US ECONOMIC UPDATE APRIL 2019

Q1 GDP – headline growth overstates strength, but still a good result

National Australia Bank

NAB Group Economics

US GDP growth accelerated in Q1 2019 to a strong 3.2% q/q (annualised). However, this was due to a boost from net trade and inventories, while domestic final demand actually weakened. We still expect growth to slow over 2019 but with Q1 GDP stronger, and financial conditions recovering more quickly, than expected we have revised up our 2019 GDP forecast to 2.5% (from 2.1%). We still expect the Fed to remain on hold this year, as the stronger activity data is offset by a weakening in inflation.

Q1 GDP – a glass half full

US GDP grew by 0.8% q/q - 3.2% on an annualised basis- in Q1 2019. This was an improvement on the previous quarter and took growth to 3.2% over the year, its fastest pace since mid-2015.

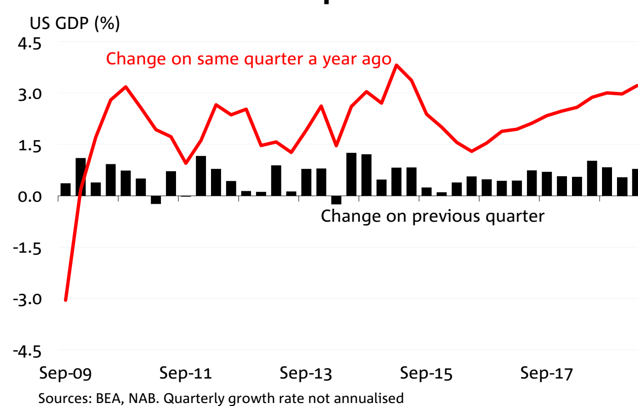
Below the headline, the composition of growth was less favourable. In particular, business investment growth moderated, as did growth in private consumption, while residential investment continued to decline. Government demand lifted despite the effects of the Federal government shutdown early on in the quarter, with unaffected areas of government spending more than compensating.

Even more importantly, a boost came from a faster pace of inventory accumulation and a sizable contribution from net exports, neither of which are likely to be sustained. While the ratio of inventories to sales does not look particularly high, it has ticked up and a more moderate pace of inventory growth is likely going forward.

Often an increase in inventories is offset by net trade, as imports can be the source of the higher inventories, but in Q1 imports declined, while export growth strengthened. Trade data are often volatile and the US-China trade dispute has added to this. US food and beverage exports increased in Q2 2018 ahead of Chinese retaliatory trade measures but then declined over the second half of the year. With China again starting to buy US farm products such as soybeans at the end of 2018, food exports increased in Q1, accounting for around three-quarters of the total increase in exports in the quarter.

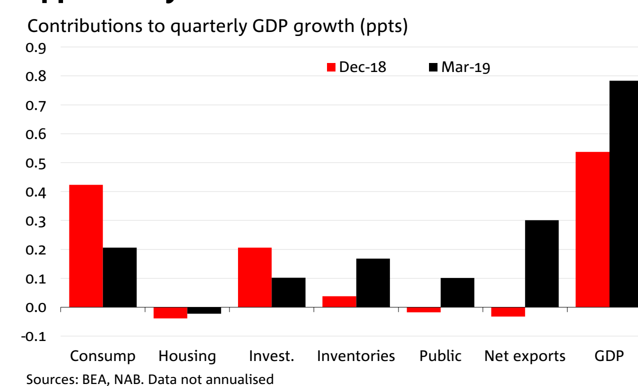
Domestic final demand weakened in the quarter, growing at its slowest pace since end-2015. The expectation for a while has been that the US economy would continue to slow into 2019 as last

GDP defies slowdown expectations and accelerates



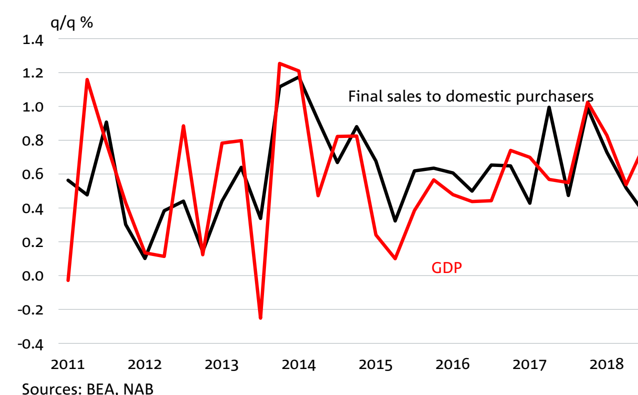
Sources: BEA, NAB. Quarterly growth rate not annualised

Supported by inventories and net trade



Sources: BEA, NAB. Data not annualised

…but domestic demand decelerated



Sources: BEA, NAB

year's fiscal stimulus fades and the impact of monetary tightening flows through. The sharp falls in equity markets last year and a slowdown in global growth only reinforced this view.

While the weaker domestic demand seen in the quarter suggests that these factors did indeed weigh on growth, the Q1 result is still re-assuring for several reasons.

Firstly, there has been a tendency in recent years for the Q1 report to be weak, perhaps reflecting seasonal adjustment issues.

Secondly, the drag from the US Federal government non-defence spending due to the government shutdown (which declined for the second quarter in a row by 1.5% q/q), should rebound in Q2 partially offsetting any inventory/trade correction. Note that the overall increase in public demand in Q1 reflected still growing defence spending and a rebound in state/local government activity.

Thirdly, the slowing in private consumption growth occurred on the back of a 1.6% m/m fall in retail sales in December. While some slowing was to be expected as the boost to incomes from last year's tax cuts became increasingly distant, the extent of the December plunge in retail sales was likely overstated. After some recovery over January/February, retail sales surged by (also likely overstated) 1.6%m/m in March, setting up a rebound in Q2 consumption.

As a result we have lifted our forecast for GDP growth in 2019 from 2.1% to 2.5%. While this is in large part due to the higher than expected Q1 result, our expectations for the rest of the year are modestly higher as well.

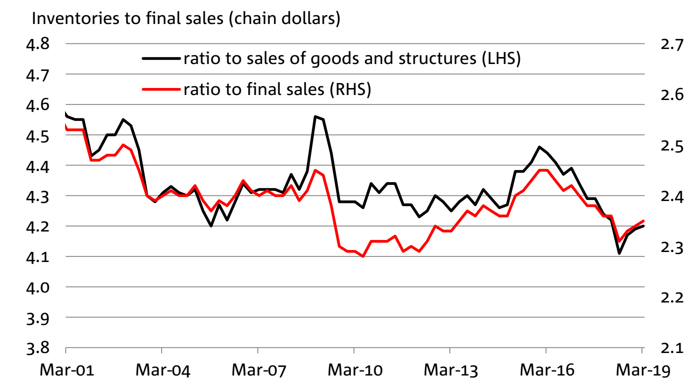
Equity markets have fully recovered the ground lost in late 2018, and broader measures of financial conditions have also largely recovered, helped along by a more dovish Fed outlook. Importantly, the improvement in conditions is starting to be reflected in partial indicators – housing market indicators (supported by an easing in mortgage rates) are showing improvement and capital goods orders have strengthened in recent months.

Nevertheless, we still expect growth to slow from here – not only will some of the factors that supported Q1 growth unwind (trade, inventories), but a fading impact from last year's fiscal stimulus, the lagged impact of the tightening in monetary policy that occurred last year as well as capacity constraints (reflected in a very low current unemployment rate) will all constrain growth.

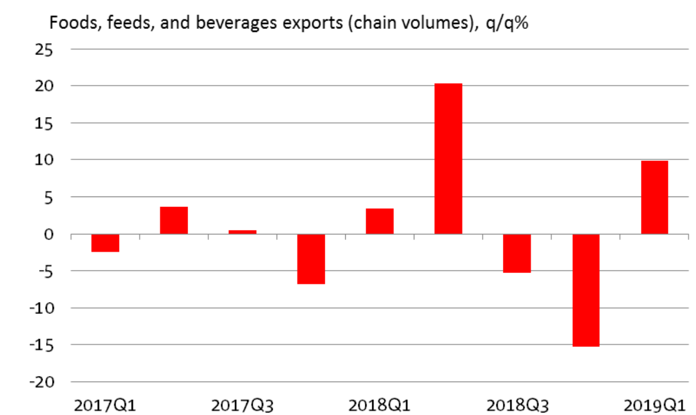
Implications for monetary policy

Better than expected economic growth suggests that the unemployment rate may decline a little further from its already low level. However, in contrast, the other side of the Fed's mandate – inflation – has come in weaker than expected.

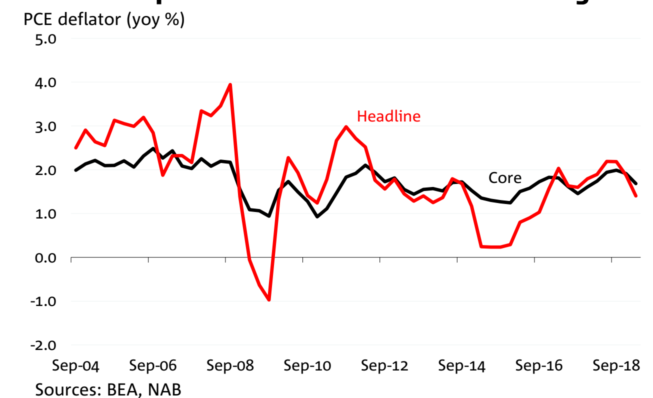
Inventories up but a major correction looks unlikely



Food exports tracking US/China trade tensions



Inflation dips further below the Fed's 2% target



Sources: BEA, NAB

The Fed's favoured measure of inflation – the core personal consumption expenditure (PCE) price index eased from 1.9% y/y in 2018 Q4 to 1.7% y/y in Q1. The monthly data are likely to show that by the month of March, annual inflation was even weaker at around 1.6% y/y.

While concerns over the outlook – including spill-overs from weaker global growth – were part of the reason for the Fed's dovish shift earlier this year, modest inflation outcomes were another factor. Concerns of some Fed members that current inflation expectations may not be high enough to consistently deliver on the Fed's 2% inflation target are an additional factor. Some Fed members have even suggested that they should aim to make-up for past misses in its inflation target- that is, if inflation has

been below target for a period, the Fed should aim for a period of above target inflation.

The Fed is indicating that it will be patient before deciding to make any changes to rates (in either direction) and we don't expect this to change at this week's meeting as higher than expected growth balances out the subdued inflation readings - at least for now. Markets are pricing in a rate cut this year, but we expect to see some re-acceleration in inflation over the rest of the year, sufficient to keep the Fed on hold.

CONTACT THE AUTHOR

Tony Kelly
Senior Economist – International
Antony.Kelly@nab.com.au

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %										
					2018			2019				2020			
	2018	2019	2020	2021	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components															
Household consumption	2.6	2.4	2.0	1.8	0.9	0.9	0.6	0.3	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.4**
Private fixed investment	5.2	2.3	2.7	1.9	1.6	0.3	0.8	0.4	**0.5**	**0.5**	**0.8**	**0.8**	**0.7**	**0.5**	**0.5**
Government spending	1.5	2.0	2.0	1.8	0.6	0.6	-0.1	0.6	**0.8**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.2	-0.2	0.0	-0.4	0.7	0.0	0.2	**-0.3**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.3	0.0	0.0	0.0	0.3	-0.6	0.0	0.3	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**2.5**	**1.9**	**1.8**	**1.0**	**0.8**	**0.5**	**0.8**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**0.4**	**0.4**
Note: GDP (annualised rate)					*4.2*	*3.4*	*2.2*	*3.2*	*1.6*	*1.8*	*2.0*	*2.1*	*1.9*	*1.8*	*1.8*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.5	2.2	2.0	0.5	0.4	0.4	0.1	**0.4**	**0.4**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
Core	1.9	1.7	2.1	2.0	0.5	0.4	0.4	0.3	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**3.7**	**3.6**	**3.6**	**3.9**	**3.8**	**3.8**	**3.9**	**3.8**	**3.7**	**3.7**	**3.7**	**3.7**	**3.6**	**3.6**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	2.5	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**
10-year bond rate	2.7	2.7	2.9	2.9	2.9	3.1	2.7	2.4	**2.5**	**2.6**	**2.7**	**2.8**	**2.8**	**2.8**	**2.9**

Source: NAB Group Economics

*Contribution to real GDP growth

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

John Sharma
Economist
+(61 3) 8634 4514

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0)436 606 175

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics

Tony Kelly
Senior Economist
+(61 3) 9208 5049

Gerard Burg
Senior Economist – International
+(61 3) 8634 2788

Global Markets Research

Ivan Colhoun
Global Head of Research
+61 2 9237 1836

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