US ECONOMIC UPDATE DECEMBER 2019

US-China deal reduces downside risks

NAB Group Economics

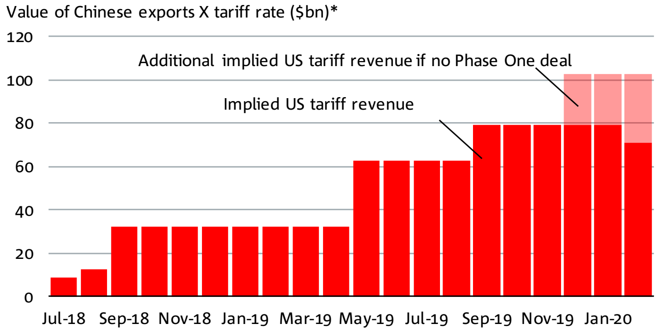
Downside risks have eased following the US-China Phase One trade deal and with Congress set to approve spending bills to fund the Government. Incoming data point to on-going growth in the economy; while consumer spending has slowed, household sector fundamentals remain solid. Business investment is likely to remain under pressure but housing investment is improving. We expect the Fed to remain on hold for the foreseeable future, although the risk is that they will have to ease policy further.

Downside risks have eased

Incoming data point to a US economy that is continuing to grow steadily, albeit at a slower pace than in recent years. This is despite several headwinds including a slowdown in the global economy and rising trade barriers and related trade policy uncertainty.

While not the only source of trade tension, the US-China dispute has nevertheless been the most significant trade tension. Therefore, the news that the US and China have reached a 'Phase One' deal – to be signed in January – is welcome. While full details have not been released, the deal means that the US and China tariffs slated for 15 December did not go ahead and that the 15% tariff on around $110b of Chinese imports that took effect in September will be reduced to 7.5%. China has agreed to additional intellectual property protections, curbs on forced technology transfers, increased access to its financial services market, and commitments to not use the currency as a competitive tool. China is also to increase its imports from the U.S in the coming years (including, but not only, agricultural products).

Trade deal only a partial wind back



Source: NAB Economics. * Based on estimated import values at the time tariffs announced. Assumes deal formally signed in January, with 15% tariff on $110b reduced to 7.5% in Feb.

However, the major portion of the tariffs that have been implemented since the dispute commenced last year will remain in place. Compliance with the agreement will be crucial to it being sustained and given some aspects are open to interpretation (how do you tell whether a currency depreciation is unfair or not?) the risk of the agreement breaking down is real. Moreover, the more difficult issues – such as China's industry policies and subsidies – have not been addressed so it is difficult to assess the prospects of a Phase Two agreement. The outcome next year's US election (and electioneering) will also have a role to play.

Nevertheless, the lift in share markets indicates that it has provided a boost to sentiment. In part this may be because the deal suggests (severe) tail risks have diminished. Less clear is whether it has removed the incentives for business to delay or cancel investment plans until the future trading arrangements that will apply become more certain. For this reason, we have not changed our forecasts for US growth following the deal but see it as re-balancing risks around the forecast with less downside risk than before.

Fiscal developments also look likely to reinforce the theme of a lowering of downside risks. Last month, to avoid a government shutdown, the Congress passed a continuing resolution which provided funding through to 20 December 2019. This week the House passed the spending bills which will ensure FY 2020 funding for Federal government operations. Press reports suggest the bills will pass the Senate before the 20 December deadline.

Outlook

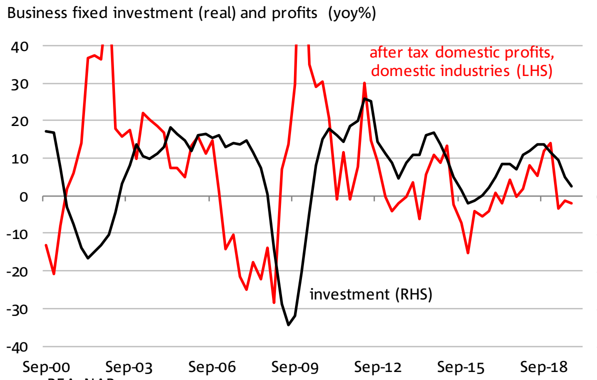
In recent quarters the story has been of strength in consumer spending offsetting weakness in business investment and (until Q3) residential investment spending. However, recent data point to a soft patch for consumer spending while some business investment indicators have not been as weak as before.

Date **December 2019** | Author Tony Kelly – Senior Economist

In particular, core capital goods orders and shipments resumed growing in October which, if sustained, points to growth in equipment investment. That said, non-residential construction spending remains weak and mining investment is still falling (based on the rig count).

While mining investment should stabilise soon (as it often lags moves in oil prices) there is no reason to assume that the underlying weakness in business investment is about to turn around substantially in the near term. Apart from trade policy uncertainty, profit growth has also been weak. While the most recent quarterly data suggest this may be stabilising, survey measures of future capex intentions have continued to soften.

Profits, not just trade, matter for investment

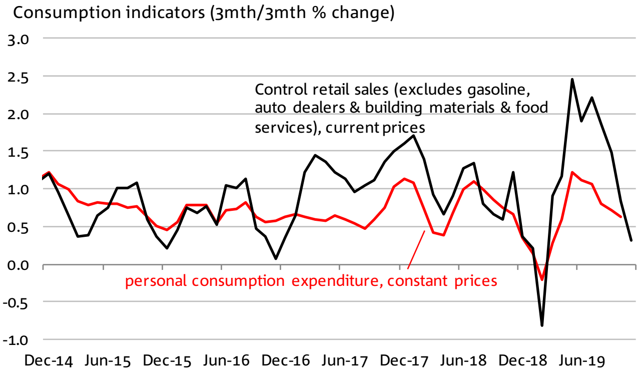


Source: BEA, NAB

The decision by Boeing to suspend production of its 737 Max aircraft as it awaits approval by regulators for the plane to return to service is a negative for GDP growth. While the plane has been grounded for a while, Boeing had been continuing production (which has fed into inventories). Estimates suggest the production halt will take around 0.5% off Q1 GDP growth (on an annualised basis).

Quarterly consumption growth slowed from its strong Q2 pace of 1.1% q/q to a still robust 0.7% in Q3 and is set to slow further in Q4. This is evident in retail sales data which again was subdued in November.

Consumption growth easing



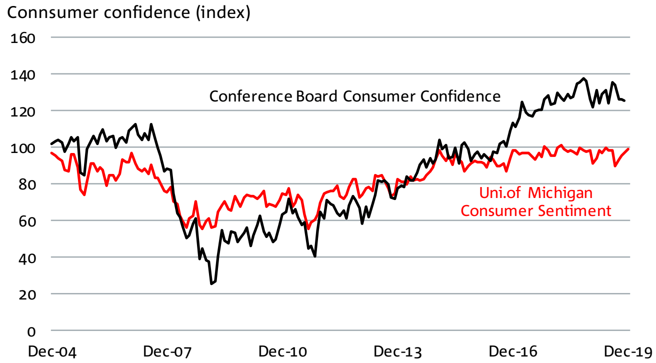
Sources: BEA, NAB

The timing of the Thanksgiving holiday (late in November) and 'Cyber Monday' (typically in November but early December this year) complicates the seasonal adjustment process and may have constrained the November retail sales data.

More importantly, while we have been expecting consumption growth to moderate from its mid-2019 highs, the fundamentals are still in place for on-going solid rates of growth.

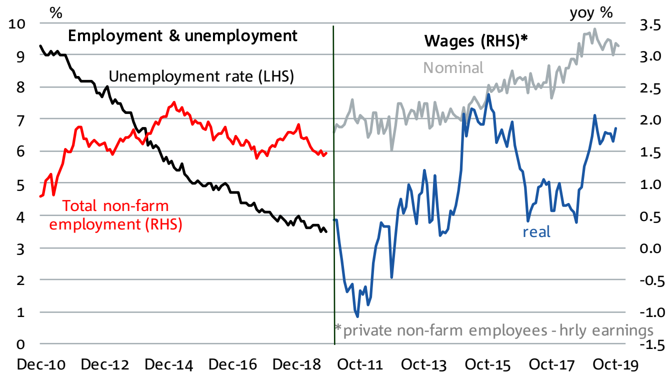
Still solid employment growth (highlighted by the net 266,000 increase in non-farm jobs in November) and real wage growth are supporting household income growth. Moreover, with the unemployment rate at a fifty year low it is not surprising that consumer confidence remains at a solid level. Household balance sheets are also in good shape.

Consumer fundamentals positive- solid confidence…



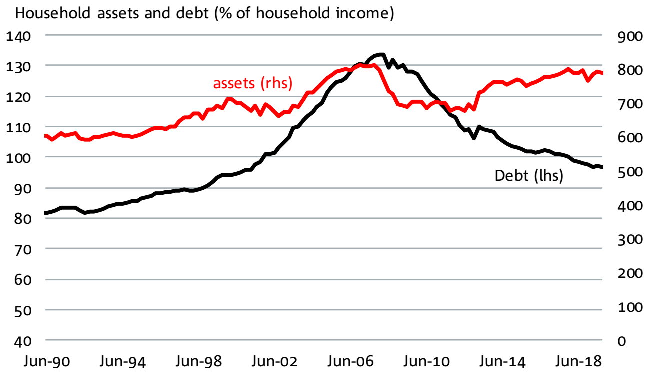
Sources: Conference Board, University of Michigan/Thomson Reuters

…healthy labour market…



Sources: BLS, NAB.

…balance sheet in good shape



Sources: Federal Reserve, NAB

An additional positive factor is the Fed's easing of monetary policy this year. This is also helping residential investment which came out of its slump in

Q3. In November the National Association of Homebuilders Housing Market Index moved to its highest level since 1999.

Trade flows – both exports and imports – have been soft, and survey indicators point to this continuing in the near term. This is partially due to US-China tariffs but in October, excluding China, both goods export and import values were lower than the same time a year ago. This likely reflects the slowdown in both the US economy (including in relatively trade intensive business investment) and in the global economy. With the US dollar expected to ease and US growth expected to settle at a lower level while global growth starts to recover (in 2020), our forecasts have a lower negative net export contribution to GDP growth than has been the case in recent years.

Our overall forecasts are unchanged – we expect year-average GDP growth of 2.3% in 2019, before declining to around 1¾ in 2020 and 2021. However, looking at quarterly growth rates, the trough is expected to be in 2019 Q4/2020 Q1 (in part due to the Max 737 production halt) before growth returns to around its trend level. Data so far released for Q4 suggest some upside risk to our 2019 Q4 forecast.

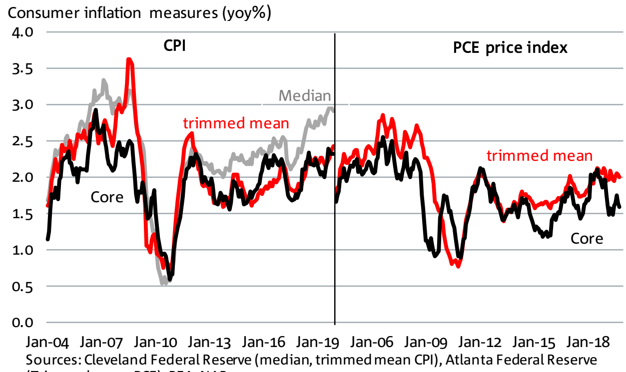
Monetary policy

With three rate cuts (totalling 75bps) since the middle of the year, the Fed considers the current policy stance to be appropriate. As a result, it is firmly in wait and see mode and it has indicated that it will take a 'material re-assessment of the outlook' for it to cut again.

Our forecasts include some further slowdown in growth in coming quarters as well as somewhat slower growth over 2020 than is expected by the median Fed member forecast. Whether – if our projections were realised – this would be considered 'material' is less clear. This is particularly so following the US-China trade deal and (arguably) greater clarity around Brexit following the UK election. The possible downside risks around these events were one of the motivating forces around the rate cuts that occurred, so as tail risks diminish the pressure on the Fed to ease further is also lowered.

The chance of a rate hike by the Fed – even with the unemployment rate at a fifty-year low – is even lower. The Fed's preferred core PCE inflation measure remains below its 2% inflation target. While other inflation measures have shown some more strength, this works more to provide re-assurance to the Fed that maintaining a fed funds rate modestly below its neutral level (its current stance) is appropriate.

Core PCE inflation still subdued but other indicators have held up



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

Moreover, some Fed members appear willing to tolerate a period of above target inflation to lift inflation expectations. The Fed Chair has indicated that a 'persistent and significant' move up in inflation will be required for the Fed to consider raising rates. There are no signs that this is occurring.

Our forecasts (out to 2021) do not see core PCE inflation moving above the 2% target. As a result, we continue to expect that the Fed will remain on hold for the foreseeable future, with the main risk around this projection being that the Fed cuts rates again.

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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	2.4	1.9	1.0	0.9	0.4	0.3	1.1	0.7	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**
Private fixed investment	4.6	1.4	0.9	1.9	1.3	0.2	0.7	0.8	-0.4	-0.3	**0.4**	**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	0.4	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.2	-0.2	0.0	-0.4	0.6	0.0	0.1	-0.2	0.1	**-0.1**	**-0.2**	**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**	**0.3**	**0.4**	**0.4**	**0.5**
Note: GDP (annualised rate)					*3.5*	*2.9*	*1.1*	*3.1*	*2.0*	*2.1*	*1.6*	*1.3*	*1.8*	*1.7*	*1.8*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.4	1.9	2.0	0.5	0.4	0.3	0.1	0.6	0.4	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.9	1.6	1.9	2.0	0.5	0.4	0.4	0.3	0.5	0.5	**0.3**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**3.5**	**3.6**	**3.6**	**3.9**	**3.8**	**3.8**	**3.9**	**3.6**	**3.6**	**3.5**	**3.5**	**3.6**	**3.6**	**3.6**
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	1.7	1.8	2.2	2.9	3.1	2.7	2.4	2.0	2.0	**1.7**	**1.7**	**1.7**	**1.7**	**1.8**

Source: NAB Group Economics

*Contribution to real GDP growth

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