US ECONOMIC UPDATE MARCH 2019

Still expecting a growth slowdown but no recession

NAB Group Economics

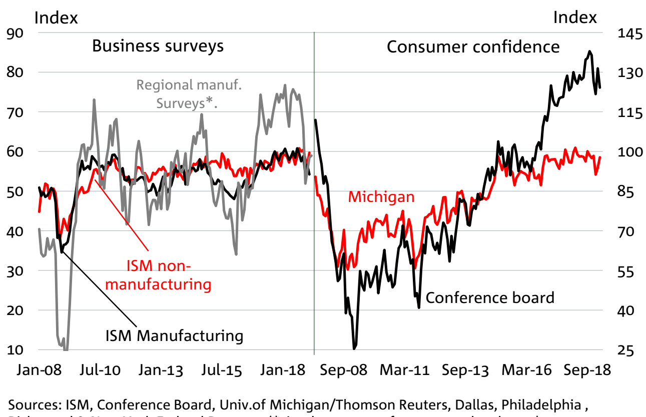
Early data point to a slowing in economic growth in Q1 2019, although business surveys remain generally solid. Inversion of the yield curve has raised concerns that the US will go into recession but our own modelling – which adds to the information content found in the yield curve – suggests that this is unlikely. The Fed's monetary policy stance has shifted and is less likely to react to a small overshoot of its inflation target; as a result we have removed our call for a Fed rate hike and now expect it to remain unchanged over 2019 and 2020 with both upside and downside risks around this outlook.

Economic Overview

Early data for Q1 2019 point to a further slowing in US economic growth. Consumption growth has softened as has business investment. Moreover, public demand in Q1 will be held back by the partial Federal Government shutdown that occurred through much of January.

Quarterly data can be volatile and in recent years the first quarter has tended to be weak. Against that backdrop, the business surveys provide a useful test of the underlying strength of the economy. Manufacturing surveys show that a slowing in the sector is underway – not surprising given the worldwide downturn – but that it is still growing. Moreover, survey results of the far larger services sector have held up and are at solid levels. Similarly, while consumer confidence has come off a little, it remains at a decent level or better.

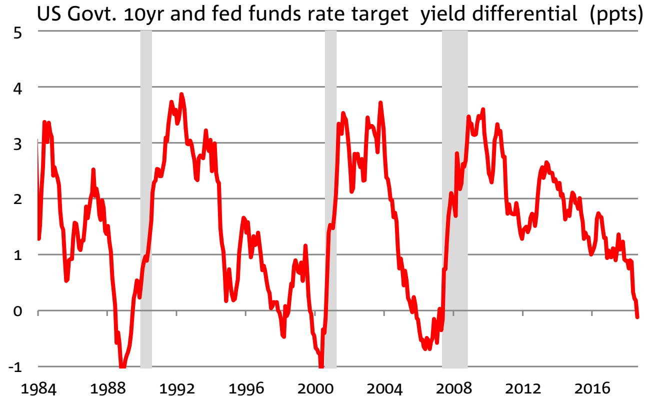
Business and consumer surveys generally solid



Sources: ISM, Conference Board, Univ.of Michigan/Thomson Reuters, Dallas, Philadelphia , Richmond & New York Federal Reserves (*simple average of survey results plus 50)

Nevertheless, concerns around the outlook for the US economy – particularly the possibility of a recession – persist. These concerns have recently come to the fore following a decline in the 10 year government yield sufficient to cause an inversion of the yield curve. Historically yield curve inversions have generally been followed by a recession around 1 to 1.5 years later since the 1980s (with some variation depending on the yield curve measure used).

Yield curve inversion in the past signals recession



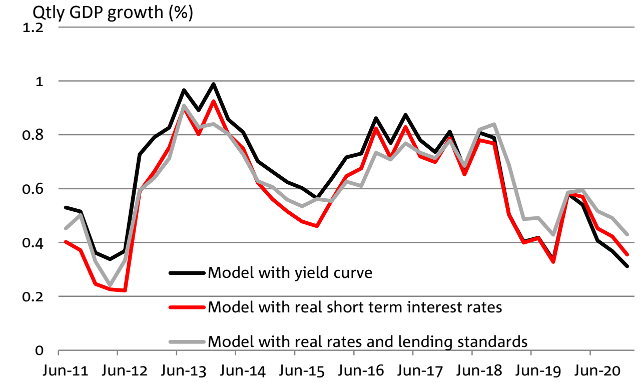
Grey areas indicate recession periods. Sources: BEA, NBER.

However, while there may have been an historical correlation in the past, this does not mean that there will necessarily be a recession this time around. Yield curves can move for a range of factors and not just due to concerns over the economic outlook and expectations of monetary policy. Moreover, not all measures of the yield curve have inverted – the 10yr/2yr differential remains positive (although in theory this is arguably less relevant) and in recent recessions the yield curve has inverted to a far greater degree than is currently the case.

In January we noted that the real information provided by the yield curve is a measure of excess tightening by monetary authorities. Moreover, while a useful 'recession alert' indicator, the signal from the yield curve can be improved by adding asset prices (for equities and housing) and other country specific terms. For the US these include oil prices and broader commodity price measures, as well as the exchange rate.

The results of our augmented yield curve model are shown below. Also shown are alternative models which replace the yield curve with real short-term interest rates and, in one case, also include a lending standards indicator.

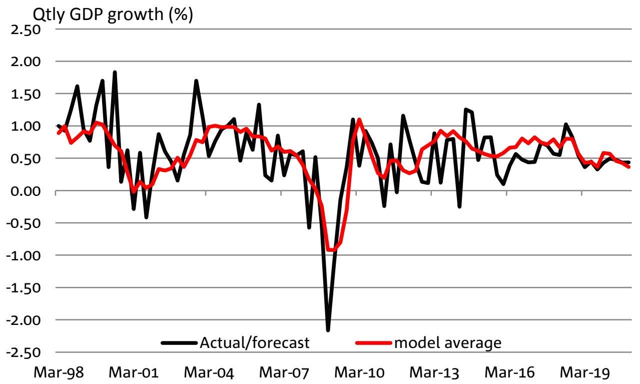
US GDP forecast models



Looking at an average of the different models and comparing to actual quarterly growth, we can see that the models do a reasonably good job of tracking the ups and downs in the US economy.

Directionally the models all have a broadly similar result and all point to a slowing in growth from last year's strong outcomes. The debate is how far the slowdown will go – recession (two quarters of negative GDP growth) or something more modest.

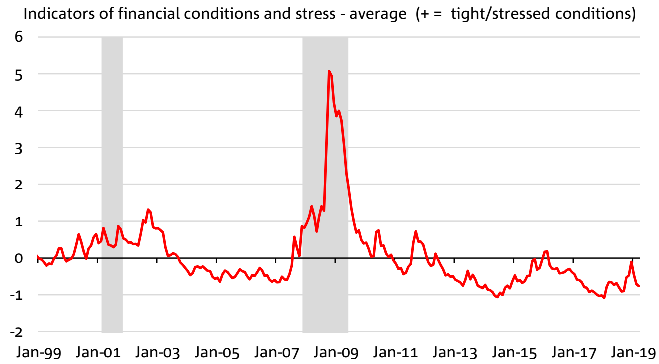
Models point to a slowdown but not a recession



As already noted, the similarity of the yield curve and real rates models results suggests that the bigger issue is whether the Fed has tightened too much. The Fed last lifted fed funds rate to 2.25-2.50% but has since indicated that it will pause. With core inflation around 2% this suggests a real rate of up to 0.5% which on the surface appears too low to trigger a major downturn in the absence of a sizable shock hitting the economy.

Since January, when we marked down our US growth outlook to take into account the major shift in US financial conditions over September to December, there has been a recovery in US equities, credit spreads and other indicators of stress have generally improved. A simple average of various measures of overall financial conditions has recovered much of the ground lost late last year (although they are still tighter than a year ago).

Financial conditions have eased in 2019



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

Against this, the global economy has been slowing faster than expected – with the Euro-zone and Japan particular concerns – and their outlook remains a major source of uncertainty.

Balancing out these different factors – an improvement in financial conditions and a slower than expected global economy – we are leaving our GDP growth forecasts unchanged at 2.1% in 2019 and 1.8% in 2020 in year average terms. Looking at growth in through the year terms (change on the same quarter a year ago) the trough is actually reached in late 2019 with some improvement in 2020.

Of course there are risks around this outlook. Trade policy remains a source of uncertainty. If, as expected, the US and China reach some sort of deal this could boost sentiment, but if it fails to materialise or if the US President raises tariffs on auto imports, sentiment could deteriorate. US fiscal policy will remain a source of uncertainty – particularly now that the House has a Democrat majority while the US Senate and Presidency are in Republican hands. Apart from the debt ceiling requiring resolution again this year, budget caps will be re-imposed in fy2020 unless there is Congressional agreement, which would move fiscal policy into contractionary territory.

Monetary policy outlook

Since its December 2018 meeting, when it last raised the Fed funds rate, the Fed has signalled a clear change in stance.

A majority of Fed member expectations (the Fed 'dots') no longer expect any rate moves in 2019 (the median view previously was for two hikes of 50bp) although they still expect one 25bp increase in 2020.

Of particular note is that the median member expectation no longer has rates sitting above their neutral level by end 2020 and through 2021. This is despite an expectation that inflation will be at target and the unemployment rate below its longer-term rate; circumstances in which monetary policy rules, such as the Taylor rule, would call for an above neutral policy rate.

The Fed is currently undertaking a review of its monetary policy strategy, tools and communications. One of the topics being examined is whether it should aim to make-up for past misses in its inflation target – e.g. if inflation has been below target for a period, the Fed should aim for a period of above target inflation.

The Fed Chair has indicated that there is a high bar for such a change, but at the margin discussion of such options – as well as lingering concerns about whether current inflation expectations are high enough to consistently deliver on the Fed's 2% inflation target – could well influence policy settings. In this environment, the Fed is less likely to react to a small shift in inflation above the 2% target of the magnitude we are projecting. With unemployment not expected to be moving significantly (in either direction) under our baseline outlook, it is hard to make the case for another rate hike.

Accordingly, we no longer expect a rate hike in 2020 (previously one after no change in 2019). Risks around this are two-sided – if the economy slows faster than expected (of the Fed fears that it will) the Fed may consider rate cuts; at the same time if wage growth continues to strengthen and starts to lift inflation the Fed could tighten again.

Fed balance sheet normalisation

The Fed in its March meeting also made some decisions around its balance sheet. The Fed started the process of winding back its balance sheet in October 2017 and since has been reducing its Treasury and Mortgage Backed Securities (MBS) holdings by a maximum of $30 billion and $20 billion a month respectively as securities mature or principal repayments are made. However, from May 2019, the maximum monthly reduction in Treasury holdings will decline to $15 billion. At the end of September the Fed will end the reductions in its aggregate securities holdings – while it will still allow agency debt and agency MBS holdings to decline by up to $20 billion a month but this will be matched by an equivalent increase in Treasury security holdings.

The Fed judges that after September 2019, the level of reserves will probably still be higher than required, but by holding its aggregate security holdings constant for a period, it can slowly reduce reserves as other liabilities (such as cash) rise over time. The Fed is yet to fully determine the level of reserves it will target in the future; but once that decision is made and the target level of reserves is reached the balance sheet will be allowed to start growing again as the target level of reserves and liabilities such as cash will grow over time. Apart from deciding on precisely what the appropriate level of reserves will be, the Fed is also still considering the appropriate maturity composition of its Treasury holdings.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %										
					2018			2019				2020			
	2017	2018	2019	2020	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	2.5	2.6	2.2	1.8	0.9	0.9	0.6	**0.4**	**0.5**	**0.4**	**0.4**	**0.5**	**0.5**	**0.4**	**0.4**
Private fixed investment	4.8	5.2	2.1	2.0	1.6	0.3	0.8	**0.6**	**0.2**	**0.2**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
Government spending	-0.1	1.5	1.9	2.0	0.6	0.6	-0.1	**0.3**	**1.1**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.0	0.1	0.1	-0.1	-0.4	0.7	0.0	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-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	**2.2**	**2.9**	**2.1**	**1.8**	**1.0**	**0.8**	**0.5**	**0.4**	**0.4**	**0.3**	**0.4**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)					*4.2*	*3.4*	*2.2*	*1.5*	*1.8*	*1.3*	*1.7*	*2.0*	*1.9*	*1.7*	*1.8*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.8	1.9	1.9	2.3	0.5	0.4	0.4	**0.3**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**
Core	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 (%)	**4.1**	**3.8**	**3.8**	**3.8**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.9**	**3.8**	**3.8**	**3.8**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	1.5	2.5	2.5	2.5	2.0	2.3	2.5	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**

Source: NAB Group Economics

*Contribution to real GDP growth

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