US ECONOMIC UPDATE DECEMBER 2018

Economy still in good shape but Fed to move more slowly next year

NAB Group Economics

National Australia Bank

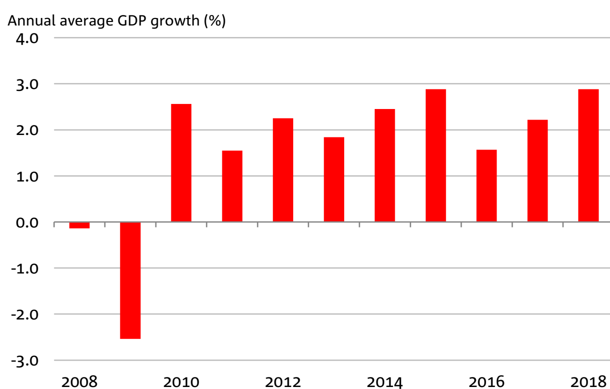
Economic growth is likely to equal its post-GFC high in 2018. Growth is expected to slow in 2019 but remain above trend, leading to further falls in the unemployment rate and a gradual lift in inflation. As a result, we expect further fed funds rate hikes, but have scaled back our expectations to two more increases over 2019 (from three) and now expect the fed funds rate to peak at 3.0% (previously 3.25%).

A look back and forward

In 2018, GDP growth is likely to achieve the equal highest growth rate seen in the expansion that has followed the GFC.

Underpinning this strong result has been solid household consumption growth, as well as another year of robust business fixed investment (the strongest in four years in annual average growth terms).

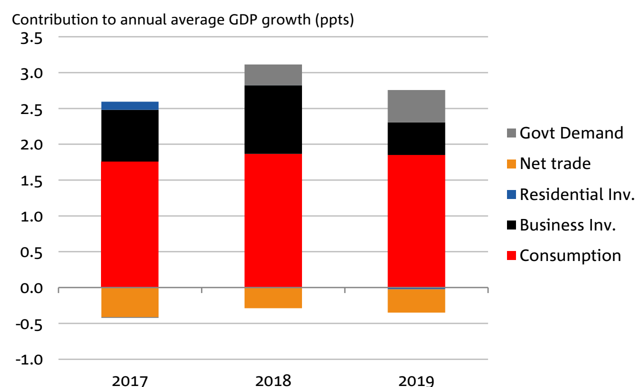
2018 growth set to be equal fastest since GFC



This year's strong performance, followed a step up in GDP growth in 2017, suggesting already decent underlying momentum as we started the year. This was given a boost by fiscal stimulus – in the form of tax cuts early in the year and increased government spending (which is still coming through). Net exports detracted from growth – with the strength of US domestic demand pulling in imports and US dollar appreciation weighing on external competitiveness – but only to a similar degree as in 2017.

One area of weakness was residential investment, which declined through 2018 following mortgage rate increases and with vacancy rates edging up as new apartment supply remained elevated. However, it is a fairly modest correction so far; over the first three quarters of this year the average quarterly decline has been 0.6%, compared to the 5% per quarter falls that started in mid-2006. With residential investment only having a small share of the economy (a bit over 3%) the resulting drag on growth is small.

Expect slower, but still above trend growth in '19



In 2019, we expect growth to slow to around 2.3% (annual average terms), which is still a solid, above trend pace.

A strong labour market producing upwards pressure on wage growth, coupled with solid household balance sheets, will support household consumption. In annual average terms we expect similar growth in consumption in 2019 to that seen in 2018, but over the course of the year growth is expected to slow as the impact from last year's tax cuts fades.

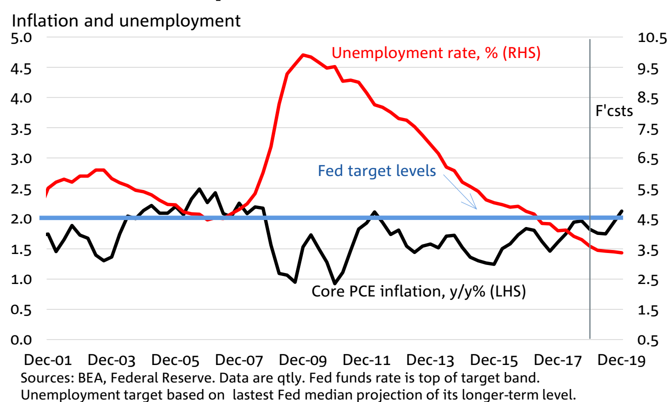
We also expect business investment growth to slow in 2019, despite still high levels of corporate profits. As labour markets tighten further, generating additional wage pressure, some tightening in margins is likely. Another factor will be the likely absence of a large ramp up in mining sector investment; from end 2016 to mid-2018 mining structures investment accounted for almost one-quarter of the increase in business fixed investment. However, mining investment slipped in 2018 Q3 and will come under further pressure given the recent falls in oil prices. While we see oil prices moving back

up in 2019, on average we don't expect them to be significantly different to 2018. Further, trade (tariff) uncertainty is likely to weight on business sentiment, possibly delaying some investment.

We expect housing investment to again be soft, although don't see the peak for long-term yields (a key driver for rates for many US mortgages) being that much higher than it reached in November 2018. So while recent falls in mortgage rates may only be temporary, the still strong labour market, and signs household formation is picking up, suggest that the housing correction will remain orderly.

With growth still above trend, we should see further falls in the unemployment rate through to mid-2019 before it stabilises at a low level. Declining spare capacity in the economy, coupled with our expectation for modest dollar depreciation, is likely to mean that the gradual upwards drift in core inflation seen over recent years continues. We continue to factor into our inflation forecasts a lift in the tariff rate on around $200b of imports from China, from 10% and 25%, treating the 90 day ceasefire as a temporary truce.

Unemployment falling and a gradual trend up in core inflation expected



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

That said, reports suggest a more positive tone to recent US-China negotiations. This suggests that there is a possibility that trade tensions could abate with no new tariffs put in place and, potentially, some trade measures rolled back (as China has announced it will do with auto tariffs). On the other hand, given the scope and complexity of issues under negotiation, it is also possible talks will break down and tariff measures escalate. Apart from direct trade effects, a key uncertainty remains how business sentiment is impacted, with the risk that a lack of clarity on future trade relationships (not just with China, but also the EU and Japan where negotiations are underway) leads to investment being delayed.

While trade has been considered the top risk this year, there are of course a range of other risks that could shape the outlook. On the upside, it is possible that the impact from this year's fiscal stimulus will linger longer than we are factoring in, or that a shortage of labour drives businesses to increase investment.

Upside and downside risk for 2019 growth

Upside risks	Downside risks
Fiscal stimulus impacts persist	Markets risk-off attitudes persist – higher credit spreads, stocks fall further
Labour shortages stimulates business investment	Global growth slowdown more rapid than expected
	US politics – govt. shutdowns, debt limit
Fed pauses in 2019	Fed has overestimated 'neutral' & tightens too far
US-China tariffs wound back	US-China disputes escalates further
	Impact of existing trade measures and negotiations on business investment more than expected

Monetary policy (discussed further below) is a dual sided risk depending on whether the Fed tightens too much or too little. Relatedly, if the recent increase in market volatility, declines in equity prices and increases in credit spreads were to persist or even worsen, this will have negative effects on household wealth, credit conditions and sentiment.

Another downside risk includes the possibility that the global economy is slowing more rapidly than we are projecting. There is also the risk that Congressional deadlock (or Presidential veto) leads to a government shutdown or a battle over the debt limit, spooking financial markets as the risk of US government default rises, and making businesses and consumers more cautious.

Monetary policy

As expected, the Fed raised the federal funds rate at its December 2018 meeting. This was the fourth increase this year, lifting the target range to 2.25- 2.50%. However, at the same time the Fed lowered expectations for the number of increases in 2019. The median projection for the fed funds rate at the end of 2019 fell from 3.125% to 2.875% (mid-point of target range). The median view is for a single hike to follow in 2020, taking the fed funds rate to 3.125%, but this is a line ball call as it would only take one member to change their mind to lower the median to no change.

In line with the modest shift in the dots, the meeting statement now talks about 'some further gradual increases', whereas previously there was no qualifier ('further gradual increases').

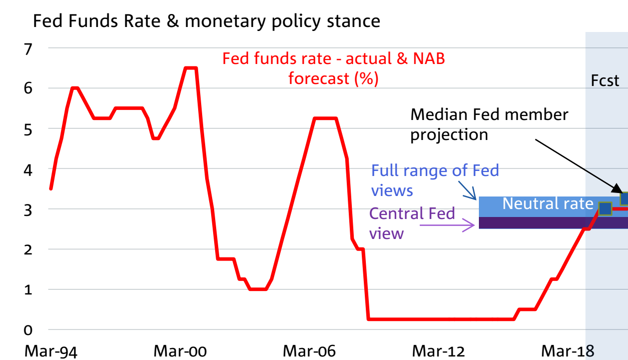
Markets reacted negatively to the decision as, while they had largely priced in a rate hike, they thought

the statement would send a more dovish signal about future action.

However, the changes to the fed funds rate projections reflect relatively modest downward changes to the Fed's view of GDP growth and inflation. The revised projections still point to an economy experiencing above trend growth through to 2020, an unemployment rate below the Fed's view of its sustainable level, and core inflation at target.

In this sort of environment, a central bank with a dual employment and inflation objective would be expected to move to a restrictive policy stance, and this is what they are projecting. The median view of the fed funds rate 'neutral' level also dropped 25bps to 2.75% and so the Fed continues to project a fed funds rate peak 30-40bps above neutral.

With Fed at or close to 'neutral' rate hikes to slow



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

Of course, actual moves in the fed funds rate will be dependent on expectations for activity, unemployment and inflation being realised. Moreover, there is a large degree of uncertainty over what the 'neutral' fed funds rate actually is. Ahead of the December meeting Fed officials had signalled that, as it moved to within the range of views of its 'neutral' level, it would become increasingly 'data 'dependent'. In effect, it will become more reactive to the ups and downs in the data flow than it has over the last couple of years where policy was tightened every quarter (either through rate increases or announcing a winding down of QE).

As with the Fed, we have adjusted our expectation for the number of rate hikes down from three to two. Our forecasts have economic growth coming back to its trend rate (and then moving below this) earlier than the Fed's. Accordingly we do not expect to see any rate hikes in 2020, leaving the top of the fed funds target range at 3.0%.

We do not expect the next move in rates to be until Q2 2019. This reflects the volatility in financial markets, greater than normal uncertainty around the outlook for the global economy, and recent relatively soft inflation prints. While we expect inflation to gradually move higher over time, the Fed may want to see several months of data to validate that view.

All this adds up to a temporary 'pause' in Q1 2019, although if the economic data perform strongly early in 2019 a move in Q1 cannot be ruled out.

As always, there are a range of risks around the forecast for the fed funds rate. These principally revolve around whether the growth/unemployment and inflation projections are realised or not. Recent soft inflation prints point to the possibility that inflation will remain at a below 2% pace through the forecast horizon, which would suggest little need for further rate increases.

On the other hand, the risk remains that increasingly tight capacity constraints will cause inflation to accelerate at some point down the track.

The Fed also continues to track various measures to see whether financial imbalances are rising; if they become concerned on this point this could be a trigger to move more aggressively.

Stretched asset valuations, such as for equities, represent one possible financial imbalance. However, as recent events show, this can go the other way. The recent large falls in the stock market (and other market pricing) represent a tightening in financial conditions. If this was to intensify, the Fed may consider the market has done its job for it and hike less over 2019.

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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	2.7	1.7	0.6	1.0	0.1	0.9	0.9	0.8	0.6	0.6	0.5	0.4
Private fixed investment	1.7	4.8	5.2	2.2	1.8	0.6	1.5	1.9	1.6	0.3	0.5	0.5	0.5	0.5	0.5
Government spending	1.4	-0.1	1.7	2.5	1.8	-0.3	0.6	0.4	0.6	0.6	0.8	0.7	0.6	0.6	0.5
Inventories*	-0.6	0.0	0.1	0.0	-0.1	0.3	-0.3	0.1	-0.4	0.7	-0.1	0.0	-0.1	0.0	0.0
Net exports*	-0.4	-0.4	-0.3	-0.3	-0.1	0.0	-0.3	0.0	0.3	-0.6	0.0	-0.1	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	0.5	0.4
Note: GDP (annualised rate)						*2.8*	*2.3*	*2.2*	*4.2*	*3.5*	*2.3*	*2.1*	*1.9*	*1.9*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.6	1.8	1.8	2.2	2.2	0.4	0.7	0.6	0.5	0.4	0.3	0.5	0.6	0.6	0.6
Core	1.8	1.6	1.8	2.1	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	3.5	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	3.00	3.00	1.25	1.50	1.75	2.00	2.25	2.50	2.50	2.75	3.00	3.00

Source: NAB Group Economics

*Contribution to real GDP growth

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