US ECONOMIC UPDATE FEBRUARY 2020

US economy travelling well but Coronavirus clouds the outlook

NAB Group Economics

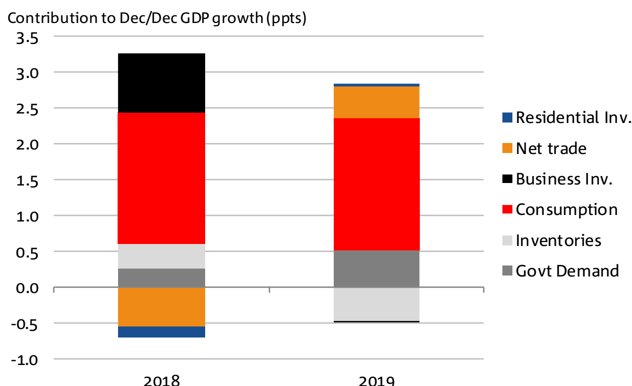
US GDP grew by 2.3% in 2019, still above its longer-term potential growth rate, but down on the 2018 pace. While we are assuming Q1 growth will likely be impacted by Boeing production cuts and Coronavirus, with some bounce back in subsequent quarters, there is a risk that the virus impact will be more significant and prolonged. We expect GDP growth a little above its trend rate over 2020/2021 and the Fed to remain on hold; however, the risks are skewed to the downside (lower growth/rate cuts).

2019 in review

US Q4 GDP growth came in at 2.1% q/q (annualised), a bit higher than our expectation of 1.7% q/q. That said, the composition of growth was largely as expected including a slowdown in consumption growth, further weakness in business investment but stronger government spending and a positive contribution from net exports.

As a result, year average growth was 2.3% – on par with the post GFC experience but above our estimate of the economy's potential growth rate. It was a meritorious result given that it has been a long expansion, the unemployment rate is very low (raising issues of possible supply constraints) and the weakness in the global economy. That said, it was well down on the 2.9% growth seen in 2018, so growth clearly slowed last year.

Growth slowed over 2019 as investment fell



Over 2019 a notable development was the weakening in business investment. This likely reflected impact of the US-China trade war, a weaker global economy, lower oil prices (discouraging mining investment) and margin compression.

In contrast, household consumption growth held up, supported by a strong labour market and a healthy balance sheet. Meanwhile trade flows – both exports and imports – were weak while government spending picked up across the different levels of government.

Coronavirus risk

While the US economy has been growing at an above trend rate, there are two factors likely to weigh on growth in Q1 2020. The first is Boeing's decision (announced late last year) to halt production of the 737 MAX aircraft (estimated impact of -0.5ppts annualised).

The other, potentially far more serious, is the fallout from the Coronavirus. Containment efforts – particularly in China at this stage but also other countries – will affect demand and supply chains. Tourism (and business travel) is directly impacted, supply chain disruption will affect manufacturers (and will become an increasing issue the longer factories are shutdown or running below capacity in other countries) while lower commodity prices will impact the mining sector. The net impact on GDP will be smaller, as imports will also be lower (e.g. less US tourists overseas) and lower commodity prices should provide some boost to household incomes.

In our most recent Global Forward View we revised our China GDP forecast to show no growth in Q1 (compared with an increase of 1.5% q/q in Q4 2019). Of the major advanced economies, the US has the least direct exposure to China – total exports to China in 2018 were less than 1% of GDP. However, the rest of the East Asia region will also be significantly impacted so this understates US exposure. The recent pick-up in the virus count in South Korea and Italy is

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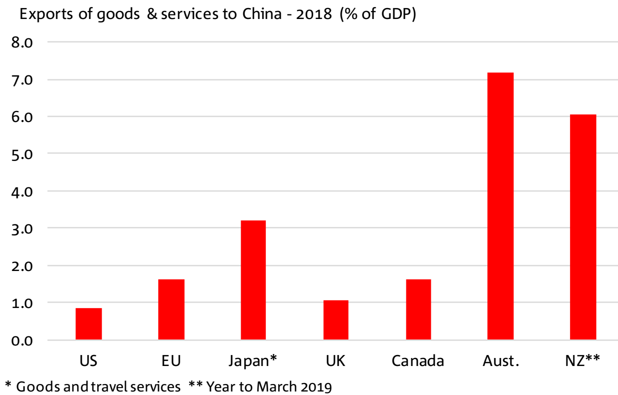
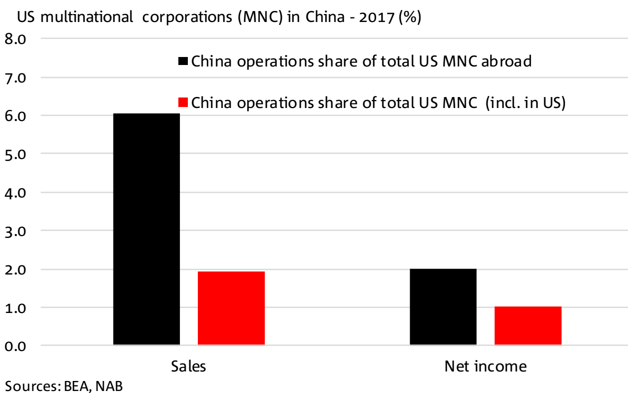
troubling, as it points to the possibility of further supply disruptions and a broadening out of the virus spread to Europe, increasing the global fall-out.

Direct trade exposures to China are small



Apart from trade linkages, US multi-nationals have operations in China, highlighted by Apple's guidance that it will fail to meet its Q1 revenue guidance due to production issues and weaker demand. Sales in China by US multi-national corporations (MNCs) are only a small part of sales (both in total or even when only including overseas sales). Moreover, the value added (GVA) by US MNCs in China is very small relative to the US economy (0.4% of GDP).

US MNC operations in China also relatively small

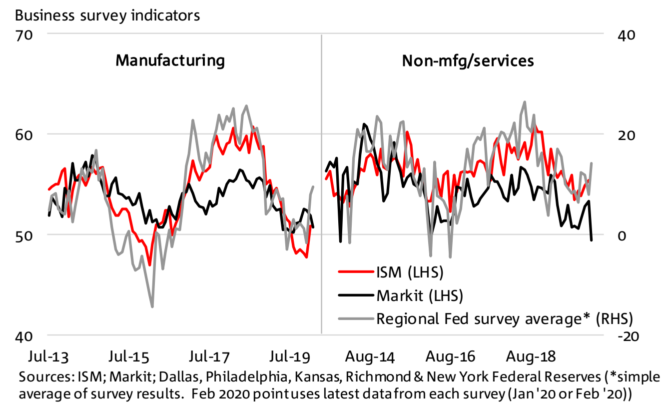


Confidence affects and financial markets are other channels through which the virus could impact the US economy. Markets have become more volatile since the emergence of the virus with some large one-day falls in stock prices. At the time of writing, the S&P 500 is 6% below its mid-January peak following large falls over the last two days. Where it goes from here will depend on indications of how successful China's containment measures have been (and factory re-openings) and whether the recent outbreaks in South Korea and Italy can be quickly contained.

Outlook

The large fall in the Markit services PMI in February highlights the risks associated with the Coronavirus. Survey respondents cited as factors the virus, along with election and broader slowdown fears. There was also a smaller fall in the manufacturing survey. However, future output expectations strengthened suggesting that respondents saw the weakness as being short-lived.

Markit PMI sends a warning shot



It is worth noting that the Markit services measure recorded a very large fall in October 2013 following the shutdown of the Federal Government. So the survey may be picking up confidence/uncertainty impacts and not just actual activity. Regional Fed surveys available for February (mainly manufacturing) have mostly shown a continuation of the recovery that started late last year; although it is probably too early to see any significant supply chain disruptions.

As a result, we have not significantly changed our forecasts although we have modestly lowered our Q1 GDP growth expectation, but lifted our forecasts for Q2/Q3. As a result, despite the better than expected Q4 outcome, our year average growth forecast for 2020 is unchanged at 1.8% and we expect growth of to 1.9% in 2021.

This is consistent with the view that the US economy will run slightly above its longer-term potential (approximately 1¾%) given that the Fed is set to maintain its current somewhat loose policy stance to lift inflation at least back to target, if not a bit above.

While we expect the Fed to be on hold this year, the risk around this is skewed to rate cuts. This may be due to growth concerns or a significant deterioration in financial markets, with the potential for a material and prolonged impact from the coronavirus the most obvious risk. Fed speakers have adopted a watching stance on the virus, suggesting that their baseline assumption is that the impact on the US will either by small and/or short-lived and quickly reversed (similar to our assumption). Events of recent days are testing this view and the possibility of Fed easing – even if on an 'insurance' basis – is a real possibility.

Even if the economy holds up, a desire to move inflation more quickly back to (or above) target is another possible trigger for a rate cut.

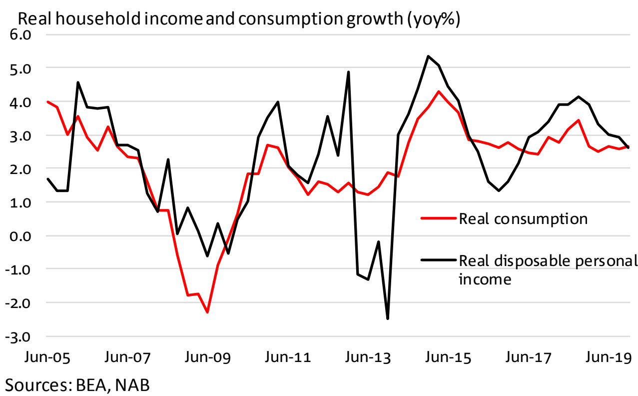
As noted above, and as with our global forecasts, these projections are based on the virus being contained over the next month or so leading to China's factories, and activity more broadly, coming

back on stream. Of course, this is an assumption only and is the 'best case' outcome. The longer it takes to bring the virus under control – and the more outbreaks there are worldwide – not only will demand and production impacts become larger, but the risk of a negative spiral from second round impacts will grow larger. For example, manufacturers forced to curb production due to supply shortages may keep staff on for a period but a lengthy production shutdown will likely see layoffs which will feed through to consumption and so on.

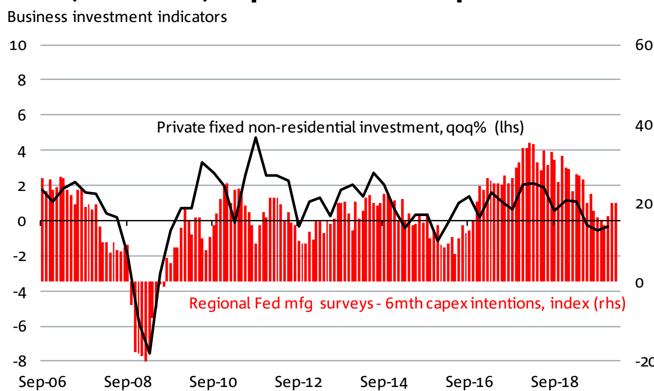
In terms of the composition of growth we are still expecting household sector activity to be solid and business investment weak (outside of intellectual property investment) but the differential is likely to narrow as the year progresses.

As noted before, consumption growth moderated towards the end of 2019. Household disposable income growth has also slowed (mainly due to non-wage income slowing). However, it remains reasonable and the overall household balance sheet is in good shape. A positive impact from the Fed's monetary easing last year is also showing up in housing sector indicators and should help support interest sensitive elements of consumption as well.

H'hold income growth has slowed but still decent



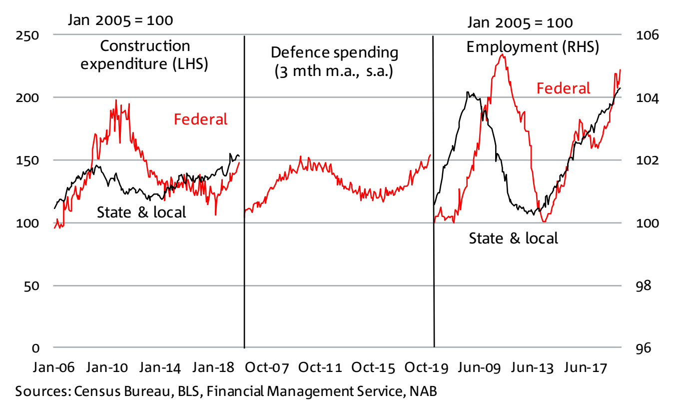
Some, tentative, improvement in capex intentions



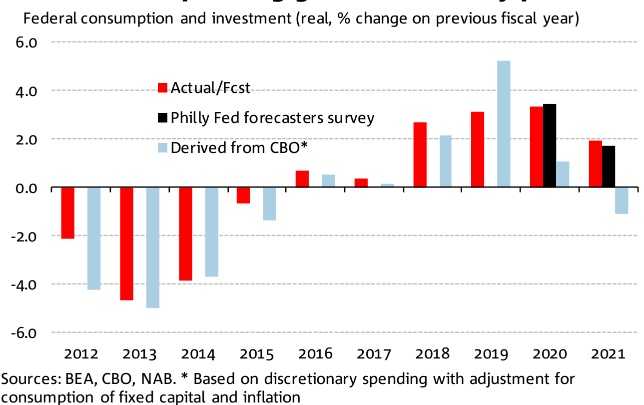
On the investment side, there are some signs of stabilisation, although the recent downturn in oil prices may weigh further on mining sector investment. Core capital goods orders appear to have stabilised while regional Fed manufacturing survey measures of capex intentions have moved higher in recent months. While considerable uncertainty around trade policy remains, the recent US-China Phase One deal may provide some relief.

After tax cuts boosted growth in 2018, the spending side of fiscal policy kicked into gear in 2019. CBO spending projections point to some slowing in Federal government spending over fiscal year (fy) 2020 and 2021. We are factoring in some slowing in quarterly growth rates this fiscal year (but in year average terms for growth to be similar to fy2019 due to base effects). State/local government spending, which is considerably larger than that of the Federal government, grew by its fastest rate in three years in 2019 and we expect a similar pace in 2020.

Government spending on the up



...but Federal spending growth has likely peaked



Beyond 2020, the results of the US elections later this year will be important. There appears to be no appetite in Washington to wind back the large budget deficits in any material way.

CONTACT THE AUTHOR

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

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %									
					2019		2020				2021			
	2018	2019	2020	2021	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	3.0	2.6	2.2	1.9	0.8	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Private fixed investment	4.6	1.3	0.7	2.2	-0.2	0.0	0.2	0.4	0.5	0.6	0.6	0.6	0.6	0.6
Government spending	1.7	2.3	2.2	1.8	0.4	0.7	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4
Inventories*	0.1	0.1	-0.2	0.0	0.0	-0.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.4	-0.2	0.1	-0.1	0.0	0.5	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.9**	**2.3**	**1.8**	**1.9**	**0.5**	**0.5**	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Note: GDP (annualised rate)					*2.1*	*2.1*	*1.1*	*2.1*	*2.0*	*1.9*	*1.9*	*1.9*	*1.8*	*1.8*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.9	1.5	1.7	2.0	0.4	0.4	0.2	0.5	0.5	0.5	0.5	0.5	0.5	0.6
Core	1.9	1.6	1.9	2.0	0.5	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment rate - qtly average (%)	**3.8**	**3.5**	**3.5**	**3.4**	**3.6**	**3.5**	3.5	3.5	3.5	3.5	3.5	3.4	3.4	3.4
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	2.50	1.75	1.75	1.75	2.50	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
10-year bond rate	2.7	1.9	1.8	2.2	2.0	1.9	1.7	1.7	1.7	1.8	1.9	2.0	2.1	2.2

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

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