# US ECONOMIC UPDATE SEPT. 2018

## US economy still strong, but trade concerns won't go away

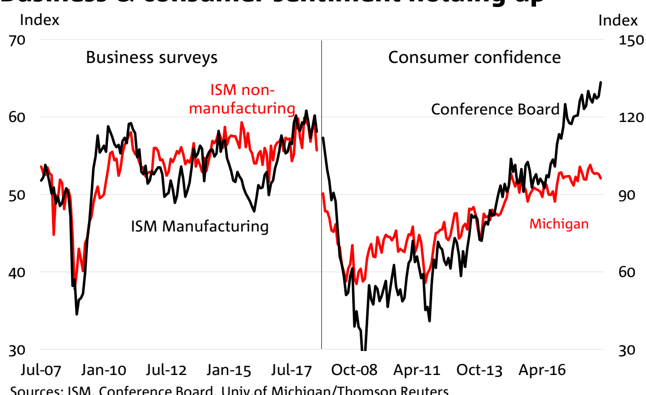
NAB Group Economics

The US economy continued to perform strongly in early Q3 2018 – growth is above trend and the unemployment rate is low and falling. With core inflation also returning to target, the Fed will continue to tighten monetary policy at a gradual (quarterly) pace with the next rate hike likely at its September meeting. Trade risks are still a major concern – particularly an escalation in US/China trade barriers and while progress has been made on NAFTA it could still fall over.

### Overview of the US economy

The US economy continues to track strongly. Business surveys are at robust levels as is consumer confidence. Partial indicators are consistent with above trend growth continuing into Q3, and the labour market is in good shape. With the labour market becoming tight, and inflation around the Fed's 2% target, the Fed will continue its path of quarterly rate increases. However, an escalation of trade disputes with major trading partners remains a key risk to the outlook.

**Business & consumer sentiment holding up**




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

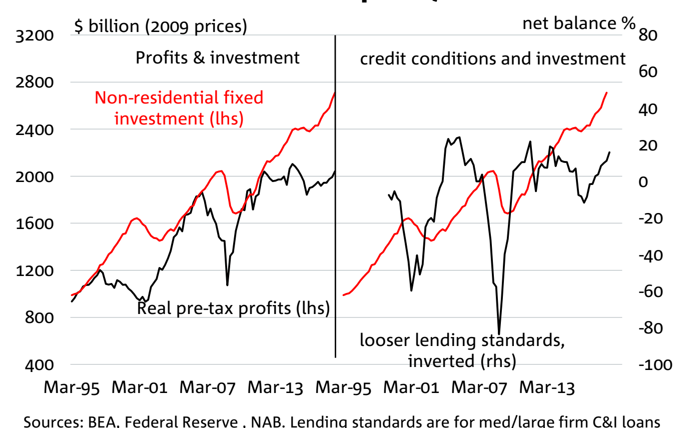
While only limited data for Q3 is available the key drivers for growth remain consumption and business investment, while residential investment remains soft. In contrast, based on July data, net trade – which made a large positive contribution to growth in Q2, perhaps due to bringing forward exports to China ahead of tariffs, looks like it will make a negative contribution to this quarter. However, as with Q2, the trade impact on growth is likely to be more or less offset by movements in inventories.

Household consumption grew at a rapid pace in Q2 and while we expect growth to ease in Q3 it should remain at a solid level. In July, consumption grew by 0.2% m/m; with two months to go it is already 0.5% above the June quarter average. Consumption is being supported by tax cuts for households, solid employment growth and gradually strengthening wage growth, along with positive sentiment, increasing wealth (equities and housing) and a household balance sheet in good shape. The tax cut impact will fade over time but the other supports are likely to remain in place for longer.

**Business investment indicators positive**

*Sep 18 qtr based on July **Average of available Philadelphia, Richmond, Dallas, Kansas City & Empire State regional Fed surveys. Capital goods data from Census Bureau.

**Consistent with favourable profit/credit conditions**




Sources: BEA, Federal Reserve , NAB. Lending standards are for med/large firm C&I loans

Business investment was also strong in Q2, and this has been sustained early in Q3. Core (ex defence and transport) capital goods orders and shipments are

trending up and manufacturing sector capital investment intentions remain elevated.

There are a number of positive factors underpinning business investment. These include strong profitability and improved credit conditions. While the Fed has been tightening its policy settings, the Fed's Senior Loan Officer Opinion Survey indicates that banks have recently been easing credit standards on commercial & industrial loans. Commercial Real Estate loans standards went through a period of tightening in recent years but this now seems to have largely run its course.

Increasing mining sector investment has been another factor supporting overall investment but this is starting to fade. While only making up around 5% of the level of business investment, mining structures investment has accounted for around 20% of business investment growth over the year to Q2 2018. However, with oil prices around the mid-$70s mark since mid-April, the number of oil and gas rigs has been broadly flat in recent months.

Trade tensions are possible headwinds for business investment, but at this stage they do not appear to be having a material effect (see Trade Risks next page).

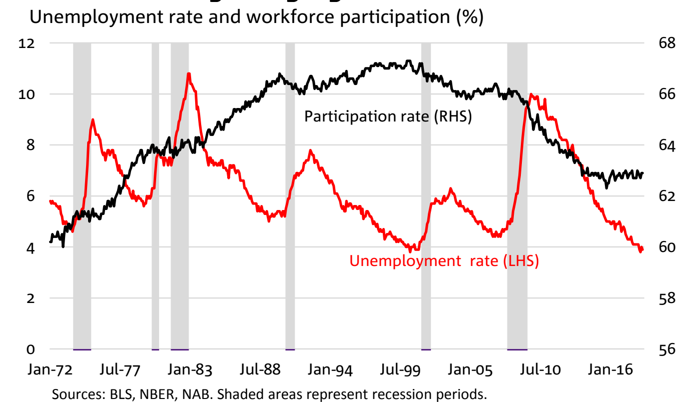
Public demand has also been growing more strongly, following the Federal government budget deal agreed to earlier this year. Federal spending over the last couple of quarters has grown at its fastest pace since 2010. Beyond the agreed two year budget deal (out to end fiscal 2019) the path of US fiscal policy is very unclear. Stimulus at this stage of the economic cycle is very unusual, but there appears little appetite in Congress to reduce the budget deficit.

In contrast to the positive signs for consumption and business investment, residential investment has declined in recent quarters, and early indicators point to more of the same in Q3. In part, this reflects the impact of a 50bp increase in the standard 30 year mortgage rate this year. Unit vacancy rates are also rising, discouraging further investment in this sector, which has also been hit by an on-going tightening in bank lending standards.

Overall, we expect GDP to grow at 2.8% in 2018, but then to slow over 2019 (2.4%) and 2020 (1.7%) as this year's fiscal policy boost fades, monetary policy tightening continues and supply constraints kick-in.

The strength of the US economy, and signs of emerging supply constraints, is evident in the labour market. The unemployment rate is at a very low 3.9%, and with the employment growth still well above the rate of population growth it is likely to fall further. Moreover, the participation rate has been broadly flat in recent years, going against its long-term down trend – driven by demographics and societal factors – and signalling that the strong economy is drawing people into the workforce. Wages growth, in fits and starts, is also moving higher.

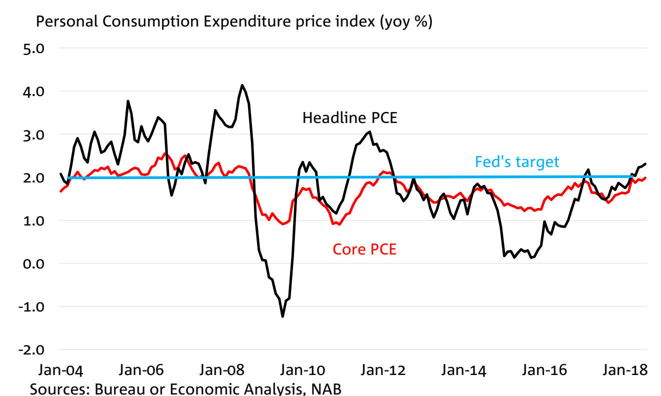
**Labour market getting tight**




Sources: BLS, NBER, NAB. Shaded areas represent recession periods.

Consumer price inflation has also come off its lows. The Fed's preferred inflation measure – PCE inflation ex energy and food (core PCE inflation) was 2.0% yoy in July, its highest level since 2012, and right on the Fed's long-term target. However, on 3mth/3mth basis, core inflation peaked several months ago suggesting that it is not (yet) accelerating beyond 2%. Moreover, with the dollar strengthening since April, there is likely to be some downward pressure on inflation in coming quarters, although in-time we do expect core inflation to move above 2% as supply constraints bite.

**Core inflation back on target**




Sources: Bureau or Economic Analysis, NAB

## Monetary policy

With the labour market in good shape and inflation back on target, it is no surprise that the Fed is increasing interest rates, particularly given that the Fed believes that the Fed funds rate is below its neutral level. Current policy settings are still supporting above trend growth, whereas a combination of below target unemployment and at or above target inflation would normally be associated with restrictive policy.

The Fed's projections, and ours, are for further increases in the fed funds rate which lead to monetary policy turning restrictive in 2019. The Fed is content to get there at a gradual (i.e. quarterly) pace as its seeks to balance the risks of allowing the economy to overheat – leading to inflation well above target – against the risk that it raises rates too high causing a serious downturn in the economy.

## Trade risk

The prospect of a major escalation in trade barriers remains a key risk to the US outlook. A couple of months ago there were prospective major increases in tariffs or other trade barriers on three major fronts: (1) US/China tariff measures, (2) the possibility of US tariffs on Euro (or all) auto imports and (3) the risk that the US would withdraw from the North American Free Trade Agreement (NAFTA).

As it stands, the first (US/China) remains major immediate risk, NAFTA may be resolved soon (but could still break down) while the US has deferred tariffs on Euro autos as the two parties start the process for a new trade deal. The US and Mexico have agreed on changes to NAFTA, but talks last week with Canada failed to reach agreement. The US/Canada have a month to reach agreement, otherwise the US government may seek to go it alone with a bilateral degree with Mexico. Whether Congress would approve a bilateral US/Mexico deal, and what this would mean for US/Canada trading arrangements, is unclear.

US/China tensions remain elevated. The public consultation over the proposed 25% tariff on a further $200b of imports from China is due for completion on 6 September. Recent talks between the US and China did not appear to make any significant progress. As a result, what will stop a major escalation is unclear, other than that it is in no one's interest for a major prolonged trade war.

If all the threatened US/China tariffs were to go ahead (which would basically cover the vast majority of imports from China) I t would increase the average US tariff rate by around 5ppts. Studies have indicated a tariff increase of this magnitude would lower US GDP by 0.5-0.9ppts over a few years, which would represent a strong headwind to US growth.

Even ahead of a major US/China escalation, the risk it may occur could affect activity through confidence affects, large movements in financial markets and a widening in risk spreads, or because uncertainty about what future trading arrangements will be, leads businesses to delay investment.

At this stage US business confidence overall – despite lots of anecdotes about business concerns – seems to be holding its ground. Similarly, risk measures in US financial markets have not moved significantly.

A survey of businesses by the Atlanta Fed in late July sought to determine whether there was likely to be a large impact on business investment because of tariff developments.

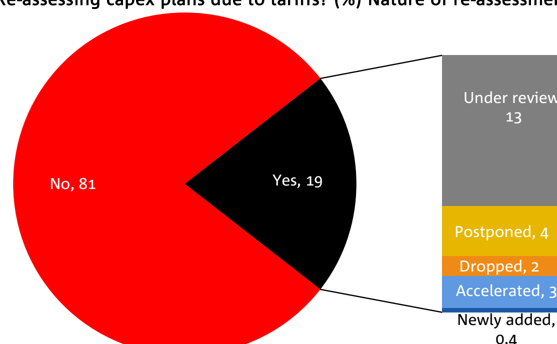
One-fifth of all businesses surveyed (30% of manufacturers) indicated they were reviewing their capex plans as a result. However, the most common action at that time was to place capex plans 'under review'. Only around 6% of respondents indicated they were postponing or cancelling investment. At the same time, reflecting the fact that tariffs will benefit some industries, a small number of firms were adding or accelerating investment (3-4%). So no major impact as yet, but a major escalation of US/China tariff barriers could change this and the overall likely impact is negative.

**Trade state of play**

| Measure | Status | Overseas Retaliation? |
|---|---|---|
| 20-50% on washing machines/solar panels | In-place | |
| Steel (25%) & aluminium (10%) | In-place | Yes |
| 25% on $50b China imports | $34b 6 July<br>$16b 23 August | China placed tariffs on $50b of US imports |
| 25% on $200b China imports | Public consultation process open until 6 September | China to put tariffs on $60b of US imports if US goes ahead |
| $200b China (rate unclear) | Threatened if China retaliates to $200b tariff | ? |
| 20-25% on autos (Europe or all, possibly includes parts) | US Section 232 investigation report was expected August buy may be delayed as EU/US work towards agreement for zero tariffs on non-auto industrial goods | Threatened |
| NAFTA re-negotiation | US/Mexico reached agreement in August. On 31 Aug. US Congress notified of intention to sign a new agreement in 90 days; but details required in 30 days – effectively the deadline for US/Canada talks. | n.a. |

**Business capex– muted reaction so far to tariffs**

Re-assessing capex plans due to tariffs? (%) Nature of re-assessment (%)*




* Allowed more than one response. Source: Atlanta Fed

**CONTACT THE AUTHOR**

Tony Kelly
Senior Economist – International
Antony.kelly@nab.com.au

# 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 | 2.5 | 2.2 | 1.7 | 0.6 | 1.0 | 0.1 | 0.9 | 0.7 | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 |
| Private fixed investment | 1.7 | 4.8 | 5.6 | 3.4 | 2.1 | 0.6 | 1.5 | 1.9 | 1.5 | 1.0 | 0.9 | 0.8 | 0.7 | 0.6 | 0.5 |
| Government spending | 1.4 | -0.1 | 1.7 | 2.5 | 1.7 | -0.3 | 0.6 | 0.4 | 0.6 | 0.7 | 0.7 | 0.7 | 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 | -0.1 | -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* | *4.2* | *3.0* | *2.5* | *2.3* | *1.9* | *1.8* | *1.7* |
| **US Other Key Indicators (end of period)** | | | | | | | | | | | | | | | |
| PCE deflator-headline | | | | | | | | | | | | | | | |
| Headline | 1.6 | 1.8 | 1.9 | 1.8 | 2.2 | 0.4 | 0.7 | 0.6 | 0.5 | 0.4 | 0.39 | 0.4 | 0.4 | 0.5 | 0.5 |
| Core | 1.8 | 1.6 | 1.9 | 2.1 | 2.2 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.4 | 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 | 3.8 | 3.6 | 3.5 | 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

## Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Jacqui Brand
Personal Assistant
+61 3 8634 2181

### Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0)436 606 175

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

### Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

### International Economics

Tony Kelly
Senior Economist
+(61 3) 9208 5049

Gerard Burg
Senior Economist – International
+(61 3) 8634 2788

John Sharma
Economist
+(61 3) 8634 4514

## Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

**Important Notice**
This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.
NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click here to view our disclaimer and terms of use.