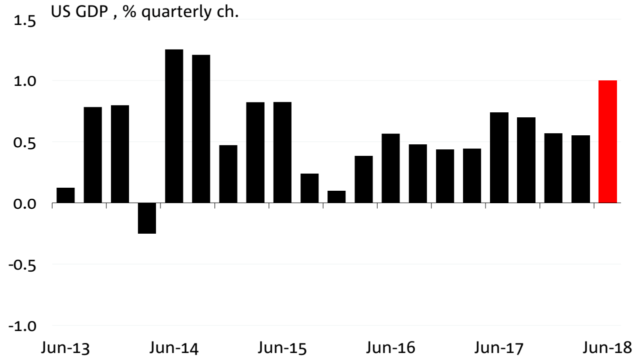
As a result annual GDP growth (change on same quarter a year ago) strengthened to 2.8% y/y, continuing the upwards trend that started in the second half of 2016. The turnaround coincided with oil prices bottoming out and starting to move higher, illustrating that the US economy – now a major oil producer as well as consumer – is not as exposed to oil prices moves as it once was.

Nor is the improvement in economic growth sensitive to the choice of measure used. Not only has GDP accelerated, but the same is true of final domestic demand ('final sales to domestic purchasers' or GDP less net exports and inventories) and final sales of domestic product (GDP less inventories).

Strong household consumption growth was the major catalyst for the Q2 strength. A rebound in consumption was expected after a slow start to the year, particularly given the underlying lift to household budgets from this year's tax cuts (notwithstanding higher fuel costs).

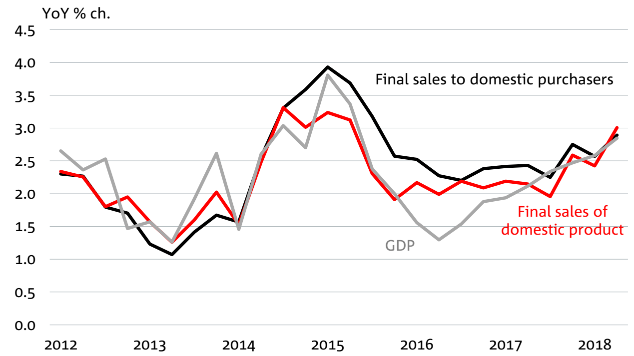
The statistician also made major changes to estimates of the household savings rate – the large fall previously thought to have occurred from 2016 onwards is now gone, and the savings rate in Q2 remained in the range it has been in since 2013. While it will be hard to sustain consumption growth at its Q2 pace, with household finances in good shape there is no reason to expect a major correction any time soon.

Rapid GDP growth in Q2



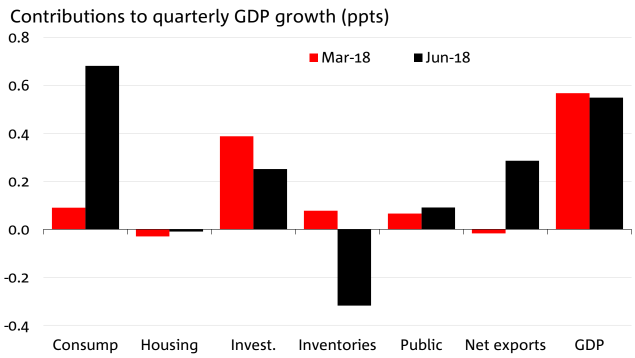
Sources: BEA, NAB

Growth pick-up since mid-2016 across measures



Sources: BEA, NAB

Consumption strong, business investment still solid



Sources: BEA, NAB. Data not annualised

While below its Q1 pace, business investment growth of 1.8% q/q was still solid. It was helped along by an oil related 18% q/q surge in mining structures investment, although even excluding this, business investment still grew at a reasonable 1.1% q/q.

One area of weakness was residential investment, which declined for the second consecutive quarter. This perhaps reflects an on-going impact from the increase in mortgage rates last year and into early 2018. Supply shortages are also reportedly a factor.

The large contribution to GDP growth from net exports reflected stronger export growth – at 2.2% q/q, the strongest growth in over four years – and anaemic import growth (0.1%). Foods, feeds & beverages grew by 20.5% - likely large due to a surge in soybean exports, possibly reflecting a desire to get ahead of China's tariffs on US soybean imports that started in early July. There was a similar surge in soybean exports a couple of years ago, and like then, we expect it to be unwound over coming months. That said, non-food export growth strengthened in Q2. With domestic demand strong, the weakness in Q2 imports is likely to be short-lived , which is also the message from the ISM business surveys import orders readings.

The large fall in inventory accumulation was probably related to the net export outcome. Farm inventories declined and a combination of strong sales of goods, with little import growth, would also be expected to put downward pressure on inventories.

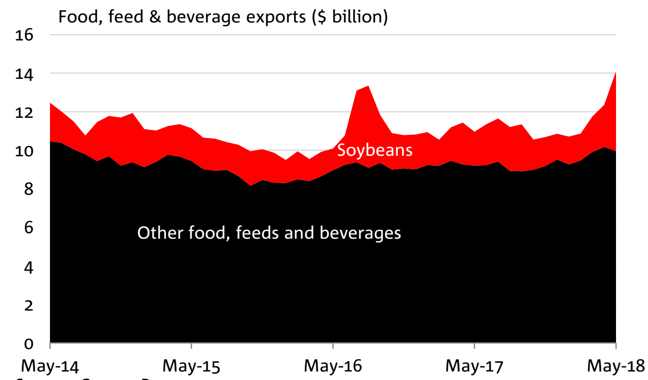
Given that the Q2 outcome was slightly higher than we expected and the composition of growth was better, we have modestly increased our expectations for the second half of 2018. Because of offsetting historical revisions, our 2018 forecast for GDP growth remains at 2.8%, but our forecast for 2019 has edged up to 2.4% (previously 2.3%). As the effects of this year's fiscal stimulus fade further and supply constraints kick-in, we expect growth to slow even further in 2020 (1.7%). Our forecasts still assume that current trade disputes do not spiral out of control.

Another factor likely to move from a tailwind to headwind for growth is monetary policy. The Fed, in its meeting this month, re-affirmed that it expects to continue to gradually tighten monetary policy. This is not surprising in an environment where inflation is around the Fed's 2% target (2.2% yoy in June on the headline PCE price measure or 1.9% on a 'core' basis), and the unemployment rate is below what the Fed considers its longer-term level (and trending even lower). We expect two further rate hikes this year, and three in 2019, which would resulting in a fed funds rate modestly above our estimate of its neutral level.

Concern over message from yield curve

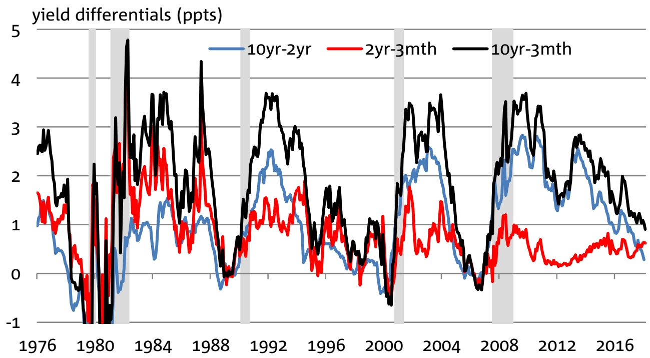
One issue that has been getting attention is the flattening in the yield curve.

Soybean led boost to exports



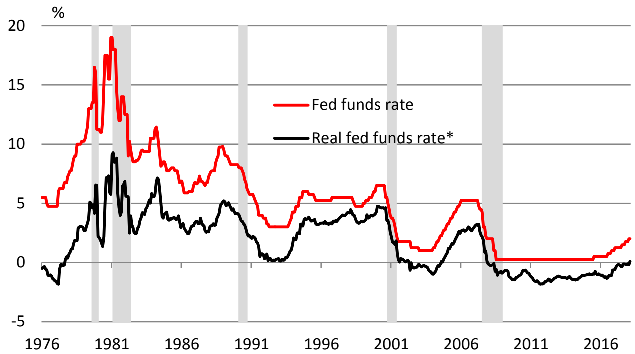
Source: Census Bureau

Yield curve & recession risk...but which yield curve?



Yields based on Govt. rates. Greay areas indicate recession periods.
Sources: Datastream, NAB, NBER.

Only a modest tightening cycle so far



*Real fed funds rate less core PCE inflation (y/y%) . Grey areas indicate recession periods. Sources: Datastream, NAB, NBER.

The focus has been on the difference between 10 and two year government bonds, with the gap between the two having narrowed substantially. However, the spread has not yet turned negative – the point at which historically it has been a good signal that a recession is looming.

Nevertheless, the flattening of the 10/2yr yield curve has raised concerns about whether the risk of a recession is elevated. In part, the concern seems to be based on the simplistic assumption that the yield curve will turn negative this year if the Fed continues to raise rates once a quarter. To a large extent two more Fed hikes this year are already priced-in and, in any event, further hikes could shift both the 2 year and 10 year rate.

Moreover, the choice of the 10yr/2yr yield curve is arbitrary. The 10yr/3mth yield curve has also flattened but by less than the 10yr/2yr curve. In complete contrast, the 2yr/3mth curve has basically been moving sideways. Historically all these different yield curves have moved lower or inverted prior to a recession.

Some research – including by the US Fed[1] – suggests that the short end of the yield curve provides more information about recession risk. Another issue is whether the still large bond holdings of the Fed (due to past QE programmes) and other central banks is distorting the yield curve and therefore distorting any signal from changes in the yield curve. Nevertheless, some Fed members are concerned, and so this is one issue which we will continue to monitor.

Trade risks…some good & bad news

While an inverted yield curve may provide a signal about the risk of a recession, a possible trigger for an economic downturn is a major trade war. Here the latest news has been mixed.

On the positive side, the risk of US tariff measures aimed at auto – particularly European – imports has fallen. This follows talks between the US and the EU which led to an agreement for the two parties to start negotiations towards zero tariffs, zero non-tariff barriers, and zero subsidies on non-automotive industrial goods; making it easier for the EU to purchase US LNG; reducing bureaucratic obstacles to trade and reforming the World Trade Organization and addressing unfair trade practices (intellectual property theft).

The discussions will also include the recent steel and aluminium tariffs imposed by the US and EU retaliatory tariffs, but for now these remain in place.

At the same time, negotiations on the North American Free Trade Agreement (NAFTA) appear to have made some progress of late. That said, optimism about a NAFTA renegotiation (as opposed to the US pulling out altogether, which would be very disruptive) has been waxing and waning for a while, so it is too early to be confident about how this process will end.

On the negative side, the US/China trade dispute has taken a turn for the worse. Following China's retaliation to US tariffs on $34b of imports from China, the US started the process which could lead to it imposing a 10% tariff on a further $200b worth of imports. Last week, the US decided to up the ante, and made the prospective tariff 25% rather than 10%. China has already indicated that if this threat was carried through, it would impose tariffs on a further $60b of US imports.

While none of these measures may yet be imposed, it is unclear what the circuit breaker will be at this stage that stops them being introduced. Moreover, previously the US President has indicated that if the tariffs on $200b Chinese imports went ahead, and China retaliated, the US would impose tariffs on another $200b of imports which would mean that the vast majority of Chinese exports to the US would be affected by new tariffs.

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[1] See Engstrom E., Sharpe S., (Don't Fear) The Yield Curve, Fed Notes, June 28, 2018

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %									
						2017		2018				2019			
	2016	2017	2018	2019	2020	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	2.7	2.5	2.6	2.2	1.7	0.6	1.0	0.1	1.0	0.7	0.6	0.5	0.5	0.4	0.4
Private fixed investment	1.7	4.8	5.5	3.4	2.1	0.6	1.5	1.9	1.3	0.9	0.9	0.9	0.7	0.6	0.5
Government spending	1.4	-0.1	1.6	2.6	1.7	-0.3	0.6	0.4	0.5	0.6	0.8	0.8	0.6	0.5	0.4
Inventories*	-0.6	0.0	-0.1	0.1	0.0	0.3	-0.3	0.1	-0.3	0.3	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.4	-0.4	-0.2	-0.2	0.0	0.0	-0.3	0.0	0.3	-0.3	0.0	0.0	0.0	0.0	0.0
Real GDP	**1.6**	**2.2**	**2.8**	**2.4**	**1.7**	**0.7**	**0.6**	**0.5**	**1.0**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.4**
Note: GDP (annualised rate)						*2.8*	*2.3*	*2.2*	*4.1*	*2.9*	*2.6*	*2.4*	*1.9*	*1.8*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.6	1.8	2.0	1.9	2.2	0.4	0.7	0.6	0.5	0.5	0.4	0.4	0.5	0.5	0.5
Core	1.8	1.6	2.0	2.1	2.2	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	**4.7**	**4.1**	**3.6**	**3.4**	**3.5**	**4.3**	**4.1**	**4.1**	**3.9**	**3.7**	**3.6**	**3.4**	**3.4**	**3.4**	**3.4**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	0.75	1.50	2.50	3.25	3.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25
10-year bond rate	2.45	2.41	3.25	3.50	3.50	2.3	2.4	2.7	2.9	3.1	3.3	3.3	3.5	3.5	3.5

Source: NAB Group Economics

*Contribution to real GDP growth

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