US ECONOMIC UPDATE FEBRUARY 2019

Growth slowing

NAB Group Economics

Economic growth appears to have slowed at the end of 2018, and we expect some further slowdown into 2019, before growth stabilises later in the year. Tariff increases on Chinese imports delayed again but trade policy uncertainty likely to remain a factor. We expect the Fed to be on hold for the rest of the year, although the Fed is set to end the run-down in its balance sheet later in the year.

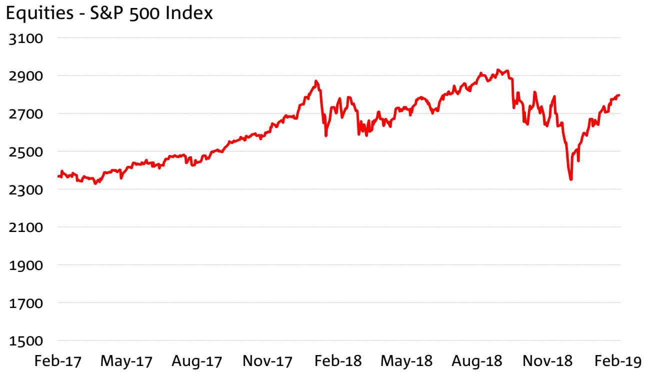
Economic Overview

After strong growth earlier in the year, the US economy appears to have slowed in the final quarter of 2018.

We expect to see some further slowing in underlying growth through much of 2019 before stabilising towards the end of the year. This reflects fading fiscal stimulus, past rate hikes by the Fed, a tightening in financial conditions more broadly, and a weakening in global growth. In response, the Fed has shifted its policy stance; now indicating that it will be 'patient' as it waits to get a clearer understanding of the economic outlook.

The end to the long-running Federal government shutdown and a downshift in Fed policy expectations has helped markets (partially) recover from their late 2018 tumble.

Recovery in financial markets from end '18 woes



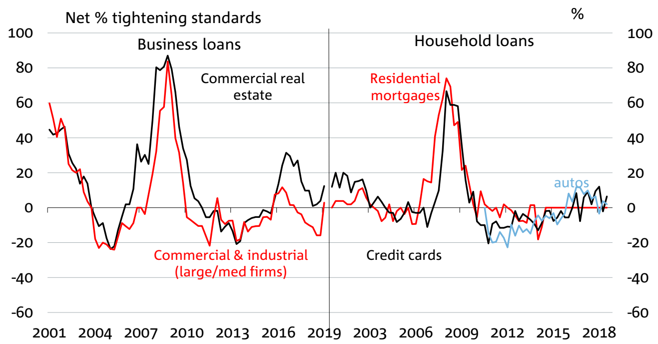
Source: ThomsonReuters Datastream. Data to 25 February 2019

The news that the US President will again delay a scheduled increase in tariffs on around $200b worth of Chinese imports – in the expectation that the US and China will be able to reach an agreement – is also a positive development. Our forecasts had been assuming that the increase in tariffs would occur in March, but with an unspecified delay, coupled with the possibility that they won't occur at all, we have now removed them.

The US President received a report on 17 February on possible auto tariffs, although the details have not been disclosed. There is a deadline of 90 days to adopt any recommendations, so the risk is that another trade spot fire may develop soon even if the China-US dispute was to settle down. As a result, we still expect trade policy uncertainty to remain an ongoing factor.

The turmoil in US financial markets in Q4 last year has also fed through into the bank system. The Fed's survey of loan officers suggests that in late 2018 there was an abrupt end to the recent easing in C&I loan standards, and standards for commercial real estate loans were tightened. Loan officers also indicated that they expect to generally tighten lending standards further over 2019.

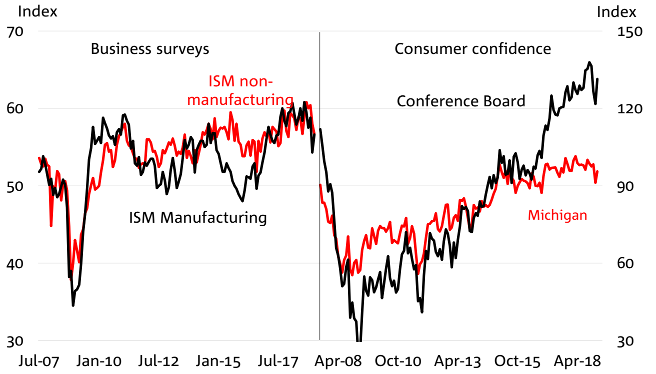
Market volatility spills over to bank lending standards



Source: Federal Reserve. CRE from Dec. '13 Qtr is a simple average of the 3 categories. Res. Mortgages 2007Q2: 2014 Q4 are prime & from 2015 Q1 average of GSE eligbile, Govt, QM non-jumbo, non-GSE eligible, QM jumbo

Business surveys and measures of consumer sentiment have softened in recent months. They still remain at solid levels, so whether the downwards shift continues (and for how long) will be the key; to that end regional Fed manufacturing surveys have been mixed for February so far while the consumer confidence indicators recovered some lost ground in February.

Surveys at solid levels but trajectory bears watching

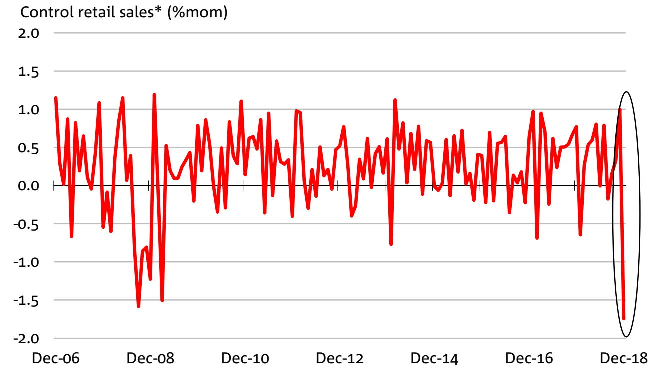


Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters

A more alarming signal came from the December retail sales report. Retail sales declined by 1.2% m/m and the 'control' measure (which excludes gasoline, auto dealers & building materials & food services) fell by a recession like 1.7%. It is unclear what could have caused such a precipitous fall in sales in an economy with still solid consumer sentiment and strong jobs growth with household budgets benefiting from a fall in gasoline prices. The wealth effects of falling equity prices are simply not that large.

Even with this very weak December retail reading, overall consumption is still on track to increase by a solid 0.7% q/q suggesting that the December result might have been in part a correction to exaggerated strength in previous months' results, as well as volatility in the data. So while we think the December retail sales decline is exaggerated, the broader message is that consumption growth is slowing.

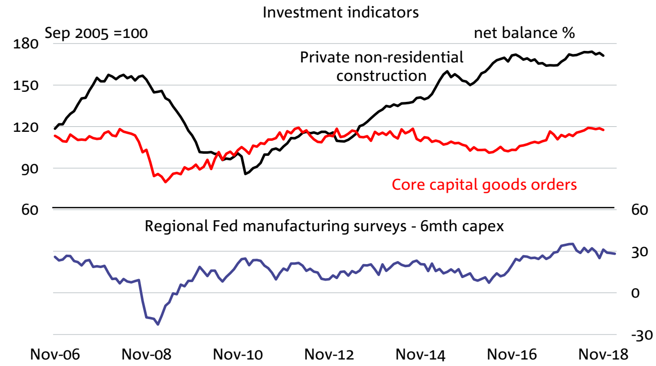
Recession like fall in December retail sales



Source: Census Bureau, NAB. * Retail sales ex gasoline, auto dealers & build. materials & food services

There has also been weakening in some – but not all – business investment indicators. Core (ex defence and aircraft) capital goods orders declined in Q4 2018, the first quarterly fall in two years, and there was also a fall in private non-residential construction in the quarter (based on data to November). However, Fed regional manufacturing survey measures show that capex intentions remain reasonably firm.

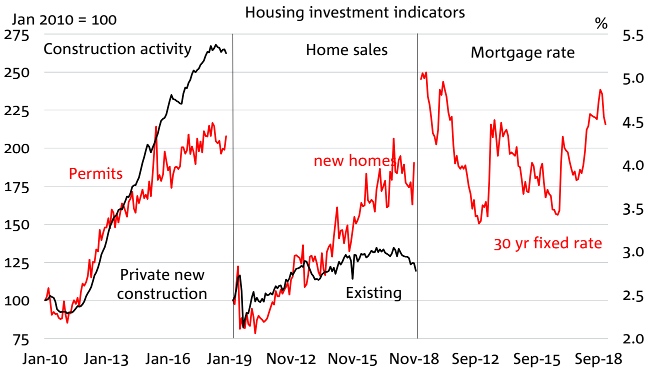
Mixed indicators for business investment



Source: Census Bureau; Kansas City, New York, Richmond, Dallas, Philadelphia Fed. Reserves, NAB

Residential investment has declined in recent quarters, weighed down by the rise in mortgage rates from mid-2016 to late 2018, and signs of increasing vacancy rates. Construction spending has been declining and house sales have fallen. However, while investment is likely to remain on the soft side in coming quarters, the recent decline in mortgage rates and the strength of the labour market, amid signs that more people are starting their own households, should help to stabilise activity later in the year.

Mortgage rate relief for struggling housing sector

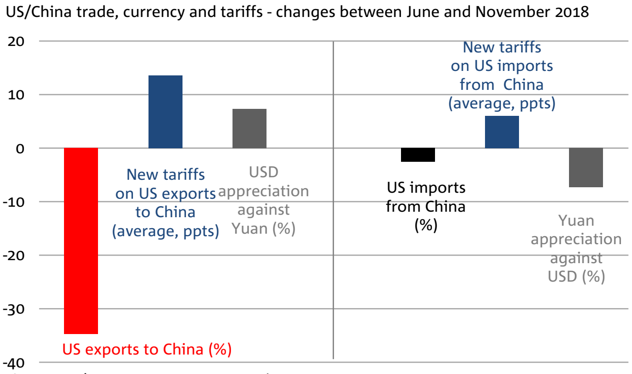


Sources: Census Bureau, Bloomberg, National Associatio of Realtors, NAB

Net exports made a large negative contribution to GDP growth in Q3, as exports fell while imports rose. However, trade data to November suggest a more neutral impact for Q4. The trade data – volatile at the best of time – are also being affected by the tariffs imposed over July, August and September by the US and China on imports from each other. Not only might this affect the level of trade, but the bring forward of trade to beat the tariffs might mean recent trade activity is artificially low.

In terms of bilateral trade, the impact on the US exports to China has been more significant than on US imports of Chinese goods. China's tariffs cover a greater proportion of US exports to China than have the US measures on imports from China. Moreover, between June and December the USD appreciated over 7% against the Yuan – this is broadly the same as the increase in the average tariff rate across all China imports ($50b at 25%, $200b at 10%, with the rest – over $250b – subject to no new tariffs) limiting the impact on China's overall competitiveness over this period.

US exports to China impacted by trade conflict



Sources: Thomson Reuters, NAB estimates

The large negative net export contribution to GDP growth in Q3 was offset by strong inventory accumulation. As with trade, we expect a reversal in Q4, with inventories likely to detract from Q4 growth. Another factor to weigh on Q4 GDP growth will be the Federal Government shutdown which started late in the quarter, although its impact should be modest (but somewhat greater in Q1 2019, with a rebound in Q2 2019).

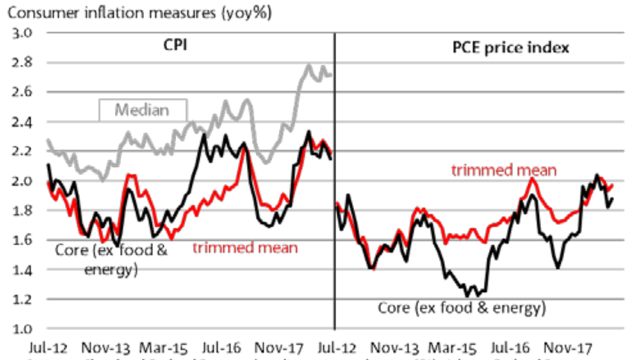
Overall, we expect Q4 GDP growth of 0.5% (2.1% annualised); this is well down on the previous two quarters, but is still above our estimate of longer-term trend GDP growth (around 1¾% per year). However, we expect growth to ease further through to Q3 2019, before stabilising towards the end of the year. Overall, we are projecting year-average GDP growth of 2.1% in 2019 and 1.8% in 2020.

Labour market indicators generally remain in good shape. Employment growth remains robust, and although the unemployment rate has ticked up in recent months to 4.0%, this may been affected by the US Federal government shutdown. That said, initial jobless claims have stopped falling and the slowdown in growth in our forecasts suggests further declines in the unemployment rate will be limited.

The tight labour market has brought with it stronger wages growth. Average hourly earnings of private non-farm employees grew by 3.2% yoy in January 2019 – up from 2.8% in January 2018 yoy and 2.4% yoy in January 2017.

Despite this, inflation is showing no signs of acceleration. On a headline basis, inflation has been declining due to lower gasoline prices, but most measures of core inflation have either stabilised since mid-2018, if not eased. The Fed's favoured core inflation measure – PCE (ex energy and food) was at the Fed's target of 2.0% in July but by November it had eased slightly to 1.9% yoy.

No sign of core inflation accelerating



Sources: Cleveland Federal Reserve (median, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB.

Monetary policy

In its January meeting statement the Fed indicated that it would be "patient", removing its previous guidance that it expected some further gradual rate rises. With the fed funds rate close to the (median) Fed view of its neutral level, no signs of inflation acceleration, and increased uncertainty around the economic outlook (both domestically and abroad) the Fed feels it can take its time to assess the state of the economy before making any further moves.

The January meeting minutes did suggested a continuing bias towards further rate rises – 'several' participants indicated that if the economy evolved as expected a rate hike would be justified, although 'several' other participants would need to see inflation above their expectations to make such a move. In contrast, there was no discussion of rate cuts, even as markets continue to price in a greater chance of a rate cut than a hike.

We are less optimistic about growth prospects in 2019 than the Fed, and can't see it increasing rates until growth stabilises. As a result we don't expect any changes in the Fed funds rate this year. We have pencilled in a rate hike for mid-2020 on the grounds that, when growth stabilises and with unemployment still low and inflation around target, the Fed will seek to move rates up to its view of neutral.

What is clearer is that the Fed is set to end the run-down of its balance sheet in the back half of 2019. The January minutes stated that "Almost all participants thought it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year."

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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	2.6	2.5	1.8	0.9	0.9	**0.7**	**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	1.8	1.9	1.6	0.3	**0.7**	**0.3**	**0.1**	**0.2**	**0.6**	**0.6**	**0.5**	**0.5**	**0.4**
Government spending	1.4	-0.1	1.6	2.3	2.0	0.6	0.6	**0.5**	**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**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.4	-0.4	-0.3	-0.3	0.0	0.3	-0.6	**0.0**	**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**	**0.5**	**0.4**	**0.5**	**0.3**	**0.4**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)						*4.2*	*3.4*	*2.1*	*1.6*	*2.0*	*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	1.8	1.9	2.1	0.5	0.4	**0.3**	**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**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**4.8**	**4.1**	**3.8**	**3.9**	**3.8**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.9**	**3.9**	**3.9**	**3.8**	**3.8**	**3.8**
US Key Interest Rates (end of period)																
Fed funds rate (top of target range)	0.8	1.5	2.5	2.5	2.8	2.0	2.3	2.5	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**	**2.8**	**2.8**	**2.8**
10-year bond rate	2.45	2.41	2.69	3.00	3.0	2.9	3.1	2.7	**2.8**	**2.8**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**

Source: NAB Group Economics

*Contribution to real GDP growth

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