US ECONOMIC UPDATE OCTOBER 2018

US economy continued to grow strongly in Q3

National Australia Bank

NAB Group Economics

The US economy performed strongly in Q3 2018, and over the last year grew at its fastest rate in over three years. With households benefiting from this year's tax cuts, consumption growth remained strong. However, with the impact of this year's fiscal stimulus set to fade and with monetary policy gradually tightening, we expect US growth to slow over the next two years.

Q3 GDP

US GDP grew by 0.9% q/q (or 3.5% on an annualised basis) in Q3 2018. While down on the previous quarter's pace (1.0% q/q), this is still a strong rate of growth. As a result the y/y growth rate increased to 3.0%, the highest it has been in over three years.

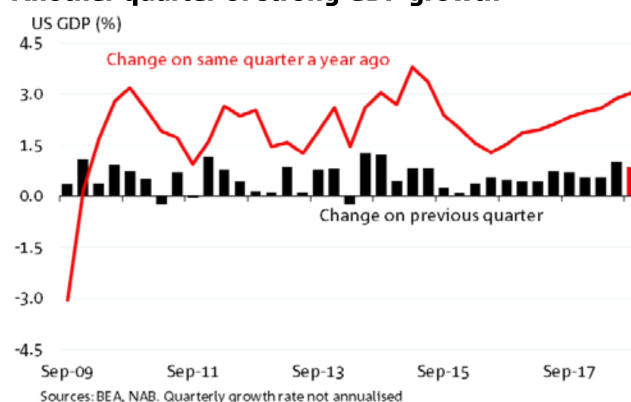
There was a large turnaround in Inventories and as a resulted they accounted for over half of the quarter's growth. Similarly, the strong net export boost in Q2 was reversed this quarter. The two are likely related – for example, soybean exports surged in Q2– ahead of Chinese tariffs – but have fallen back this quarter. This also had the effect of reducing inventories in Q2. Inventories as a ratio of sales are, if anything, on the low side so the risk of a major inventory correction appears low.

Of more concern was the large slowdown in overall business investment growth to just 0.2% q/q from over 2% in Q2. This included a fall in structures investment, which previously has been supported by strong mining sector investment but there was a small decline in this sector in Q3. Investment can be volatile on a quarterly basis, and the y/y growth remained strong at over 6%, which is not too different to what has been seen over the last year.

The constant factor underpinning growth is the consumer with a second consecutive quarter of strong growth. Household incomes were boosted at the start of the year by income tax cuts. However, the savings ratio is now back to where it was at the end of last year, suggesting that the boost from this factor may be nearing its end.

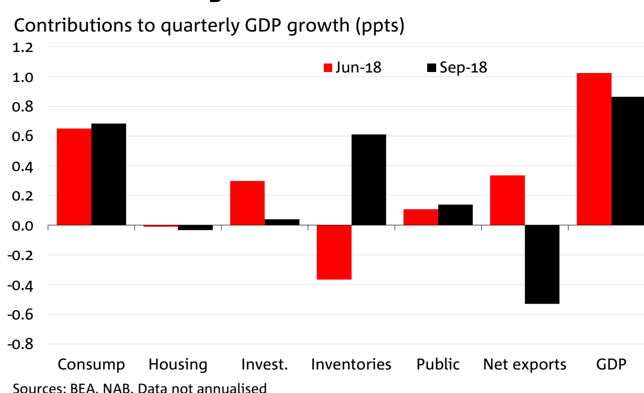
In contrast, residential investment again declined. It is still a little higher than at the same time a year ago, so it is only a modest correction so far.

Another quarter of strong GDP growth



Sources: BEA, NAB. Quarterly growth rate not annualised

Consumers strong as investment takes a back seat



Sources: BEA, NAB. Data not annualised

The fiscal stimulus that is boosting the US economy this year came not just in the form of business and personal income tax cuts, but also a lift in Federal government spending. There was another strong quarter of Federal government spending in Q3, which in y/y terms was at its highest level since the GFC inspired stimulus of 2010. The larger state/local government spending component has been more subdued but it too lifted in Q3, growing at its fastest pace in several years.

Outlook

The Q3 result was a little higher than we had been expecting although the details – particularly the

sharp slowdown in business investment – were less favourable.

The overall picture of an economy in strong shape is reflected in other indicators as well. Business surveys remain at robust levels as is consumer confidence.

Consumers are benefiting from a strong labour market; the unemployment rate is at its lowest level since 1969. Jobs growth and gradually strengthening wage growth are supporting household income. The household balance sheet is also in good shape. The recent rise in gasoline prices is likely only a short-term headwind as oil prices have already started to subside. However, with the impact of this year's tax cut likely to start fading soon, we expect consumption growth to start slowing.

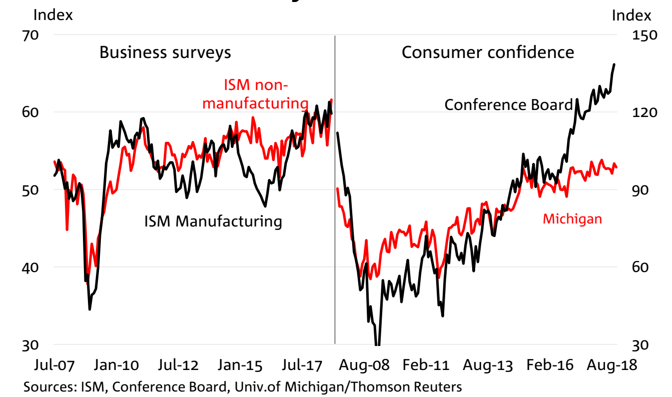
The recent tick-up in oil prices may stimulate mining sector investment, particularly as oil sector investment has been weaker than would normally be expected at current prices. Due to its capital intensive nature, this sector can have an outsized influence on aggregate investment. More generally, investment indicators remain positive, although manufacturing capex intentions have come off their recent highs. This year's corporate tax cuts remain a supportive factor, as are still high profit levels and diminishing spare capacity. While interest rates have been rising, bank lending standards for business loans are easing.

There is little evidence yet that China-US import tariffs are having a significant impact on investment, although this risk remains, given that tensions could escalate further. Moreover, as the labour market tightens further, lifting wage growth, this may reduce business margins. Given this, and with little sustained upside to oil prices expected, business investment growth is likely to ease over the next few years.

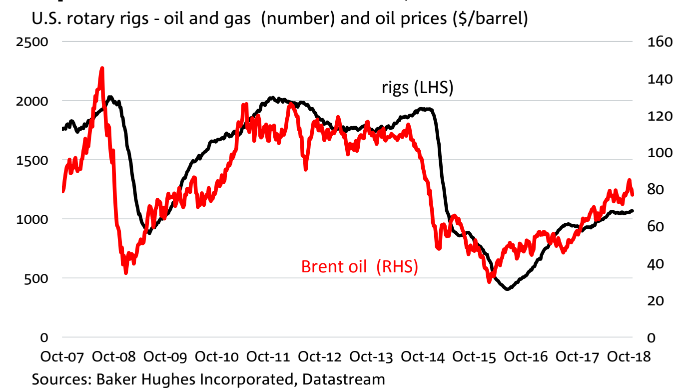
The recent weakness in residential investment likely reflects the increase in mortgage interest rates earlier in the year. Rates jumped again through September and October, and with the Fed continuing to tighten policy, further increases are likely, meaning the recent softness is likely to persist. We don't expect a major correction in residential investment as there has not been a major overbuild, as can be seen by still low vacancy rates. Moreover, labour market strength finally appears to be translating to an increase in the number of people setting up their own households, which will underpin demand for housing.

On the trade front, over July and August tariffs came into effect on $50b of China imports and then, in late September, on a further $200b of imports (the latter at 10% but will become 25% on 1 January). China has reciprocated with tariff measures on US imports. It is too early to see the full impact of the tariff measures on the trade data, particularly as it is likely that activity was brought forward ahead of tariff increases.

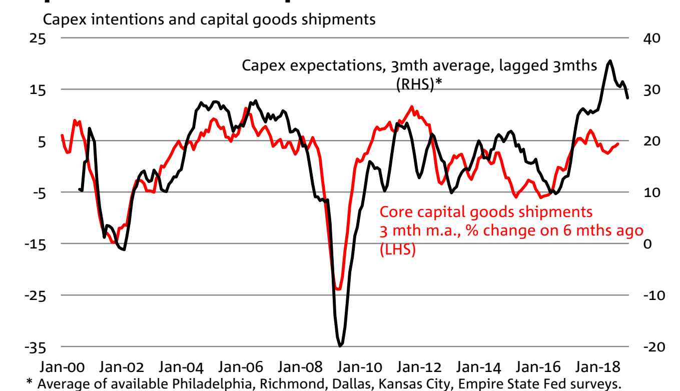
Robust business surveys and consumer confidence



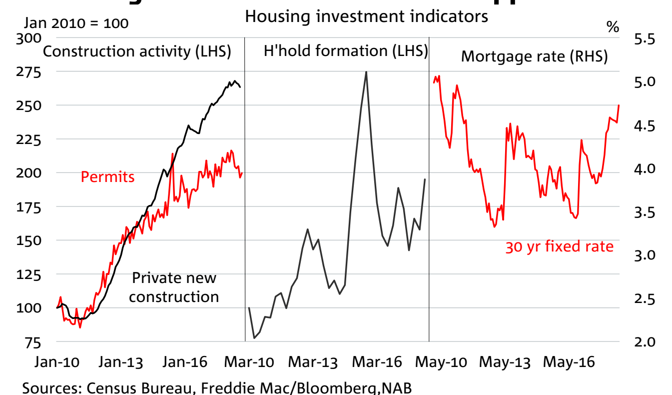
Oil prices: consumer headwind, investment tailwind



Capex indicators still positive



Housing market soft as interest rates rise, but increasing number of households a support



That said, looking at annual growth rates, there has been a noticeable fall in US exports to China (through to August), contributing to a slowdown in total US export growth (although it is only modest and given

the volatility in the data, the extent is uncertain). Imports from China have also slowed but overall import growth is largely unchanged (and in price adjusted terms is actually trending up). Tariffs discourage trade flows but there will be a degree of trade diversion to other countries and supply chains will adjust slowly, mitigating or delaying the impact.

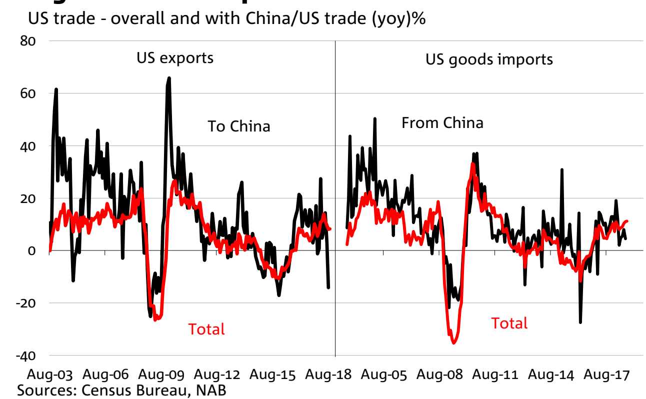
Over the year to September 2018, the USD dollar (on a trade-weighted basis), has appreciated by 6.9% (and by over 4% against the Yuan). In isolation this is a negative for US exports, and support imports, but we expect the USD to weaken modestly out to 2020. Overall, we expect net trade to make a small negative contribution to growth over the forecast period, in part due to the current strength of the US economy.

Looking at macro policy settings, both fiscal and monetary policy are on paths that will slow the US economy over coming years. The Fed has been raising the federal funds rate for a while but with rates still below their 'neutral' level (as best as can be determined) policy settings are still supporting above trend growth. However, with inflation back at target and unemployment lower than the Fed thinks is sustainable over time, we expect the Fed will continue to gradually raise rates through much of next year, with the federal funds rate to peak at around 3.5%. The Fed is likely to pause at this point as, absent significant inflationary pressures, it will try to avoid the risk of pushing too far and triggering a recession.

While the Fed has been reducing the support to growth from monetary policy, fiscal policy has provided a big boost this year. Not only were there large tax cuts, but also an increase in spending. However, IMF projections suggest that fiscal stimulus will be smaller in 2019 and even turn negative in 2020. However, fiscal policy is subject to change and next month's Congressional elections will have a big bearing on what happens in practice.

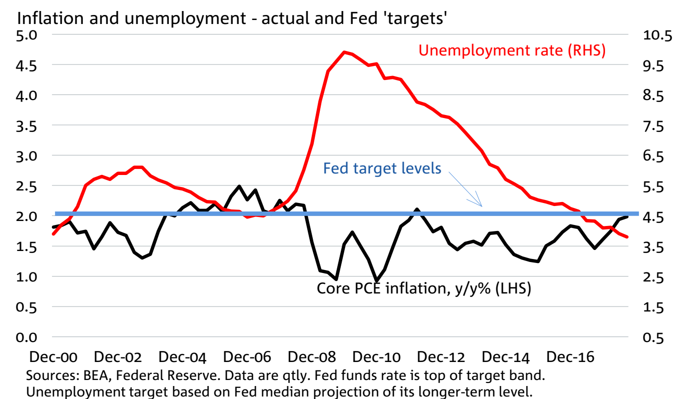
Overall we expect growth of 2.9% in 2018 (revised up from 2.8%), with the economy set to slow in 2019 (2.3%) and 2020 (1.6%). The 2020 growth rate is below our estimate of the economy's trend potential growth rate, and reflects monetary policy turning restrictive, and the absence of a fiscal policy tailwind.

Large fall in US exports to China



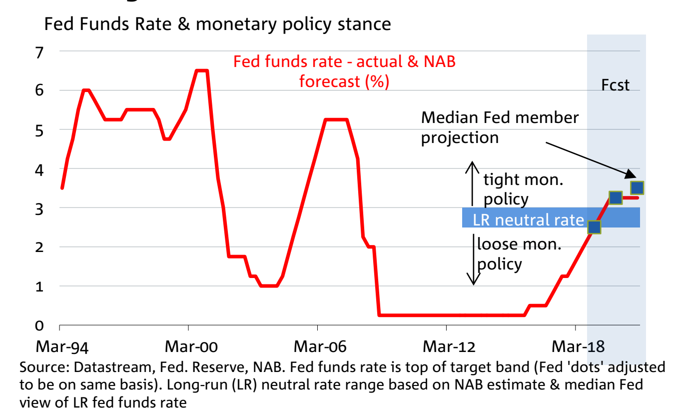
Sources: Census Bureau, NAB

Inflation at target, below target unemployment…



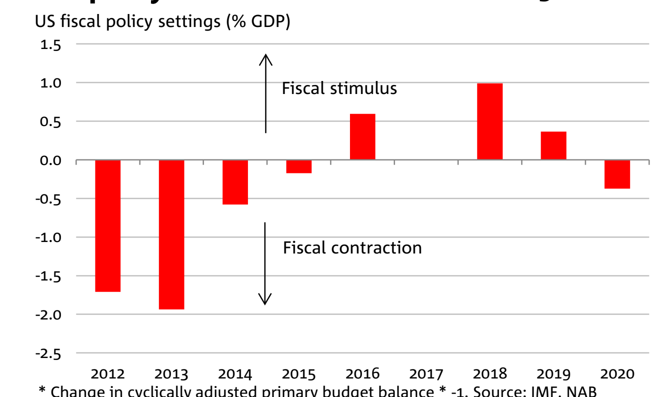
Sources: BEA, Federal Reserve. Data are qtly. Fed funds rate is top of target band. Unemployment target based on Fed median projection of its longer-term level.

…means gradual rate rises to continue



Source: Datastream, Fed. Reserve, NAB. Fed funds rate is top of target band (Fed 'dots' adjusted to be on same basis). Long-run (LR) neutral rate range based on NAB estimate & median Fed view of LR fed funds rate

Fiscal policy tailwind set to fade from 2019



* Change in cyclically adjusted primary budget balance * -1. Source: IMF, NAB

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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	2.7	2.4	1.5	0.6	1.0	0.1	0.9	1.0	**0.7**	**0.5**	**0.5**	**0.4**	**0.4**
Private fixed investment	1.7	4.8	5.0	2.7	2.0	0.6	1.5	1.9	1.6	-0.1	**0.7**	**0.7**	**0.8**	**0.7**	**0.5**
Government spending	1.4	-0.1	1.8	2.8	1.7	-0.3	0.6	0.4	0.6	0.8	**0.8**	**0.8**	**0.7**	**0.6**	**0.5**
Inventories*	-0.6	0.0	0.1	0.1	0.0	0.3	-0.3	0.1	-0.4	0.6	**-0.1**	**0.0**	**-0.1**	**0.0**	**0.0**
Net exports*	-0.4	-0.4	-0.3	-0.3	0.0	0.0	-0.3	0.0	0.3	-0.5	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**1.6**	**2.2**	**2.9**	**2.3**	**1.6**	**0.7**	**0.6**	**0.5**	**1.0**	**0.9**	**0.6**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*2.8*	*2.3*	*2.2*	*4.2*	*3.5*	*2.3*	*2.1*	*1.9*	*1.8*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.6	1.8	2.1	2.0	2.2	0.4	0.7	0.6	0.5	0.4	**0.6**	**0.6**	**0.4**	**0.4**	**0.6**
Core	1.8	1.6	2.0	2.2	2.2	0.4	0.5	0.5	0.5	0.4	**0.5**	**0.6**	**0.5**	**0.5**	**0.6**
Unemployment rate - qtly average (%)	**4.7**	**4.1**	**3.6**	**3.4**	**3.6**	**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

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