US ECONOMIC UPDATE AUGUST 2019

More Fed cuts likely as trade headwinds strengthen

NAB Group Economics

Trade headwinds picked-up in August with additional tariffs on China imports announced. Apart from their direct impact, they can impact the economy by disrupting financial markets and reducing business sentiment. We expect a further 50bp of cuts in the fed funds rate over the rest of 2019. GDP growth is expected to slow in H2 2019 before stabilising in 2020 and 2021 at around trend, but risks are to the downside.

Trade headwinds getting stronger

The US-China trade dispute took another turn for the worse over August. On 1 August, the US President announced a 10% tariff of an additional $300b of imports from China (i.e. most remaining imports). This was subsequently modified so that the tariff on some products – such as mobile phones, laptops, toys and some footwear and clothing items – would be delayed until December 15, and certain items were removed entirely from the tariff list. Estimates of the scope of this latest tariff action now suggests that the September tariff increase will apply to around $110b of imports and the December increase to around $160b (so $270b in total).

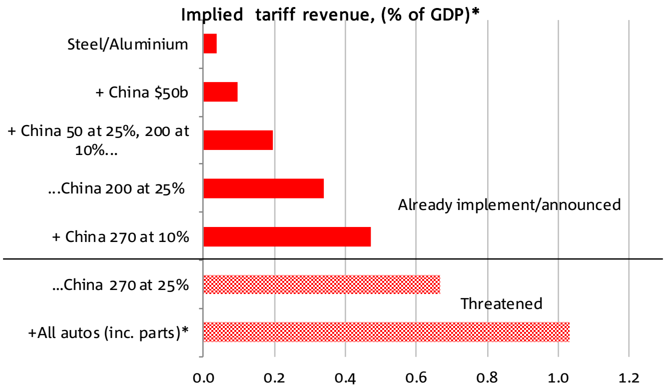
Uncertainty also continues on the technology front. On 19 August, the US extended the licence for certain transactions with the Chinese tech company Huawei by 90 days. The rationale was to give US consumers of Huawei more time to transition away. Moreover, an additional 46 Huawei affiliates were brought under current restrictions.

The August announcements follow closely on the increase in tariffs, from 10% to 25%, on around $200b of Chinese imports in May.

As with any tax, increases in tariffs represent a fiscal contraction. Based on the tariff rate and the level of imports to which they applied at the time of the announcement, then the revenue from tariffs implemented or announced to-date would be around $100b or 0.5% of GDP. Of course, actual tariff revenue will likely be lower as consumers switch to other goods or other suppliers (either domestic or from other countries).

Some of the tariffs came into force last year suggesting much of their direct impact has already been felt. The fiscal headwind from the most recent announcements (in May and August 2019) amounts to around 0.3% of GDP, which by itself would not appear big enough to de-rail the economy.

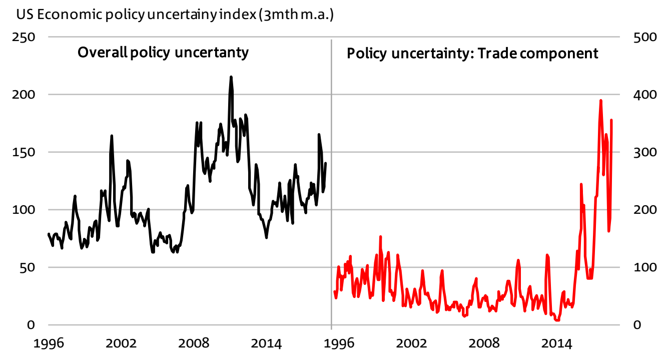
Tariff fiscal impact building



However, the concerns over the trade war are not limited to their direct fiscal impact. Studies suggest that financial market and confidence affects can be as large (if not larger) than the direct tariff impacts.

Businesses faced with uncertainty about the most cost-effective location to locate a factory or other infrastructure may simply defer or cancel planned capital expenditure.

Trade disputes raising uncertainty for businesses



Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com

The issue here is uncertainty – no one can be certain for how long tariffs that have been implemented will be maintained, nor that there won't be further additional measures (either on China, or for example, on auto imports from a broader range of countries).

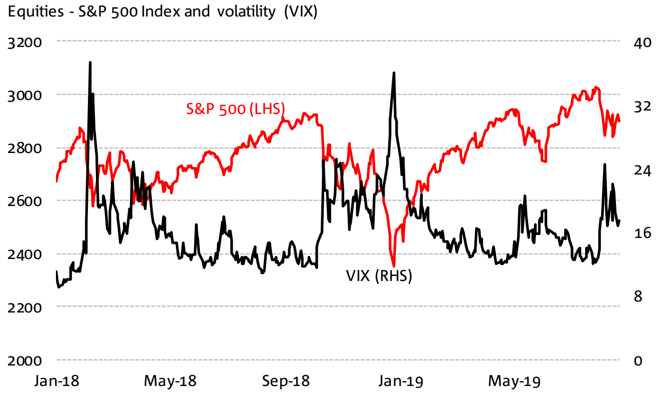
The US-China trade dispute is not just affecting US (and China) business sentiment. Due to highly integrated global supply chains its impact is more widely felt, with a particularly large impact on East Asia. The trade dispute is adding to the downward pressure on the global economy, which slowed over much of 2018 and this has continued through to 2019. We recently lowered our forecasts for global growth in 2019 and expect it to remain below par in 2020 as well. This suggests a soft external environment for US exporters and for US businesses with overseas operations.

Financial Market reactions

Following the 1 August tariff announcement, US stock markets moved sharply lower, volatility increased, bond yields fell, and there was some appreciation in the US dollar.

At the time of writing, the decline in the S&P500 from its end July level was up to 5% (with similar moves in overseas markets). The VIX – a measure of volatility – also spiked higher.

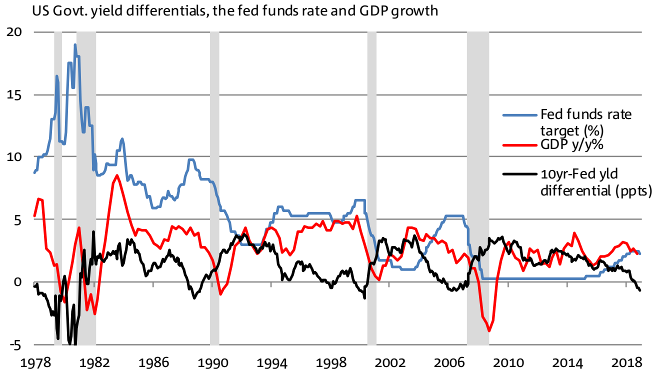
Negative reactions in stocks to tariff news



Yields on 10 year government bonds dropped sharply – from a little over 2% at the end of July to between 1.5-1.6%. This likely reflected a combination of lower expectations for the US fed funds rate as well as a 'flight to safety'. As a result, the US yield curve became even more inverted. As yield curve inversions have historically often been followed by recession, this only added to negative sentiment.

That said, while there was some upwards pressure on credit spreads, the increase was modest, and the level of spreads are not high by historical standards. Another financial channel is bank lending standards. The latest loan officer survey by the Fed – conducted over late June/early July –suggested there was little change in bank lending standards after the May tariff increase. There is no sign yet of a sustained tightening in lending standards to businesses, something which has occurred prior to the last two recessions.

Yield curve inversion adds to recession concerns



Grey areas indicate recession periods.

Policy reaction

Market expectations for Fed policy also changed markedly in August. Since the end of July, futures pricing for the fed funds rate at end 2019 has fallen 25bp and for end 2020 by 40bps lower. As a result, markets are now pricing in a further 100bps of Fed rate cuts through to end 2020.

We had been expecting one further 25bp rate cut this year and for the Fed to then go on hold. However, because of the extra growth headwind from the August tariff increases, we now expect two more 25bp rate cuts this year (starting in September).

The Fed has indicated that the decision to cut the fed funds rate in July was partly for 'risk management' purposes – due to the downside risks to the outlook (e.g. from trade uncertainty) even as their baseline outlook for the economy remained favourable. The post-meeting messaging was that future cuts would be more data dependent.

While this, and recent comments from some Fed members casting doubt on the need for further cuts, might suggest a higher bar to further action, we expect to see further weakening in the economic data which will force the Fed's hand. The escalation of the US-China trade dispute in August is a development the Fed will also have to incorporate into its projections for the economy. Moreover, most Fed members are concerned that inflation expectations are too low, or could become so if below-target inflation persists, adding to the case for some further policy easing.

Ahead of the July meeting there was speculation as to whether the Fed might cut rates by 50bp. For now, we expect the Fed to move in 25bps steps, particularly given the differences within the Fed (some wanted 50bps of cuts in July, some no cuts at all) and the need to maintain a degree of consensus. However, this could change if uncertainties over the outlook were to increase or incoming data to weaken more quickly than expected.

Our forecasts assume that tariffs already implemented remain in place, and announced measures will occur, but that there no other changes.

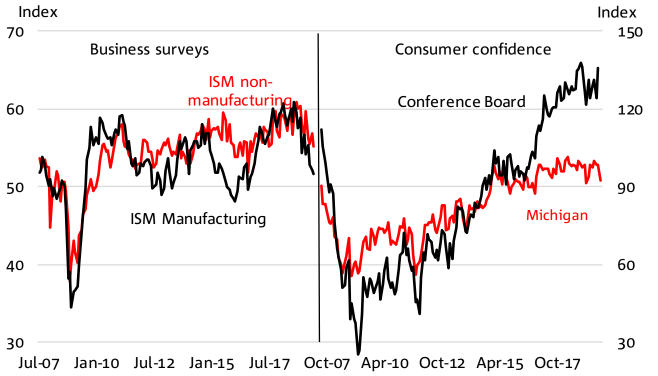
Clearly there are risks around this – from a US-China deal which starts to unwind implemented tariffs to further tariff increases.

On the fiscal policy side, there has been some speculation recently that the administration might seek tax cuts – e.g. to payroll tax or to capital gains tax, possibly funded by tariff revenue. The US President's latest comments indicate that this is no longer being considered. While this may change, substantive action would likely require the approval of Congress, and with Democrats in control of the House, this would not be assured.

US outlook & risks

The most recent business surveys suggest that the economy continued to slow early in H2 2019. Manufacturing – which is relatively more exposed to trade developments and business investment – has been most affected but conditions in non-manufacturing have also softened. In contrast consumer sentiment remains solid.

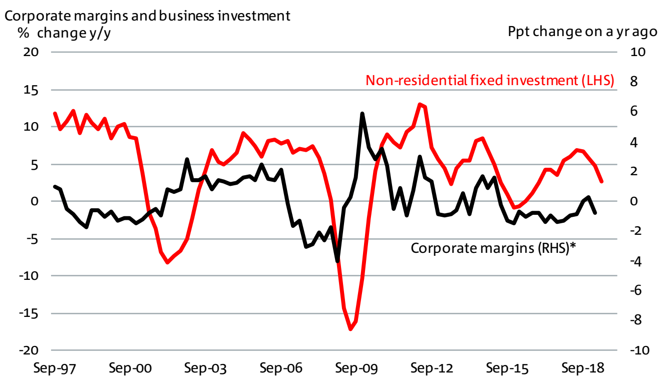
Business surveys point to a slowing economy



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

This split is also evident in the activity data. July retail sales growth was robust and, while it may have been boosted by Amazon's Prime Day promotion, this suggests consumption growth will remain solid in Q3. In contrast, business investment fell in Q2 2019. Investment is not just coming under pressure from trade uncertainty and the global slowdown, but also a decline in margins over recent years.

Falling margins a negative for business investment



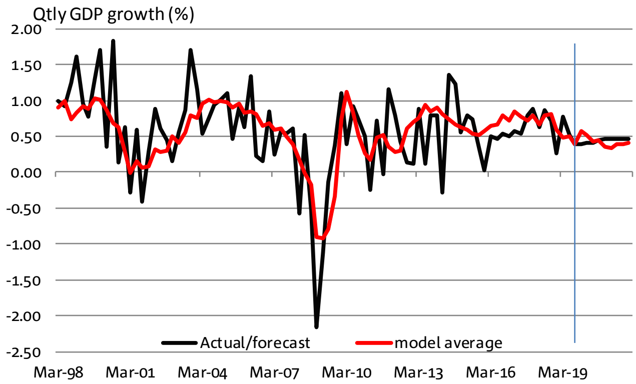
* Calculated as Corporate net operating surplus divided by net value added

These two trends are not unrelated – the strengthening in wages growth that has occurred, combined with limited inflation, points to a boost to household income at the expense of margins.

Historically, as with an inverted yield curve, declining margins are another development that has preceded US recessions. Unsurprisingly, concerns over whether the US might go into recession have risen.

While we expect the US to slow in H2 2019 to a little below its trend or potential growth rate, we do not see a recession occurring. Our macro models for the US – one of which incorporates a yield curve term as well as other variables – if anything point to some near-term upside risk to our forecasts.

NAB US macro models – average result



Overall, we expect year-average GDP growth of 2.2% in 2019. This incorporates a slowdown in growth in H2 2019 to a level a bit below trend. However, as monetary easing starts to kick in, we expect growth to stabilise and then return to around our estimate of the potential growth (around 1¾%).

Of course, there are risks around any forecast. As noted previously, we assume no worsening or improvement in current trade disputes. In contrast, market pricing – such as embodied in the yield curve – reflects a range of views and possible scenarios around things such as trade policy. With the global economy slowing (and for how long, and to what extent, uncertain), geo-political risks to the fore (e.g. a no-deal Brexit) and the risk of further escalation in trade disputes, risks to growth appear slanted to the downside. This also implies that the risk to our call for a 50bp reduction in the fed funds rate is that there will be more easing rather than less.

CONTACT THE AUTHOR

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

U.S. ECONOMIC & FINANCIAL FORECASTS

					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	1.9	1.0	0.9	0.4	0.3	1.1	0.6	0.5	0.5	0.5	0.5	0.5
Private fixed investment	4.6	1.7	1.2	2.0	1.3	0.2	0.7	0.8	-0.2	0.2	0.3	0.3	0.3	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	-0.2	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	-0.1	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**	**0.5**
Note: GDP (annualised rate)					*3.5*	*2.9*	*1.1*	*3.1*	*2.1*	*1.5*	*1.6*	*1.6*	*1.7*	*1.8*	*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	0.3	0.1	0.6	0.3	0.6	0.6	0.5	0.5	0.6
Core	1.9	1.7	2.0	2.0	0.5	0.4	0.4	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	3.8	3.7	3.8	3.8	3.9	3.8	3.8	3.9	3.6	3.7	3.7	3.7	3.8	3.8	3.8
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	2.5	1.8	1.8	1.8	2.0	2.3	2.5	2.5	2.5	2.0	1.8	1.8	1.8	1.8	1.8
10-year bond rate	2.7	1.5	1.8	1.9	2.9	3.1	2.7	2.4	2.0	1.5	1.5	1.5	1.6	1.7	1.8

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