US ECONOMIC UPDATE MAY 2019

US-China trade dispute a headwind to growth

NAB Group Economics

US growth is expected to slow over the rest of 2019 due to a fading of last year's fiscal stimulus, the lagged effects of past monetary policy tightening and the market turbulence of late last year, as well as supply constraints. The escalation in the US-China trade dispute is a further headwind, and led us to reduce our GDP growth forecasts by around 0.2ppts.

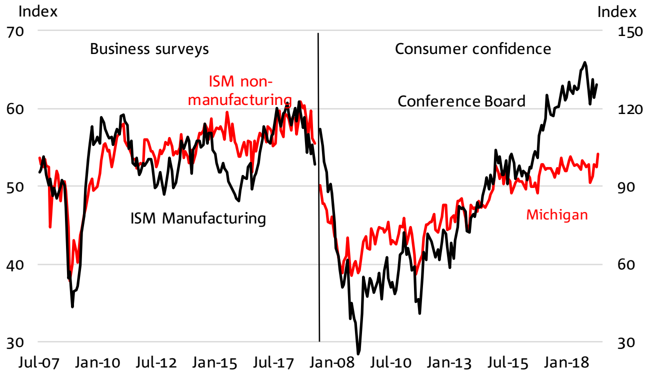
Overview

We continue to expect that US economic growth will slow over the rest 2019, following a period of strong growth over 2018 and early this year.

This view is based on a fading impact of last year's fiscal stimulus, the lagged effects of past tightening in monetary policy (and the market turbulence late last year), as well as supply constraints (the unemployment rate is at a fifty year low). The intensification of the US-China trade dispute (disappointing expectations of a resolution) is another headwind.

Early indicators for Q2 are consistent with this view. The ISM business surveys point to a slowing in activity. This is particularly so for the manufacturing sector, which is relatively trade exposed and is therefore feeling the impact of trade disputes, a global slowdown in manufacturing and a high USD. The service sector ISM survey has also softened, but not quite to the same extent.

Business and consumer surveys



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

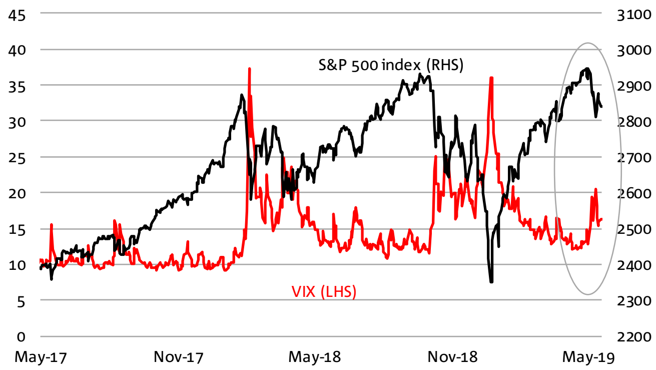
The ISM survey indicators are still at levels that historically have been consistent with a reasonable rate of growth. However, data are only available to April, and other business surveys available for May have been mixed, but on net probably indicate some further weakening.

The strong growth in Q1 GDP was based on large contributions from inventories and net trade, masking a softening in domestic final demand. However, initial indications are that consumption growth will accelerate in Q2, boosting domestic demand, but business investment indicators are mixed, as is the case for housing investment.

Surveys also suggest manufacturing sector capital expenditure intentions are still at solid levels. However, they have been gradually easing, which is not surprising given the pressure on the sector. The recent escalation of the US-China trade dispute may also provide further drag on investment plans.

Financial conditions have improved in 2019...but recent trade war escalation a negative

US equities - S&P 500 index and volatility (VIX)



The weakness in Q1 domestic demand was against the backdrop of turbulence in financial markets at the towards the end of 2018, as well a partial Federal Government shutdown early in the quarter. However, financial conditions have since improved, reflected in rising stock market values, and lower financial market volatility. Some of these gains have been given up following the US and China tariff increases but, overall, conditions are still better than in Q4 last year.

Date **May 2019** | Author Tony Kelly – Senior Economist
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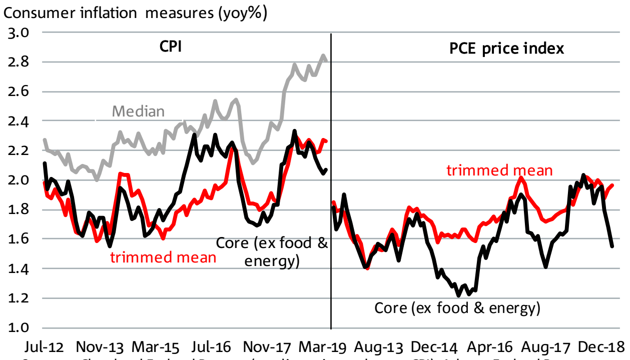
One factor behind the improvement in financial markets was a change in stance from the Fed, moving away from signalling rate hikes to a 'patient', no rate change stance. Financial markets have gone further, pricing in a rate cut by the end of the year. A key issue to watch in this regard, absent a major shift in the trajectory in the economy, will be inflation.

Core inflation (PCE inflation ex food and energy) has slowed to 1.5% yoy, below the Fed's 2% target. There is also concern that, with inflation expectations relatively low by historical standards, sub-below 2% inflation is becoming entrenched.

The Fed's view is that core inflation has fallen below 2% due to some transitory factors. Other measures of underlying inflation support this as they have not fallen in the same way. We also expect inflation to track back to 2% and so do not expect a rate cut. Clearly though, if inflation does not move higher at some point the Fed may feel it needs to act.

Measures of underlying inflation diverging



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

While we expect inflation to track back to around 2%, we do not expect it to move much beyond this. With the unemployment rate falling to 3.6% in April, its lowest level since 1969, the other side of the Fed's mandate is increasingly tight. However, absent inflationary pressure there is little incentive for the Fed to increase rates. This is particularly so as many Fed members, given their concerns over low inflation expectations, may welcome a period of above target inflation. As a result, it is hard to see a scenario where rates are increased this year.

We are forecasting US GDP growth of 2.5% in 2019 and then around long-term trend growth of 1.8% in 2020 and 2021. What is disguised by the year-average growth numbers is that that our forecasts see the slowdown as mainly occurring this year. Clearly, this will be dependent on no new shocks to the economy, including further escalation of the US-China trade dispute, something which is a clear risk.

US-China trade dispute

Heading into May the general expectation was that the US and China would soon make a deal on trade. Not only have these hopes been dashed, but the trade dispute has worsened.

The US increased tariffs on around $200b of Chinese imports from 10% to 25%. Moreover, it has formally started the process of putting in place tariffs on most remaining imports from China. There have also been actions targeted at specific Chinese companies (e.g. Huawei) which (rightly or wrongly) are being viewed as part of the trade dispute. In return, China has increased the range of tariffs on around $60b of imports from the US from 5-10% to 5-25%.

The measures announced in May by the US amount to a tax increase on US consumers and businesses (importing intermediate goods) of around 0.15% of US GDP. Similarly, China's tariff measures amount to a tax increase on its consumers and businesses, but only of around 0.05% of GDP.

Tariff measures in context

	total tariffs on China*	of which: May 19 measures
US tariff revenue ($US, bn)	62.5	30
US tariff revenue (% GDP)	0.30	0.14
Goods exports affected by China tariffs		
as % of total exports	6.6	3.6
as % of GDP	0.5	0.3
Increase in average tariff rate		
US	2.5	1.2

* Includes July/August 2018 (25% on 50b), September 2018 (10% on $200b) and May 2019 tariffs (extra 15% on 200b)

The burden of the tariffs may not simply be on consumers in the country imposing the tariff, as affected exporters may choose to absorb some of the tariff in their margins. However, IMF research suggests that in the US, the tariffs have largely been passed through to consumers or absorbed in the margins of US importers. Of course, faced with higher prices, demand for the affected products will fall (or substitutes from other countries used) so exporters in both countries will also be affected.

In any event, taken together the recently announced US and China tariff measures amount to a small fiscal contraction for the respective economies and an even smaller one for the global economy.

Tariffs having a large impact on US-China trade

Sources: Census

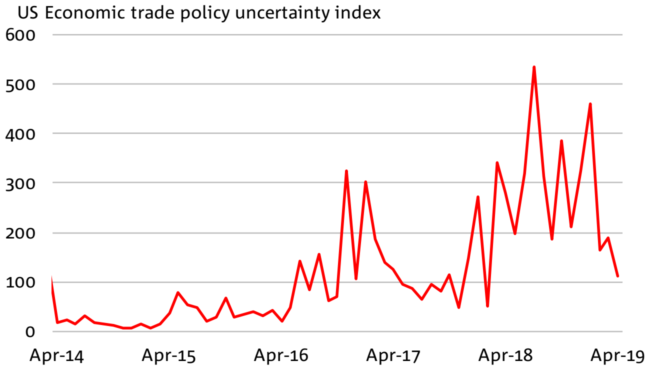
This is particularly so given the scope to reduce the tax burden of the tariffs by sourcing the affected imports from suppliers in other countries (or producing them domestically). The impact of previously announced tariff measures is evident in the trade data – with US imports from China (and vice versa) down significantly.

This month's developments raise the prospect of further escalation of the trade dispute. If tariffs were further extended to all imports from China at a 25% rate, there would be an additional fiscal contraction of around 0.3% of GDP, bringing the total US fiscal contraction over 2018/2019 from tariff measures to around 0.6% of GDP which is starting to become sizable. This is even before considering possible US auto tariffs, a decision on which has been deferred by 180 days as the US seeks negotiations with countries it imports motor vehicles from.

Moreover, there are a range of potentially important indirect impacts from confidence and uncertainty affects as well as financial market volatility.

These are highlighted by the falls in equities markets following the recent tariff increases. The fall in equities is also consistent with the notion that tariff increases are a supply shock that will permanently lower growth (by dampening productivity as supply chain efficiency is reduced). An expectation of lower future growth can be quickly incorporated into forward looking indicators such as equities.

Trade policy uncertainty had been easing from very high levels before May tariff escalation



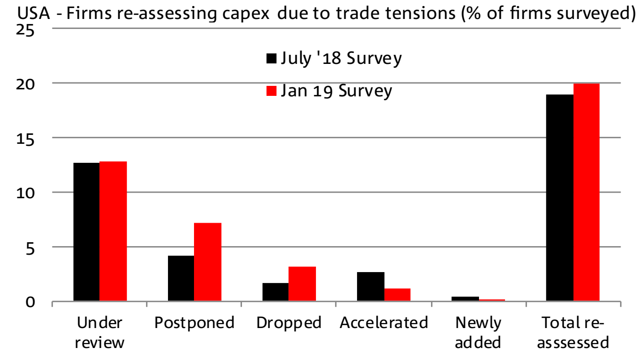
Uncertainty reflects the fact that while tariffs have increased, it is unclear whether they will be increased further or, alternatively, be scaled back in the event of an agreement being reached. It is hard to plan where is the best location to build your factory, for example, when you don't know what trading arrangements will be in coming years.

The Economic Policy Uncertainty index suggests that uncertainty relating to trade policy, after being at very high levels, had started to ease by April. While data are not available for May, this will almost certainly reverse. Research suggests that such uncertainty can negatively affect business investment.

The Atlanta Federal Reserve has been asking businesses about the impact of the trade dispute on capital spending. In mid-2018, it appeared small – while almost 20% of businesses were, or had, reassessed their plans the number of firms that had cut back, or postponed, investment wasn't much higher than the number of firms that had increased investment. However, by January, the impact had become more pronounced, with around 10% of business scaling back their investment plans for 2019 (while few were adding investment). Most of this is through 'postponed' investment, consistent with the notion that businesses are waiting to see where trade policy ends up before committing resources.

Based on separate questions about actual capex, the Atlanta Fed estimates a nationwide impact on private investment of -1.2% in 2018. For 2019, the likelihood is that this impact will be even greater.

Uncertainty weighing on investment plans



Source: Atlanta Fed

A range of studies have been conducted about the possible impact on the US economy of tariff increases. For a 1ppt increase in the average tariff in the US (with matching retaliation from countries affected), the range of estimates of the resulting reduction in GDP is -0.06 to -0.18%. The tariffs announced this month on China amount to an increase of around 1.2ppts in the average US tariff rate. Following the tariff decision, we reduced our US GDP growth forecasts by close to 0.2ppts over the rest of 2019 and into early 2020. This is around the top end of estimates, reflecting the ongoing high levels of uncertainty about what will happen next and the impact on confidence.

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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	2.3	1.9	1.8	0.9	0.9	0.6	0.3	**0.7**	**0.5**	**0.4**	**0.4**	**0.5**	**0.5**	**0.4**
Private fixed investment	5.2	2.2	2.4	1.9	1.6	0.3	0.8	0.4	**0.3**	**0.6**	**0.7**	**0.7**	**0.6**	**0.5**	**0.5**
Government spending	1.5	1.9	2.0	1.8	0.6	0.6	-0.1	0.6	**0.7**	**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**	**-0.1**	**-0.1**	**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**	**1.8**	**1.8**	**1.0**	**0.8**	**0.5**	**0.8**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.4**
Note: GDP (annualised rate)					*4.2*	*3.4*	*2.2*	*3.2*	*1.4*	*1.7*	*1.7*	*1.8*	*1.9*	*1.9*	*1.8*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.6	2.2	2.0	0.5	0.4	0.4	0.1	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**	**0.6**	**0.5**
Core	1.9	1.8	2.1	2.1	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**	**3.6**	**3.6**	**3.6**	**3.9**	**3.8**	**3.8**	**3.9**	**3.7**	**3.6**	**3.6**	**3.6**	**3.6**	**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**	**2.7**	**2.7**	**2.8**	**2.8**	**2.9**	**2.9**

Source: NAB Group Economics

*Contribution to real GDP growth

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