US ECONOMIC UPDATE OCTOBER 2019

US growth has slowed, but remains solid

National Australia Bank

NAB Group Economics

While US GDP growth has slowed, it remains solid. Consumers continued to be the main driver of growth while business investment was again weak. Due to the slightly better than expected Q3 result, we have revised up our year-average GDP growth forecasts to 2.3% in 2019 and 1.7% in 2020. However, we still think growth will slow a bit further in coming quarters before stabilising. After cutting rates again in October, the Fed is signalling policy is likely to be on hold for now (in line with our expectation), but this will ultimately depend on incoming data and how risks (such as trade disputes) evolve and we continue to see a risk that the Fed may cut again.

Overview of Q3 GDP

US GDP grew by 0.5% q/q (1.9% annualised) in Q3 2019, only marginally below the Q2 outcome. However, this took the annual growth rate to 2.0%, the lowest it has been since the end of 2016.

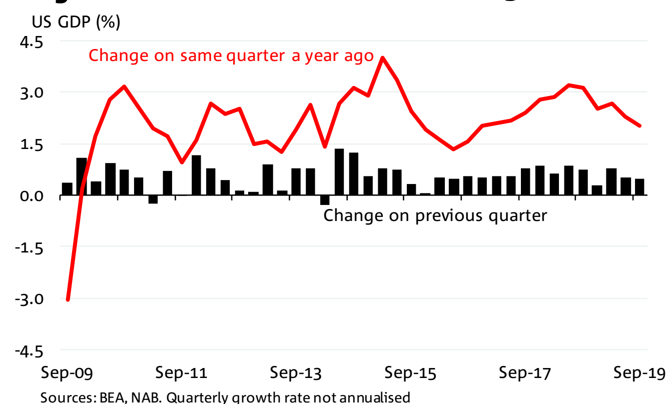
In line with recent trends, household consumption growth was the main driver of growth while business investment was weak. Net exports again made a negative contribution to GDP growth. Public spending growth moderated (Q2 was temporarily boosted by the end to the government shutdown earlier in the year). One clear break from recent trends was in residential investment, which increased in Q3 after a period of sustained decline.

Consumption grew by 0.7% q/q. While this was slower than in Q2, this still represents a solid rate of growth. This result is not surprising given that the labour market is still strong (the unemployment rate is at a 50 year low), consumer confidence remains at solid levels, and household balance sheets are in good shape.

Residential investment increased for the first time since end-2017. Both construction in new dwellings and 'other structures' investment (which includes sales commissions and so largely reflects new and established housing sales) increased in the quarter. The turnaround likely reflects the reduction in mortgage interest rates since late last year, providing evidence that the loosening in monetary policy is starting to have an impact.

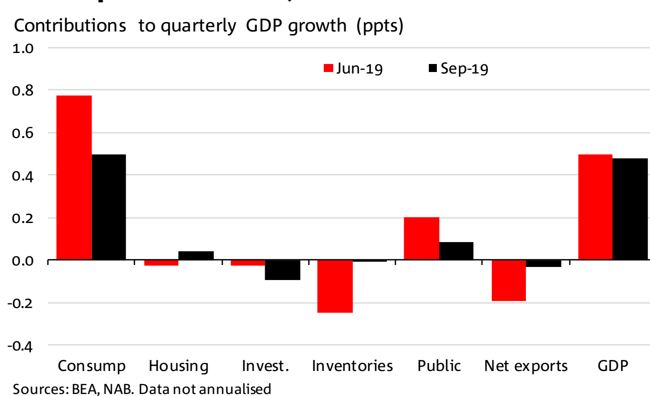
Business fixed investment declined for the second consecutive quarter, falling by 0.8% q/q. This was due to a fall in both non-residential structures and equipment investment (-4.1 and -1.0% q/q respectively). In contrast, intellectual

US growth slowdown continued into Q3



Sources: BEA, NAB. Quarterly growth rate not annualised

Consumption still solid, business investment weak



Sources: BEA, NAB. Data not annualised

property products investment continued its rapid growth, and has increased 8.1% over the last year.

Business investment is coming under pressure from several sources including the uncertainty caused by trade policy, the slowdown in global growth, as well as declining profit margins. Industry specific factors

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are also at play – oil industry investment has declined due to lower oil prices (and accounted for almost half the fall in non-residential structures investment in Q3) and Boeing's 737 MAX problems have been weighing on aircraft investment.

Net exports again detracted GDP growth, albeit more modestly than in the previous quarter. Quarterly growth in both exports and imports picked up in Q3, but trade growth was still very subdued – exports were only 0.1% higher than a year ago, while imports were only 0.8% higher. The weakness in exports likely reflects the slowdown in global growth, increases in trade barriers and US dollar appreciation. Boeing's problems with its 737 MAX are also evident in the export data, although the decline in aircraft related exports was much smaller in Q3 (-0.9% q/q) than in Q2 (-14.3%).

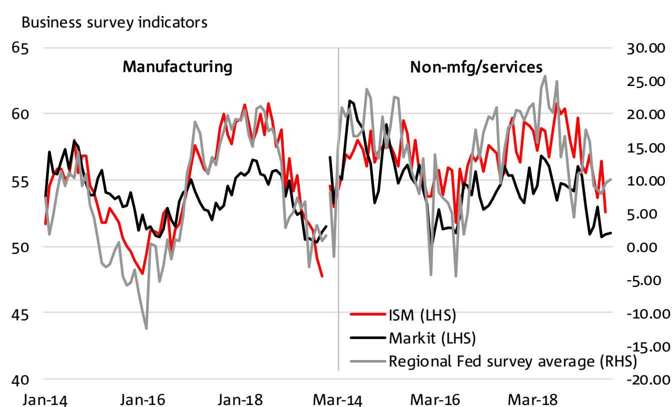
Core inflation (personal consumption expenditure price index excluding energy and food) accelerated for the second consecutive quarter. However, the annual growth rate remains below the Fed's target of 2%, increasing by 1.7% y/y in Q3 (up from 1.6% in Q2).

Outlook

The Q3 GDP outcome provides further evidence that the US economy has slowed. Even so, annualised growth of 1.9% is still a bit above our view of the economy's underlying growth potential (1.75%). This indicates that the economy continues to perform solidly albeit unevenly given the weakness in investment and trade.

Business surveys available to September (ISM) and October (preliminary Markit, regional Federal reserve surveys) also highlight the slowdown underway in the economy. They indicate there has been a larger impact on the more trade and investment exposed manufacturing sector although the services sector has not been spared.

Business surveys point to growth easing



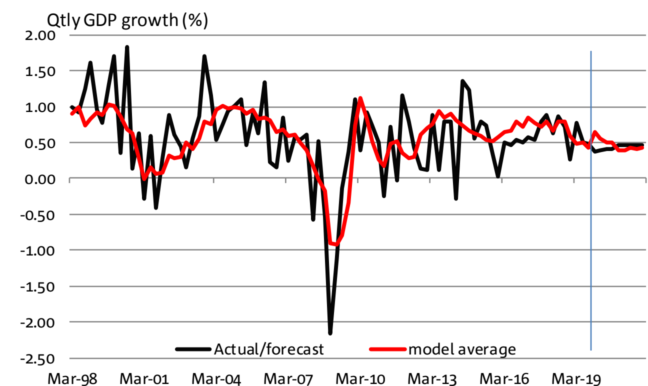
The surveys also suggest there is a risk of a further slowdown in activity Q4. Future capex intentions (as indicated by regional Federal Reserve surveys) moderated further in October indicating business investment will remain weak, at least in the near term. We also expect to see some moderation in inventory accumulation, which would detract from GDP growth.

Apart from global and trade drags, one reason for the slowdown has been the fading impact of last year's fiscal stimulus (both tax cuts and government spending increases). However, fiscal policy is likely to be broadly neutral in coming years rather than turn contractionary. Support for growth is coming from the easing in Federal Reserve monetary policy. The impact of the policy shift is starting to become evident in the housing sector. We also expect global growth to stabilise in 2020.

We expect to see somewhat below trend growth in the US economy in Q4 and into early 2020. This reflects an expectation of some further moderation in consumption as employment growth slows, as well as continued soft structures and equipment business investment. However, barring further shocks to the economy, we then expect growth to stabilise and return to around its trend rate.

Our US macro models also suggest that growth is unlikely to significantly deviate from around its trend rate over our forecast period. The macro models utilise variables such as the yield curve (or real interest rates) as well as asset prices, FX, oil prices and lending standards. Indeed, they are somewhat more optimistic in the near term than our current forecasts, suggesting some upside risk.

Macro models point to around trend growth



A key risk remains trade policy. Our forecast assumption is that existing trade policy (e.g. tariff increases) will remain in place or come into effect as announced. There are both upside and downside risks around this assumption. Hopes are currently high for a 'phase one' deal between the US-China suggesting some possible de-escalation of the dispute. However, even if this were to occur, uncertainty about what happens next will remain. Moreover, there were similar hopes at one stage last year only for them not to be realised and for the trade dispute to escalate further. The US President is also still to decide on whether to impose auto tariffs

(a decision on a US Section 232 report was deferred until November 2019).

In year average terms we expect GDP growth of 2.3% in 2019 (revised up from 2.2%) and 1.7% in 2020 (revised up from 1.6%). The upwards revision reflects the slightly higher than expected Q3 outcome (1.9% annualised q/q compared to our forecast of 1.7%). We still expect growth of 1.8% in 2021.

Monetary policy

The combination of below target inflation, slowing growth as well as the range of (generally downside) risks to the outlook (particularly trade) has seen the Fed reduce its target range for the federal funds rate by 75bps since July, including a 25bp cut at this week's Fed meeting.

In his October meeting press conference, the Fed Chair noted that the reductions in the federal funds rate were intended to provide 'insurance' against risks to the outlook.

He also noted that the Fed expects '...the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook of moderate economic growth, a strong labor market, and inflation near our symmetric 2 percent objective."

This indicates that the Fed considers further reductions in the fed funds rate will probably not be required, at least for now. This is in line with our current projections for the fed funds rate, which is for no further change (up or down) through to end 2021.

Our expectation that there might be some further slowing in growth suggests that there is a risk that the Fed may re-assess and again cut rates, perhaps in early 2020. However, the Fed Chair indicated that a 'material reassessment' of the outlook would be needed for the Fed to respond. What constitutes a material re-assessment is unclear, although the Fed will be closely watching not only incoming data but also developments on the trade front and other global risks.

With inflation still well contained, and the desire of at least some Fed members to have a period of above target inflation, the risk of the Fed reversing this year's rate cuts any time soon looks very low.

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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	2.6	2.3	1.9	1.0	0.9	0.4	0.3	1.1	0.7	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**
Private fixed investment	4.6	1.3	0.5	2.0	1.3	0.2	0.7	0.8	-0.4	-0.3	**0.1**	**0.2**	**0.3**	**0.4**	**0.5**
Government spending	1.7	2.3	2.1	1.8	0.6	0.5	-0.1	0.7	1.2	0.5	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.2	-0.1	0.0	-0.4	0.6	0.0	0.1	-0.2	0.0	**-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**	**2.3**	**1.7**	**1.8**	**0.9**	**0.7**	**0.3**	**0.8**	**0.5**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)					*3.5*	*2.9*	*1.1*	*3.1*	*2.0*	*1.9*	*1.5*	*1.5*	*1.6*	*1.7*	*1.8*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.5	2.0	1.9	0.5	0.4	0.3	0.1	0.6	0.4	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.9	1.7	2.0	1.9	0.5	0.4	0.4	0.3	0.5	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**	**3.6**	**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	1.8	1.8	1.8	2.0	2.3	2.5	2.5	2.5	2.5	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**
10-year bond rate	2.7	1.5	1.8	1.9	2.9	3.1	2.7	2.4	2.0	2.0	**1.5**	**1.5**	**1.6**	**1.7**	**1.8**

Source: NAB Group Economics

*Contribution to real GDP growth

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