US ECONOMIC UPDATE JANUARY 2020

Growth likely slowed in Q4

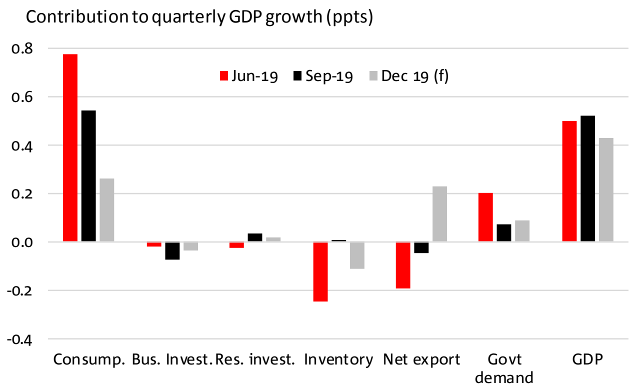
NAB Group Economics

We expect Q4 GDP growth of 0.4% q/q (1.7% annualised), confirming the shift down in growth in 2019 from its 2018 level. We expect a sluggish start to 2020 – due to Boeing's production woes – but then for the economy to grow at, or a bit above, its potential growth rate. Trade headwinds have lessened – highlighted by the US-China Phase One deal – but trade uncertainty (and risk of re-escalation) remains. The Fed's policy review is likely to lead to it adopting a flexible average inflation target; while we still are projecting the Fed to remain on hold in 2020, such a move would increase the chance of the Fed further easing policy.

Q4 GDP preview

The first estimate of Q4 GDP will be released late this month. We expect it to show growth of around 0.4% q/q (1.7% annualised). If this were to eventuate, it would be the weakest quarter of GDP growth in 2019. That said, it is still around our estimate of the US's long-term potential annual growth rate (1¾%). Moreover, it would see the annual growth rising modestly to 2.2% y/y (from 2.1%, as the weak Q4 2018 drops out of the calculations).

Modest consumption growth to weigh on Q4 GDP



The slowdown in Q4 is likely to be led by household consumption, which is expected to show only modest growth following two strong quarters. Business investment is again likely to be weak, with machinery & equipment investment and non-residential structures investment likely to decline again. In contrast, inventories are likely to detract from growth.

Support to growth is likely to come from net exports, firm government demand and the recovery in residential investment that started last quarter and looks to have continued.

Trade risks ease but haven't gone away

As expected the US and China signed the Phase One trade agreement this month. It includes intellectual property protection and enforcement measures, agreement not to allow forced technology transfers or to engage in competitive currency devaluations, improved agricultural market access (including through reducing regulatory barriers), an opening up of China's financial market to US companies, and undertakings by China to increase imports from the US. The agreement does not address the difficult issue of China's industrial policies, including subsidies for state-owned businesses.

The US will also halve the 15% tariff on around $110 billion of imports from China that started in September 2019. This still leaves the bulk of tariffs imposed by the US in place (25% tariff on around $250b of imports from China).

As such the Phase One deal represents a pause in the trade dispute as much as anything else. Successful implementation and follow through of Phase One will be necessary before any Phase Two deal is possible. Given that this will take time, and with the US Presidential election in November, this suggests that further progress is unlikely this year.

There is also a clear risk that the agreement breaks down – leading to a re-escalation of the dispute. This could be because one party sees the other as not following through on its commitments or even simply

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because of practical difficulties in meeting some of the commitments. For example, there are concerns over the ability of China to meet its undertaking to purchase an extra $77 billion of imports from the US in the first year of the deal and an extra $123 billion in the second year, relative to their 2017 level. The extra imports are to come from selected categories of manufactured and agricultural goods, energy products and services.

Total US exports to China in 2017 were $186 billion, so the agreement calls for a 66% increase in exports relative to 2017 (and greater relative to 2018 as exports in that year were $178 billion). One concern is that the target will be met by crowding out exports to China from other countries.

Agriculture illustrates this concern. The agreement calls for a lift (relative to 2017) of $12.5b in year 1 and $19.5b in year 2. This represents a near doubling of US agricultural exports to China from their 2017 level (and quadrupling from the 2018 level). In each of 2017 and 2018 China's total imports of the specified agricultural imports increased by around $14b – i.e. by less than the increase that needs to come from the US. So, absent a rise in commodity prices lifting the value of imports, it is likely that other exporters will miss out, domestic food production is cut or imports stockpiled to meet the target.

Another positive trade development was the passage of the USMCA (the new trade agreement between the US, Mexico and Canada) by the US Congress. It now just requires the US President's signature (a formality) and approval by the Canadian parliament.

A ceasefire (until the end of the year) in an international taxation dispute between the US and France has also been agreed. The dispute had led the US to threaten punitive tariffs on certain French goods. The US and EU are also undertaking trade negotiations with recent reports holding open the prospect of an agreement this year. However, at the same time the US President is making clear that if negotiations aren't productive he is ready to impose tariffs on EU auto imports.

Outlook

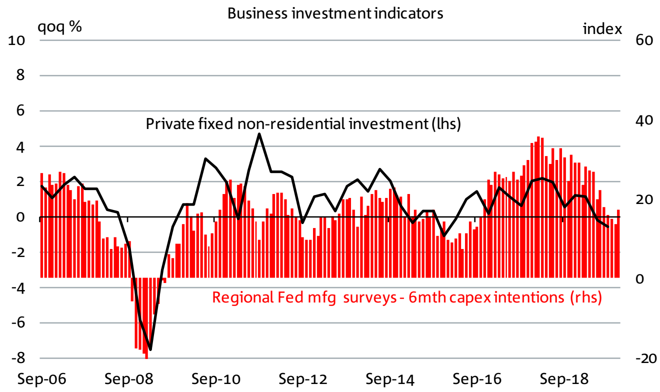
The slowdown in the annual US growth rate from over 3% in mid-2018 to just over 2% in Q3 2019 (and likely the same in Q4) reflected several factors.

For much of the year, trade tensions worsened adding pressure to an already slowing global economy. Trade disputes and the slowdown in global growth weighed on trade and business investment. Pressure on profit margins and lower oil prices also impacted investment. In addition, monetary policy was tightened through 2018 – with its impact evident in a decline in residential investment in the first half of 2019. At the same time the boost to growth from tax cuts at the start of 2018 was fading.

However, some of these headwinds have receded. Monetary policy has been eased, oil prices have (broadly) stabilised and there are tentative signs that the trough in global growth may be been reached. The turnaround in residential investment in Q3 is evidence that the shift in Fed policy is helping to support growth.

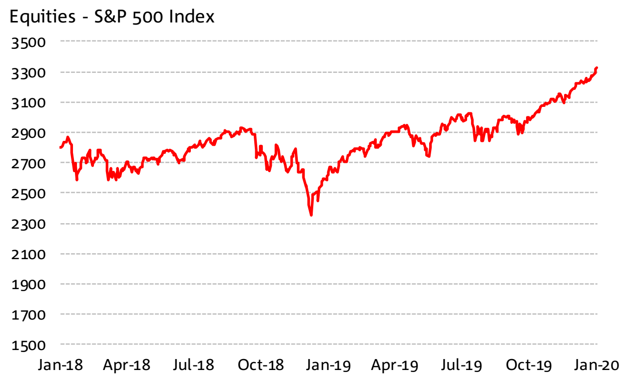
It is unclear how much of a boost the US-China Phase One trade deal will be to activity. The tariff roll-back is only small. Moreover, the uncertainty around future trading relations remains and so some businesses will continue to have a reason to defer investment. That said, there are some early signs that investment intentions may be stabilising. An average of future capital expenditure intentions as reported in regional Fed manufacturing surveys in December increased to its highest level in four months. Available surveys for January point to a further lift.

Dec. rise in capex intentions – noise or turnaround?



At the very least the trade agreement reduces near term downside risks. The improvements on the trade front have been a factor behind the rise in equity valuations.

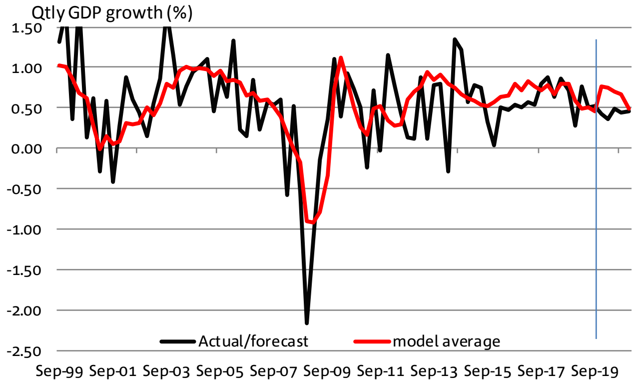
Equities on the rise



Source: ThomsonReuters Datastream. Data to 17 January 2020

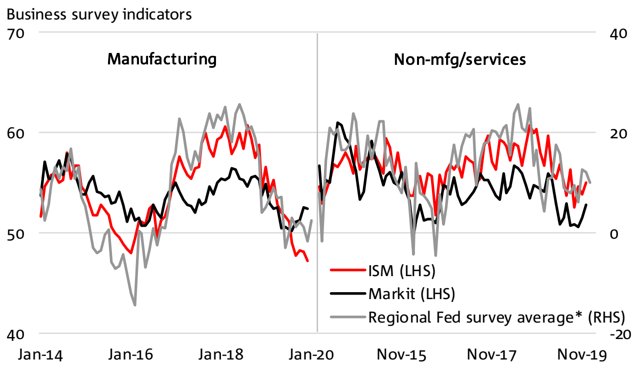
Equities are one variable in our US macro models, which also use variables such as the yield curve (or real interest rates) as well as house prices, FX, oil prices and lending standards. As we noted late last year, these top down models are more optimistic in the near term than our current forecasts, and are suggesting that US growth may accelerate into 2020 (although growth at the model projected levels could encounter capacity constraints, given the already very low unemployment rate).

NAB US Macro models point to upside risk



At this stage business surveys are pointing to growth stabilising, with most coming off their recent lows (but still well down on 2018 levels), although the US manufacturing ISM continued to weaken through to end 2018.

Most business surveys point to growth stabilising



Sources: ISM; Markit; Dallas, Philadelphia, Kansas, Richmond & New York Federal Reserves (*simple average of survey results. Jan 2020 point uses latest data from each survey (Dec 19 or Jan '20))

Based on these factors, we see quarterly US growth stabilising through 2020 at, or a little above, its long-term potential rate. In year average growth terms, this translates into GDP growth of 2.3% in 2019, and then 1.8% in 2020 (revised up from 1.7%).

Our forecasts include a weak Q1 due to the halt in production of the Boeing 737 MAX aircraft. Estimates suggest that this will take around 0.5% off Q1 GDP growth (on an annualised basis) which will be reflected in weaker inventory accumulation. Absent this factor our forecast for Q1 GDP would be consistent with around trend growth.

Monetary policy - the Fed's review

Back in November 2018, the Federal Reserve announced a review "…of the strategy, tools, and communication practices it uses to pursue the monetary policy goals established by the Congress: maximum employment and price stability."

The Fed is indicating that it expects to announce the results of the review around the middle of this year. Recent Fed meeting minutes provide a guide to some of the likely outcomes.

Regarding possible tools (in addition to changing the fed funds rate when it is not at its lower bound), the Fed still considers QE (large scale asset purchases) and forward guidance as useful tools.

The Fed has also discussed the option of targeting or capping short-term and long-term interest rates. The option of capping long-term rates (as is currently being done by the Bank of Japan) has only limited support. In contrast, the Fed appears more open to capping short-term rates as a means of reinforcing forward guidance about the policy rate.

The Fed has also discussed whether negative interest rates might be a suitable future policy tool. The answer appears to be a resounding 'no'. From the October minutes:

> "All participants judged that negative interest rates currently did not appear to be an attractive monetary policy tool…"

In terms of strategy, the Fed appears likely to adopt some form of 'make-up' strategy. Currently the Fed aims for 2% inflation regardless of what inflation has been in the past. Under a make-up strategy, the response to a period of undershooting the target is to target a period of overshoot (or vice versa). From the September 2019 minutes:

> "… most participants were open to the possibility that the dual-mandate objectives of maximum employment and stable prices could be best served by strategies that deliver inflation rates that over time are, on average, equal to the Committee's longer-run objective of 2 percent."

Make-up strategies come in different forms including price level targets or targeting 2% inflation, on average, over time – though a significant issue with this approach is how the relevant time period is set. The Fed appears to be leaning towards setting a flexible target – e.g. targeting 2% inflation over the cycle or on-average rather than a more rigid target (e.g. 2% inflation, on average, over ten years). What this all means for the monetary policy stance this year is not entirely clear. With the fed funds rate currently above its lower bound it is changes to the Fed's target ('strategy') rather than tools which could shift the monetary policy stance.

On the face of it, given that inflation is currently below the two per cent target, moving to a make-up strategy should cause a shift to a more accommodative stance. Moreover, one concern within the Fed will be that without some action to go along the change the new target won't be credible.

However, Fed members appear comfortable with the current policy stance (assuming their projections hold up). Fed members already consider the fed funds rate to be stimulatory as it is below its neutral level, even with the unemployment rate at a very low level.

Moreover, given concerns from some Fed members that current inflation expectations are too low, and that a period of above target inflation is needed to lift expectations to a level consistent with 2% inflation, the appropriate stance may not shift much with a move to average inflation targeting. In other words, some Fed members have already been pushing for a period of above 2% inflation under the current target.

We are currently projecting an unchanged Fed funds through 2020 and 2021. However, our view has been that the balance of risks is heavily skewed to there being further easing with the chance of a rate hike much lower. This view has been in part based around the prevalence of downside risks to the outlook as well as the Fed Chair's own comments about needing to see a persistent and substantial increase in inflation before rate rises are considered. The likely outcome of the Fed's review – including the likely adoption of average inflation targeting – reinforces this balance of risks.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %							
					2019				2020			
	2018	2019	2020	2021	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components												
Household consumption	3.0	2.6	2.3	1.9	0.3	1.1	0.8	**0.4**	**0.6**	**0.5**	**0.5**	**0.5**
Private fixed investment	4.6	1.3	0.6	1.9	0.8	-0.4	-0.2	**-0.1**	**0.3**	**0.4**	**0.4**	**0.5**
Government spending	1.7	2.3	2.1	1.8	0.7	1.2	0.4	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.1	-0.2	0.0	0.1	-0.2	0.0	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Net exports*	-0.4	-0.2	0.0	-0.1	0.2	-0.2	0.0	**0.2**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**2.3**	**1.8**	**1.8**	**0.8**	**0.5**	**0.5**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**
Note: GDP (annualised rate)					*3.1*	*2.0*	*2.1*	*1.7*	*1.4*	*1.9*	*1.9*	*1.8*
US Other Key Indicators (end of period)												
PCE deflator-headline												
Headline	1.9	1.5	2.0	2.0	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	0.3	0.5	0.5	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**3.5**	**3.5**	**3.4**	**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)	2.50	1.75	1.75	1.75	2.50	2.50	2.50	1.75	**1.75**	**1.75**	**1.75**	**1.75**
10-year bond rate	2.7	1.9	1.8	2.2	2.4	2.0	2.0	1.9	**1.7**	**1.7**	**1.7**	**1.8**

Source: NAB Group Economics

*Contribution to real GDP growth

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