US ECONOMIC UPDATE JANUARY 2019

Market turbulence to weigh on growth in 2019

NAB Group Economics

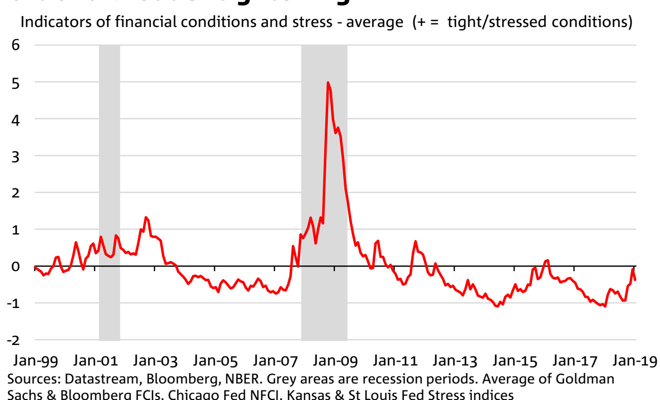
The significant tightening in US financial conditions since October is expected to weigh on US growth over 2019. A partial US government shutdown and slowing global growth add to the headwinds. While growth may move modestly below trend for a period, recession fears are overblown. One consequence is that the Fed is likely to be on hold for the rest of the year.

Since the end of September there has been a significant tightening in US financial conditions. This has been most evident in US equities which, from their peak in September, fell by as much as 20%. Even with some recent recovery, they are still down around 9%.

Equities highlight shift in US financial conditions

Source: ThomsonReuters Datastream. Data to 18 January 2019

Part of a broader tightening

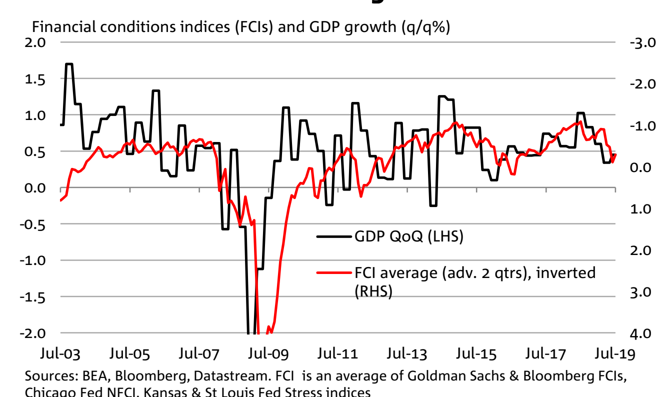


Sources: Datastream, Bloomberg, NBER. Grey areas are recession periods. Average of Goldman Sachs & Bloomberg FCIs, Chicago Fed NFCI, Kansas & St Louis Fed Stress indices

There was also a fall back in stock prices early in 2018 and yet the US economy looks to have achieved its strongest performance (measured by annual GDP growth) since the GFC. However, in contrast to the early 2018 episode, the decline this time around in stock prices has been larger and more sustained.

More importantly, broader measures of financial conditions – which can include variables such as the currency, credit spreads, yields, market volatility as well as the stock market – have experienced their largest tightening since the period from early 2015 to early 2016. GDP growth in 2016 ended up being the equal lowest seen since the GFC.

Similar tightening in conditions in 2015/16 associated with slower GDP growth



Sources: BEA, Bloomberg, Datastream. FCI is an average of Goldman Sachs & Bloomberg FCIs, Chicago Fed NFCI, Kansas & St Louis Fed Stress indices

In our recent report NAB Research on Yield Curves we looked at the message coming from various models of US economic activity – which utilise variables such as the yield curve (or real interest rates) as well as asset prices, FX, oil prices and an indicator of credit supply. The clear implication of these models is that US economic growth is set to slow noticeably into the second half of 2019, but they also suggest that recession fears are overblown.

How much growth slows in these models is in part dependent of assumptions made about the future path of the variables including equities. Assuming that the recent partial recovery in equity prices will be sustained, they still point to growth slowing through to Q3 2019. Growth then recovers towards

the end of the year and into 2020 as benefits from lower oil prices start to come through.

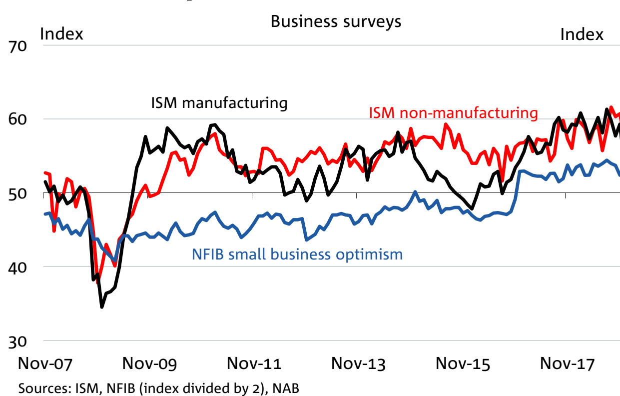
Factors weighing on the US economy include a Government shutdown and slower than expected growth overseas, including in the Euro-zone. When the partial US government shutdown will end is highly uncertain; our forecasts assume it will be relatively soon, resulting in largely temporary impacts (reducing Q1 growth but boosting Q2 as Federal employees return to work). The longer it goes on, not only will these temporary growth swings be larger but it also risks more longer lasting damage to growth as private firms impacted put plans on hold or financial markets become destabilised.

As a result, we have decided to lower our year-average GDP growth forecast for 2019 from 2.3% to 2.1%. At the same time we have revised up our 2020 forecast from 1.6% to 1.8%.

The fall in growth in 2020 in year-average terms is a bit misleading – 2019 growth is supported by the base effects from a strong H2 2018. Comparing growth over the year (i.e. Q4 against Q4 of the preceding year) we now expect growth over 2020 to be higher than over 2019 as the shock from the recent tightening in financial conditions fades and as a mild depreciation in the US dollar boosts trade competitiveness. Moreover we expect an extended pause in the fed funds rate at what is likely a below neutral level.

As always there are a range of risks around these forecasts. On the upside, it is possible that the real economy holds up better in the face of the deterioration in financial conditions. Business surveys provide mixed evidence on this score – while softening recently, significantly so in the case of the manufacturing ISM, they still remain at levels consistent with solid growth. It is also possible that equity prices could rebound more strongly than we expect; a possible trigger for this could be a US/China trade deal (even if it is only partial, pushing discussions on some of the thorny issues down the track).

Business surveys still solid but have softened



Sources: ISM, NFIB (index divided by 2), NAB

Downside risks include the uncertain duration of the Government shutdown, the risk that trade news deteriorates (news reports have again raised the possibility of the US increasing auto tariffs), or continuing falls in global growth triggering further financial market disruption.

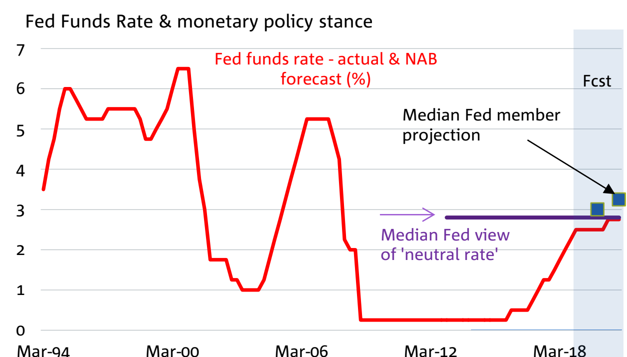
Monetary policy

Fed officials have recently indicated that they are prepared to be patient, pointing to a pause in Fed monetary policy tightening. In our December US Economic Update, we expected the Fed to be on pause until the middle of the year. However, if our revised growth forecasts prove to be broadly right we now expect the pause to extend into 2020.

The anticipated slowdown in growth is to below trend levels, but only modestly so and for a short period of time. As a result it shouldn't place any serious upwards pressure on unemployment. In this environment the Fed is likely to sit tight.

However, as growth recovers from late 2019 and into 2020, a combination of low unemployment and core inflation a little above target would be expected to lead the Fed to return rates to at least what they consider the 'neutral' level. With 2.75% being the current median Fed view of the 'neutral rate' this suggests a further hike in 2020 (which we have pencilled in for Q2 2020). Unless the still low unemployment rate starts to generate further inflationary pressures, the Fed is unlikely to have little need to lift rates above neutral.

Extended Fed pause in 2019; possible hike in 2020



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

Of course any forecasts made that far out are at the mercy of unexpected developments, including geo-political shocks. The rate hike factored in 2020 simply reflects the fact that the Fed will try and get to the economy back to trend and with rates at a neutral level (as it can best estimate). This should not distract from the key takeaway from our forecasts, which is that any further Fed action appears a long way off.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %										
						2018			2019				2020			
	2016	2017	2018	2019	2020	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components																
Household consumption	2.7	2.5	2.7	2.7	1.8	0.9	0.9	1.0	0.6	0.5	0.4	0.4	0.5	0.5	0.4	0.4
Private fixed investment	1.7	4.8	5.2	1.7	1.9	1.6	0.3	0.6	0.3	0.1	0.2	0.6	0.6	0.5	0.5	0.4
Government spending	1.4	-0.1	1.6	2.4	2.0	0.6	0.6	0.6	0.2	1.2	0.6	0.5	0.5	0.5	0.5	0.5
Inventories*	-0.6	0.0	0.1	0.1	0.0	-0.4	0.7	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.4	-0.4	-0.3	-0.4	-0.1	0.3	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	1.6	2.2	2.9	2.1	1.8	1.0	0.8	0.6	0.4	0.4	0.3	0.4	0.5	0.5	0.4	0.4
Note: GDP (annualised rate)						*4.2*	*3.4*	*2.4*	*1.6*	*1.8*	*1.4*	*1.8*	*2.0*	*1.9*	*1.7*	*1.7*
US Other Key Indicators (end of period)																
PCE deflator-headline																
Headline	1.6	1.8	1.9	2.0	2.2	0.5	0.4	0.4	0.3	0.5	0.5	0.6	0.5	0.6	0.5	0.5
Core	1.8	1.6	1.9	2.0	2.1	0.5	0.4	0.4	0.4	0.5	0.5	0.6	0.5	0.6	0.5	0.5
Unemployment rate - qtly average (%)	4.8	4.1	3.8	3.7	3.7	3.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
US Key Interest Rates (end of period)																
Fed funds rate (top of target range)	0.75	1.50	2.50	2.50	2.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.75	2.75	2.75

Source: NAB Group Economics

*Contribution to real GDP growth

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