US ECONOMIC UPDATE NOVEMBER 2018

Economy still on track but Fed policy uncertainty is rising

NAB Group Economics

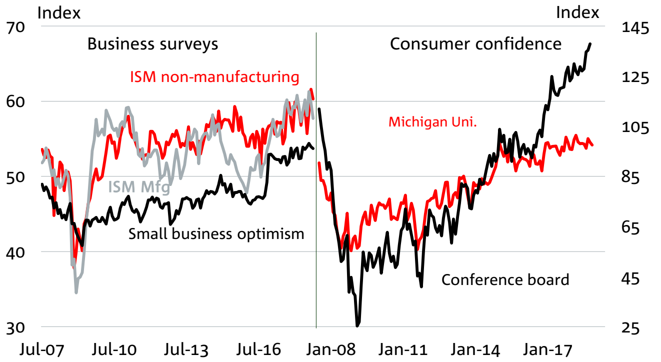
Initial indicators for Q4 suggest the economy continues to perform strongly towards the end of 2018. The recent large decline in equity prices is a concern, although increases in other measures of financial stress are not yet at worrying levels. As the Fed funds rate moves closer to the Fed's view of its neutral level, uncertainty around the timing, and extent, of increases in rates is likely to increase.

Overview

Early indicators suggest that the economy continues to perform strongly in 2018Q4 notwithstanding the recent large falls in equity markets. While we expect the economy to slow from its recent strong growth rates, it should remain at an above trend rate over the next year or so, resulting in further falls in the unemployment rate.

Business surveys and measures of consumer confidence provide the timeliest indication of how the economy is tracking, and they remain elevated.

Business & consumer surveys remain strong



Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, NFIB (index divided by 2).

While there has been some recent softening in capex orders, indicators of future investment plans remain high. However, there was a large fall in the National Association of Home Builders survey in November, suggesting that the weakness in residential investment is set to continue, likely due to increases in mortgage interest rates.

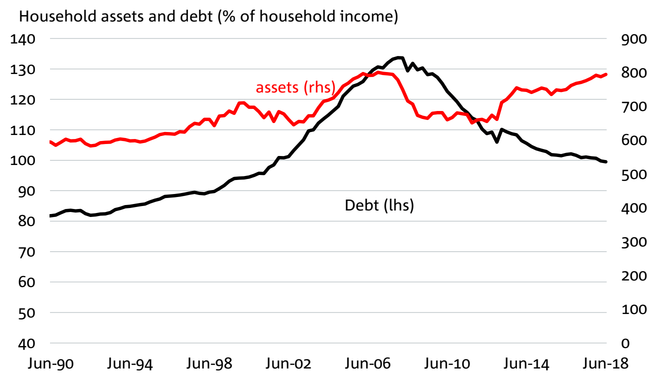
While the activity indicators suggest momentum in the economy is still positive, recent falls in equity markets could be a warning of emerging risks. At the time of writing, the S&P 500 is around 10% below its September peak. Declines in equity markets may signal that the economic outlook has deteriorated. They may also affect the economy directly, including by lowering household wealth and, as a result, consumption.

October fall in equities

Source: ThomsonReuters Datastream. Data to 16 November 2018

The fall in equities need to be seen in the context of solid household balance sheets. While data are only available to Q2 June 2018, equity prices are only a little below their mid-year level and house prices are continuing to rise. With consumer sentiment holding up, any significant impact on consumption is likely to be limited; indeed October retail sales pointed to ongoing solid consumer demand.

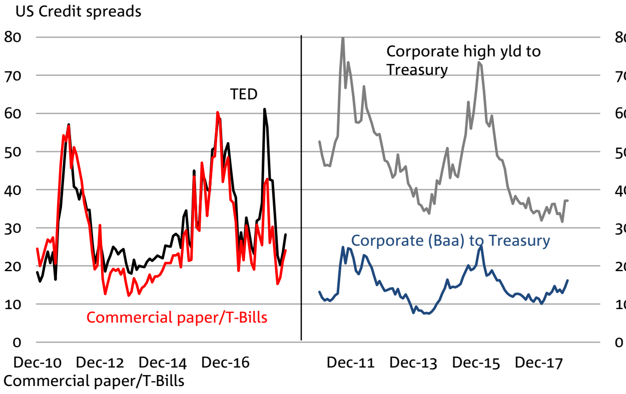
Household balance sheet in good shape



Sources: Federal Reserve, NAB

The fall in equity markets has also been accompanied by a rise in financial market volatility, and some widening in credit spreads. To date the widening in spreads has not been dramatic, but nonetheless still indicates there has been some tightening in financial conditions. It remains to be seen whether the recent moves in financial markets are sustained or, like earlier in the year, prove to be transitory.

Spreads up but not to particularly high levels



Apart from equity markets, the other big fall over the last month or so has been in global oil prices. Lower oil prices probably have greater implications for individual sectors (and regions) of the economy than they do for aggregate growth. If the falls are sustained they will lead to lower business investment but will provide a boost to household consumption. At this stage, our oil price forecast sees much of the recent weakness being reversed, but we will continue to monitor developments.

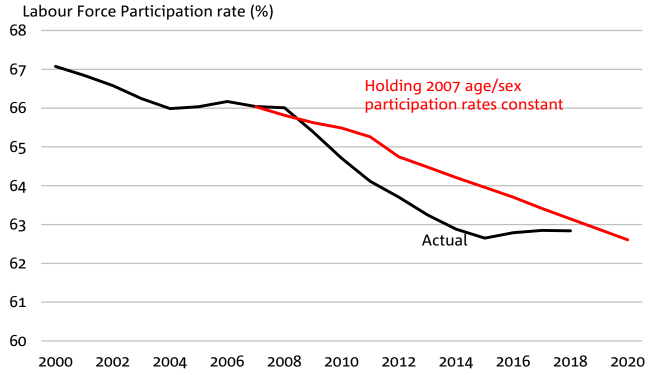
We expect GDP growth of 2.9% in 2018, then slowing to 2.3% in 2019 and 1.6% in 2020. This partly reflects monetary policy tightening and a fading tailwind from this year's tax cuts and budget deal.

We also expect supply constraints to increasingly weigh on growth. October employment growth of 1.7% yoy was well above the estimated growth in population over the same period (1.0%) and with the unemployment rate at its lowest level since 1969, and already below measures of 'full employment'.

Over recent years, increases in workforce participation have boosted labour market capacity. As the labour market has tightened and wages growth has risen, the 'encouraged worker' effect has seen additional workers enter the labour market, reversing some of the post-GFC slump in participation.

At some point the encouraged worker effect will wane and the underlying demographic trends (such as ageing) that have been pushing workforce participation down since 2000 will become more apparent. The red line in the chart below shows what the participation rate would have been if pre-GFC (2007) participation rates by age and sex were applied to the actual (and projected) population mix. It suggests that the participation rate is now about where the underlying demographic trend indicates it should be. Given this, we think the cyclical recovery in workforce participation has largely run its course and the downwards trend will soon resume, constraining labour supply growth.

Workforce participation recovery nearing its limit



Source: Datastream (BLS), NAB. 2018 actual based on first 10mths of the year.

Participation rates by age and sex are not constant over time, so our estimate of the underlying trend may be too low or high. However, with wages growth now more clearly showing signs of accelerating – making being part of the workforce more attractive – and reports indicating employers are open to a wider range of employees than before (such as felons), an upside risk to our outlook is that the workforce grows more quickly than we expect.

The US-China trade dispute remains a downside risk. While the US and China are at least talking to each other again, recent sparring suggests no resolution is close. With US tariffs set to increase automatically in January, the risk appears tilted towards further escalation.

Monetary policy outlook

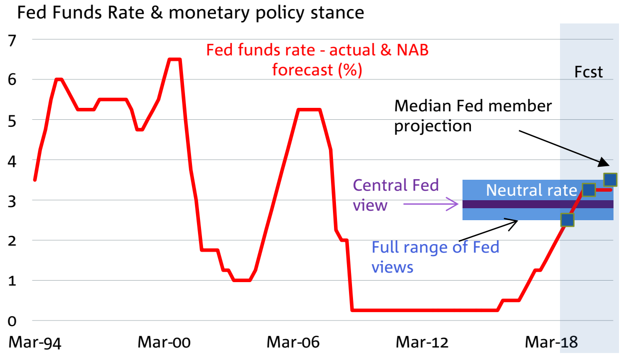
Our central projection is that the Fed will again increase the Fed funds rate at its December meeting, and then by a further three times in 2019, before pausing.

With the unemployment rate already below the Fed's view of its non-inflationary level, the Fed is likely to move to a modestly restrictive monetary policy stance, slowing the economy below its trend rate. We also expect core (ex food and energy) PCE inflation to reach as high as 2¼% yoy, although this is in part due to a number of temporary factors – tariff increases and our expectation of modest USD depreciation over the next few years – which the Fed will look through unless they lift inflation expectations. This lack of strong upswing in inflation limits the need for the Fed to be overly aggressive.

Our outlook is broadly similar to the Fed's September median member projection, albeit we have one less hike factored in. There appears to be a mix of views within the Fed whether they should aim to lift rates to a 'neutral' or higher ('restrictive') level.

What constitutes a neutral policy setting (i.e. the fed funds rate consistent with trend GDP growth), let alone a 'modestly restrictive' one is unclear. Up to now, it has seemed pretty obvious that interest rates were 'loose' and needed to be tightened. But with the top of the fed funds rate target range now at 2.25% it is almost within the range of Fed member views of its 'neutral' level. While the majority of Fed members think the neutral rate is higher – at around 2.75-3.00% – there is a great deal of uncertainty around estimates of this threshold.

Fed approaching 'neutral'?



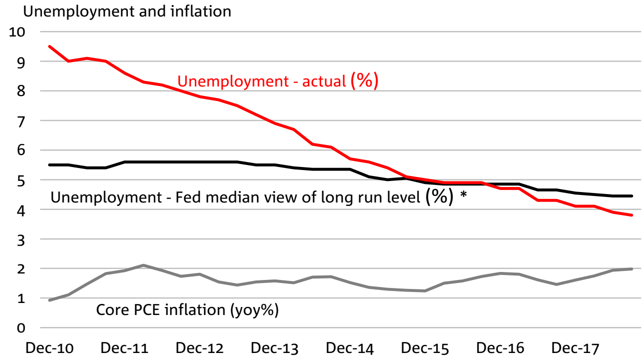
Source: Datastream, Fed. Reserve, NAB. Fed funds rate is top of target band (Fed 'dots' adjusted to be on same basis).

In this environment, more uncertainty is likely to creep into the timing of expected future rate moves; a change from the last two years of a regular schedule of quarterly tightening announcements. The Fed will likely become more sensitive to the ups and downs in the data flow. For example, if the economy starts to slow more than expected, then that would raise a query whether the neutral rate is lower and policy already tight. Even if they think it is only temporary weakness, the Fed may become more inclined to wait for evidence that this is the case.

Apart from the exact timing of rate increases, there are, as normal both upside and downside risks to our central forecast.

A key risk on the upside would be stronger than expected inflation arising from the emerging supply constraints in the economy. A larger than expected decline in the unemployment rate may also further raise concerns over a build-up in inflationary pressures. However, as the unemployment rate has steadily moved down in recent years to what is now a very low level, with only a very muted inflation response, the Fed's view of what level of unemployment is consistent with stable inflation has also shifted down. This suggests that higher core inflation will increasingly become necessary to make the Fed more aggressive.

Fed's view of sustainable unemploy. rate falling



Sources: BLS, BEA, NAB. *prior to Q3 2015 mid-point of central tendency used.

On the downside, events such as the recent movements in financial markets (stock prices down, volatility and spreads up), particularly if sustained, may give the Fed reason to pause; even if only because the resulting tighter financial conditions means part of the Fed's job is already done. That said, a December 2018 hike still looks likely, but it may bring forward Fed deliberation as to how it will go about setting (and communicating its intentions) policy in an environment where the path (and even direction) for policy will become more uncertain.

Another downside risk to our Fed track includes a faster than expected slowdown in the economy or concerns over the outlook. For example, this could be triggered by adverse overseas developments if they were of sufficient magnitude to raise concerns over the future strength of US growth.

Further increases in US-China tariffs (or a broadening out of the trade war) present both upside and, more likely, downside risk to our fed funds rate call. With the tariffs perceived a negative for the economy the Fed might move to a lower expected path for the fed funds rates. However, if the otherwise temporary inflationary effects of the tariffs were to lead to a jump in inflation expectations, then the Fed may raise rates to head off the possibility of these expectations becoming entrenched. That said, with inflation expectations still relatively low the Fed could easily tolerate some increase, and the potential fallout from a trade dispute could mitigate the direct price impacts of tariffs – e.g. lower demand reducing inflationary pressures or a fall in commodity prices.

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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	2.5	1.5	0.6	1.0	0.1	0.9	1.0	**0.7**	**0.6**	**0.5**	**0.4**	**0.4**
Private fixed investment	1.7	4.8	5.0	2.5	2.0	0.6	1.5	1.9	1.6	-0.1	**0.7**	**0.7**	**0.7**	**0.6**	**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*	*2.2*	*1.9*	*1.8*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.6	1.8	1.9	2.2	2.2	0.4	0.7	0.6	0.5	0.4	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**
Core	1.8	1.6	1.9	2.2	2.2	0.4	0.5	0.5	0.5	0.4	**0.4**	**0.5**	**0.5**	**0.6**	**0.6**
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**	**3.4**	**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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