US ECONOMIC UPDATE JULY 2019

Growth slowed in Q2 but was still solid

National Australia Bank

NAB Group Economics

GDP growth slowed in Q2 to a still solid 2.1% q/q (annualised) rate. Growth was supported by strong consumption but business investment declined and last quarter's boost to growth from inventories and net exports was reversed. We still expect growth to ease further in H2 2019 before stabilising in 2020. The Q2 GDP result is unlikely to change the Fed's thinking - a July meeting rate cut remains highly likely, and we expect another cut in September before the Fed goes on hold.

Overview of Q2 GDP

US GDP grew by a slightly faster than expected 0.5% q/q (2.1% annualised) in Q2 2019. This was below the pace seen in Q1 and the annual growth rate (change on same quarter a year ago) fell to 2.3% y/y, the lowest it has been since mid-2017.

The composition of growth was broadly as expected as well. Consumption rebounded strongly. Public spending also strengthened as the impact of the Q1 government shutdown was unwound. However, there was a weakening in business investment and last quarter's unsustainable boost to growth from inventories and net exports was reversed.

Consumption grew by 1.1% q/q. This was the fastest pace since late 2017, but followed weak growth in the previous two quarters (due, in part, to an inexplicably large fall in retail sales in December). The accounts also included substantial upwards revisions to the household savings rate, suggesting a good portion of last year's tax cuts were saved rather than spent, providing households a buffer in the event of any future pressure on their budgets.

In contrast, residential investment again declined in Q2, its sixth consecutive decline. While the reduction in mortgage interest rates late last year has not been enough to see a turnaround in the sector, the pace at which residential investment is falling has eased. Construction in new dwellings eked out a small gain in Q2 for the first time since 2017 but not enough to offset a decline in 'other structures' investment (which includes sales commissions and largely reflects new and established housing sales).

Business fixed investment also declined a little in Q2, down 0.2% q/q. This was the first decline in business

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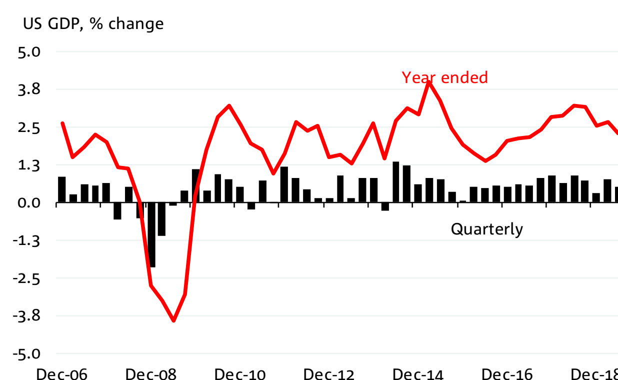
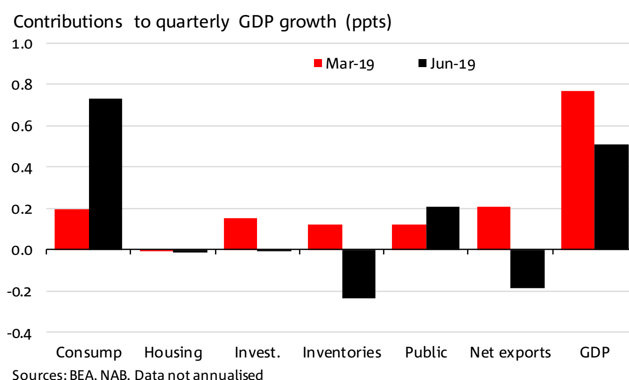
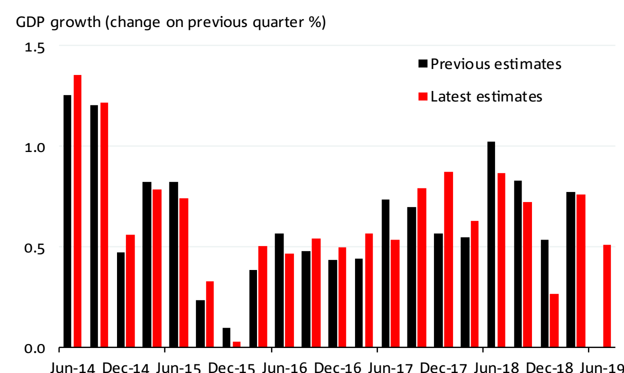


Consumption leads the way



Sources: BEA, NAB. Data not annualised

Past revisions – overall little change but 2018 down



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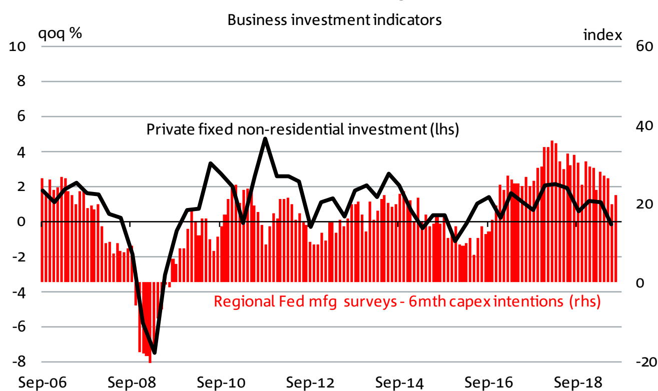
investment since 2016 and reflected a fall in non-residential structures, with equipment investment recording a small increase and intellectual property also growing (but at a more moderate rate than previous quarters).

Business investment is coming under pressure from several sources including trade policy, the slowdown in global growth, as well as declining profit margins. While Q2 data on corporate profits are not yet available, the data for prior quarters were revised down – over the year to Q1 corporate profits are now estimated to have declined rather than grown (as previously estimated). The downturn in oil prices is one factor weighing on corporate profits, and investment in mining structures has fallen almost 8% over the last year.

That said, while future capex intentions have also moderated, they are still at reasonable levels. Similarly, core capital goods orders have increased in five of the last six months. So, while the headwinds facing business investment mean that it will likely remain subdued, it is not in a major slump.

Business investment turns negative but capex intentions do not point to a major slump



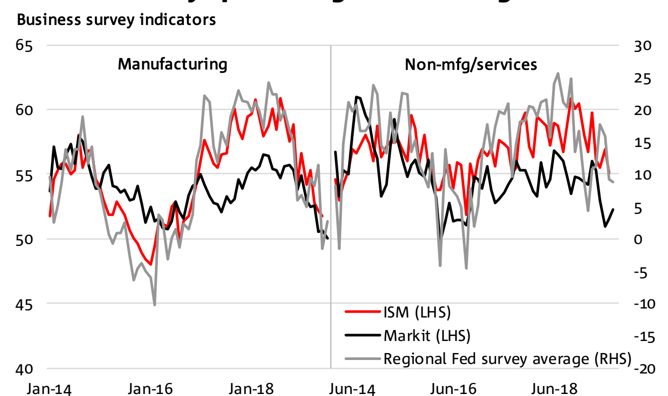
The turnaround in the net export contribution was due to a 1.3% q/q fall in export volumes (with imports unchanged). Exports in Q2 were 1.5% lower than the same time a year ago, likely reflecting the impact of various headwinds. These include a slowdown in global growth, increases in trade barriers and US dollar appreciation. Boeing's problems with its 737 MAX are also evident with aircraft related exports falling 15.5% in the quarter (accounting for around half the total fall in exports).

Core inflation (personal consumption expenditure price index excluding energy and food) strengthened from a low 0.26% q/q in Q1 to 0.45% in Q2. However, the annual growth rate declined to 1.5% so, overall, there remains little in the way of inflationary pressure.

Outlook

A slowdown in quarterly growth was widely expected, but with growth in 2018 revised down, GDP grew at a faster pace in the first half of 2019 than in H2 2018. However, while on the surface this offers hope that growth is stabilising, this is not backed up by business surveys. This is particularly in the trade and investment exposed manufacturing sector.

Business surveys point to growth easing



That said business survey indicators are still at levels consistent with continuing growth in the economy. While concern has rightly focussed on the downshift in business investment, future capex intentions reported in regional Fed manufacturing survey are still at reasonable levels. In line with this, our expectation is for subdued investment activity as the slowdown in growth (domestically and abroad), as well as the heightened trade policy uncertainty, takes its toll, although the decline in corporate profits and margins points to a risk of a weaker outcome.

Importantly, the labour market remains healthy. Initial jobless claims – the timeliest indicator of labour market conditions – remain at exceptionally low levels. This is not surprising as while growth has slowed since mid-2018, it has remained above our assessment of the its longer-term potential growth rate (around 1 ¾%). Solid wage income growth, robust consumer confidence indicators and household balance sheets are in good shape and will all help support consumption growth.

Overall, we expect year-average growth of 2.2% in 2019, revised down from our previous estimate of 2.4%. While the Q2 outcome was a bit higher than expected, this was more than offset by the impact of downward revisions to previous quarters.

The year-average forecast masks our expectation for slower growth in the second half of 2019 (at around an annual pace of 1½ to 1¾%). The boost to growth from last year's fiscal stimulus has largely passed through, trade policy is a headwind (particularly to business investment) and while the pace of inventory accumulation slowed in Q2 (leading to a negative contribution to growth) it was still solid and some further correction is likely.

We see growth stabilising and possibly picking up a little in 2020 (1.7%) and 2021 (1.8%) as the full impact of an easing in monetary policy comes through and an expected stabilisation in global growth. However, these forecasts do not allow for any further

significant increase in trade barriers. If, for example, tariffs were extended to all Chinese imports or to auto imports then these forecasts would be marked down.

Implication for monetary policy

The Q2 result is unlikely to shift the Fed's thinking in either direction. While growth was at a solid above trend pace in Q2 the Fed is more focussed on the still below target level of inflation and the risks to the outlook – particularly from trade policy, the slowdown in global growth and other geopolitical issues such as Brexit and its flow through to business investment.

Given the Fed Chair's recent assessment that these uncertainties continue to weight on the outlook, a cut in the Fed funds rates is widely expected at the end of this month. The debate has been more about the size of the cut – 25bp or 50bp. We expect a cut of 25bp followed by another 25bp cut following the September meeting, and for the Fed to then go on hold.

The risk is that the Fed will end up cutting rates by more, rather than less, than we are projecting. This reflects uncertainties around the direction of the global economy, the risk of future trade actions (if not US-China then elsewhere), as well as the Fed's concern over subdued inflation and inflation expectations. Reinforcing this downward bias is that some Fed members are considering the adoption of make-up strategies for past undershoot on its inflation target, although the outcome of the Fed's review of monetary policy strategies won't be known until the first half of next year.

Fiscal policy risk recedes

In his recent testimony to Congress, one of the uncertainties over the outlook mentioned by the Fed Chair was fiscal policy. Specifically, he mentioned the federal government's debt ceiling but he would have also been aware that without Congressional action automatic budget cuts would go in place in fiscal year 2020 (which starts in Q4 2019).

These fiscal policy risks have substantially diminished following a budget deal reached between the President and Congressional leaders. The deal suspends the debt limit for two years and allows for a small increase in spending from current levels (split between defence and non-defence programs). It has already been passed by the House and is expected to be passed by the Senate shortly.

Assuming Senate passage – and putting aside the issue of the long-term sustainability of the US' fiscal position – the remaining fiscal risk this year is a Government shutdown. The budget deal only sets the overall level of spending and bills to appropriate the money to specific functions still need to be passed. This needs to occur by 30 September to avoid a Federal government shutdown.

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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	3.0	2.4	2.1	1.8	1.0	0.9	0.4	0.3	1.1	**0.6**	**0.5**	**0.5**	**0.5**	**0.4**	**0.4**
Private fixed investment	4.6	1.8	1.5	1.8	1.3	0.2	0.7	0.8	-0.2	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Government spending	1.7	2.4	2.2	1.8	0.6	0.5	-0.1	0.7	1.2	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.1	-0.1	0.0	-0.4	0.6	0.0	0.1	-0.2	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.4	-0.3	-0.2	-0.1	0.2	-0.6	-0.1	0.2	-0.2	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**2.2**	**1.7**	**1.8**	**0.9**	**0.7**	**0.3**	**0.8**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*3.5*	*2.9*	*1.1*	*3.1*	*2.1*	*1.6*	*1.6*	*1.8*	*1.8*	*1.7*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.7	2.1	1.9	0.5	0.4	0.3	0.1	0.6	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
Core	1.9	1.7	1.9	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**	**3.5**	**3.5**	**3.5**	**3.9**	**3.8**	**3.8**	**3.9**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**	**3.5**	**3.5**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	2.5	2.0	2.0	2.0	2.0	2.3	2.5	2.5	2.5	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**
10-year bond rate	2.7	1.9	2.3	2.4	2.9	3.1	2.7	2.4	2.0	**1.9**	**1.9**	**2.0**	**2.1**	**2.2**	**2.3**

Source: NAB Group Economics

*Contribution to real GDP growth

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