US ECONOMIC UPDATE JUNE 2020

MAY REBOUND, BUT VIRUS SPREAD A RISK

NAB Group Economics

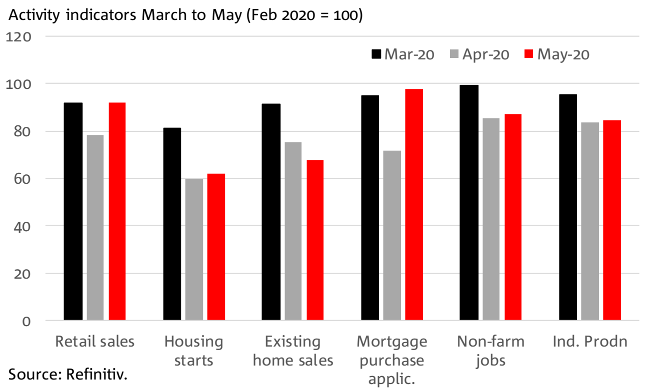
The US economy started to recover in May and this appears to have continued into June. There has been an increase in the number of COVID-19 cases, raising the risk of delays to further easing of restrictions in some locations, or even a re-imposition of restrictions. The Fed is likely to move to outcome or date based forward guidance but the bottom line is that the fed funds rate will stay at its current level for a long time.

May rebound

The economy started to recover in May following the large declines in activity in March and April. This turnaround has coincided with the partial easing in Coronavirus (COVID-19) containment measures.

Retail sales increased 18% m/m in May, and there was also a substantial rebound in mortgage applications. Industrial production, housing starts and non-farm employment also increased but more modestly. However, all these activity indicators remain below their February levels - in many cases substantially. Existing home sales, which declined further in May, were an exception but they reflect the completion of contracts signed in March/April when restrictions were at their peak.

Monthly indicators point to growth in May

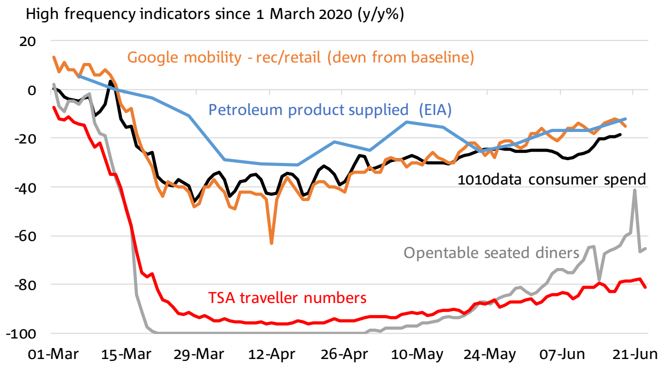


Source: Refinitiv.

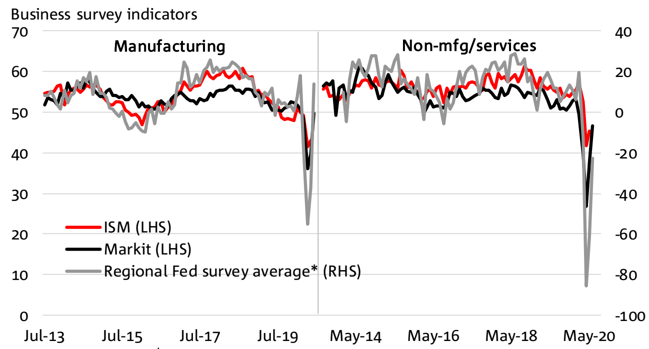
While there may be an element of pent-up demand in the May lift, higher frequency indicators generally point to the recovery continuing through to mid-June. Since late May there has been considerable social unrest in the US, which may have weighed on activity, although it is hard to quantify whether it has had a material impact.

Nevertheless, a range of high frequency indicators of activity suggest that the recovery continued into June. Similarly, business surveys available for June (Markit and some regional federal reserve surveys) also showed further improvement.

High frequency indicators suggest June up too...



...as do business surveys



Sources: ISM; Markit; *simple average of Philadelphia, Richmond & (mfg only) New York federal reserves). Up to May '20 for ISM, June '20 Markit (prelim) and Reg. Feds.

Overall, available indicators for May and June are showing greater improvement than we had expected. As a result, we now expect the decline in activity in Q2 to be smaller than we had previously forecast. Consequently, we have revised up our forecast for 2020 GDP growth (to -5.9% from -6.8%).

Date **June 2020** | Author Tony Kelly – Senior Economist
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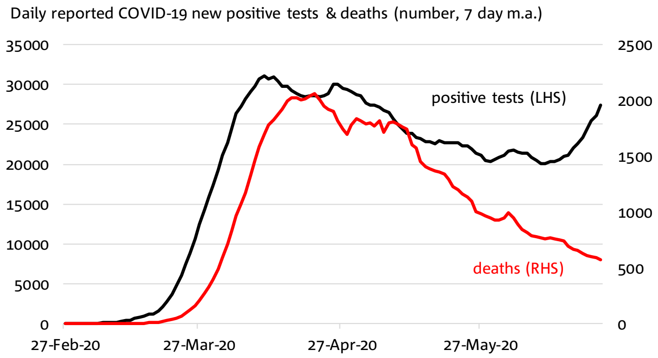
However, we have lowered our forecast for 2021 GDP to 4.2% (from 5.3%). This in part reflects the quicker than expected recovery during Q2, but also ongoing risk around further virus spread.

At the national level, reported COVID-19 deaths have been declining, and on 22 June (using a seven-day average) reached the lowest level since the end of March. However, there has recently been a notable increase in the number of positive test results (i.e. new cases), centred on a few states including Texas, Florida and Arizona. This raises the risk of delays in the lifting of restrictions and possibly a re-imposition of measures in some localities.

Deaths from COVID declining but new cases up



Source: Covidtracking.com

The Governors of Texas and Florida – two of the larger states seeing rapid increase in cases – have not reimposed restrictions at this stage, although they are reinforcing the need for continued social distancing and enforcement of current restrictions. This could of course change, and there has already been a shift in Texas where the governor has asked people to stay at home and is considering greater restrictions (although they may be at a local level rather than state wide). In any event, the increase in cases may mean that household and business confidence and activity soften even without new measures.

The possibility of ongoing issues with the virus in certain localities, is one factor behind our expectation that a full economic recovery will take a considerable length of time. Other reasons include permanent business closures due to the downturn, a sustained shift up in unemployment, significant structural change that will take time to absorb (less travel, more on-line activity, work from home), a tightening in financial conditions, and damage to government finances. The latter is particularly a concern for sub-national governments where balanced budgets are a requirement. These factors are also likely to lead to lower levels of business investment which could result in lower productivity growth in the future.

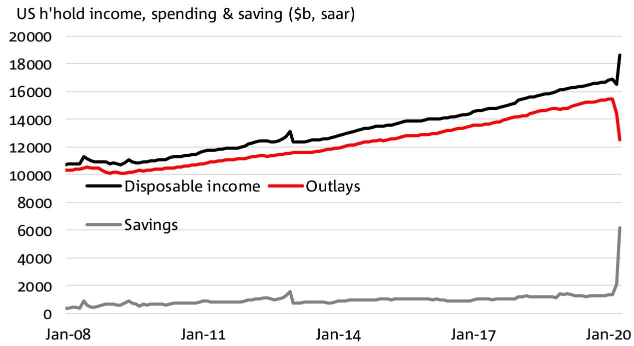
There remains considerable uncertainty around any forecasts in the current environment. There are also a range of risks which, if they were to eventuate, would have a negative impact on the outlook, including a re-escalation of the US-China trade dispute.

Another key uncertainty is the path of fiscal policy. Some of the measures put in place have ended or are winding down (one-off payments to households, loans from the Paycheck Protection Program were capped at 2.5 times the average monthly payroll so initial recipients who don't have their business fully operating may face a funding gap.

Discussions are underway within Congress and the President's administration for a further stimulus bill, with a possible total package size being reported at between $1 to $3 trillion. Apart from size, details of what it might include also remains uncertain. Too rapid a withdrawal of fiscal support could undermine the recovery but, given it is an election year, we expect a significant package to be implemented at some point.

The unusual nature of this downturn complicates any assessment of the appropriate stance of fiscal policy. Fiscal policy moved very quickly at the onset – this can be seen in the large increase in household income in April despite widespread job losses and a resulting loss of wage income. Despite the extra income there was a massive fall in spending as people either did not want to go out, or were restricted from doing so. As a result, there was a massive increase in the saving rate, in aggregate, for households. This means that, even as Government transfer start to wind down, there will be a stock of savings for many to draw on.

Govt stimulus has built up household savings



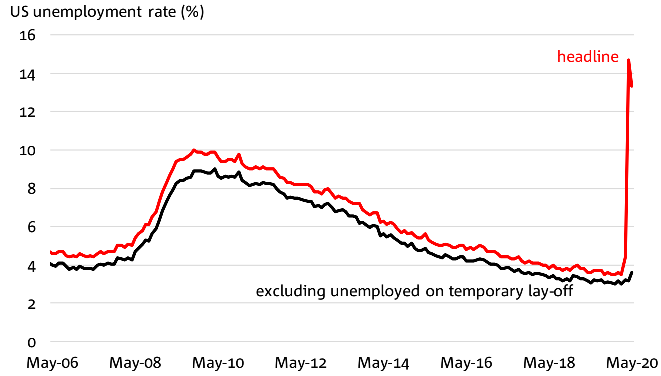
Source: BEA (Refinitiv)

A welcome labour market surprise

Prior to the May employment report, the consensus estimate for the change in non-farm employment was for a ***fall*** of 8 million. This reflected still exceptionally high numbers of initial jobless claims. In the event, however, non-farm employment ***increased*** by 2.5 million and the unemployment rate declined from 14.7% to 13.3% (though it remains at a very high level). This suggests that there was enormous churn going on within the economy – with many businesses laying off workers as others re-opened, bringing staff back-on.

We have noted previously that most of the increase in unemployment over March/April was categorised as 'on temporary lay-off'. While the unemployment rate declined in May, excluding the temporary lay-off category, there was an increase. The longer the economy takes to recover, the more some expected 'temporary' lay-offs will become permanent. With the recovery expected to take an extended time, the unemployment rate is likely to stay well above its pre-virus level for an extended period.

Unemployment down, but signs of long lasting scarring



Fed policy

At the onset of the downturn the Fed quickly reduced the federal funds target range to 0-0.25%, a level it considers is the lower bound. In addition, it has set up a wide range of programs to support market functioning and to support the provision of credit to businesses, households and local authorities, including through asset purchases (QE). It has also put in place a lending program for businesses that were in good shape prior to COVID-19 (the Main Street Lending program) with a backstop being provided by the US Treasury.

Apart from continuing to tweak exiting programs (with some already expanded since the initial announcement), the Fed is also considering what policy settings it needs to achieve its 2% inflation objective in coming years.

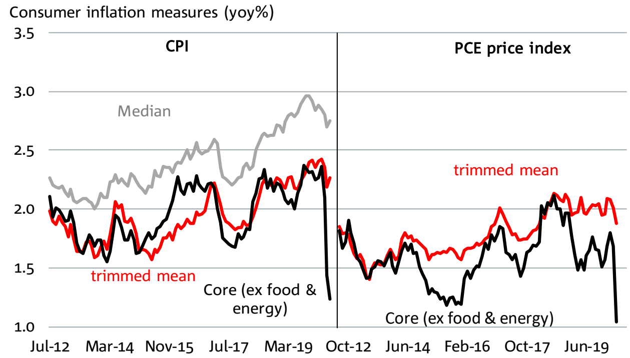
Since the GFC core PCE inflation (the Fed's preferred inflation measure), has generally run below target. The Fed's June meeting projections indicate that most Fed members think that inflation will run below 2% through to end 2022.

Moreover, Vice-Chair Clarida indicated in a recent speech that, even before the downturn, he was concerned that the level of inflation expectations was at the low end of the range consistent with the inflation target.

Measures of core inflation have moved down in recent months, particularly for the 'excluding energy and food' measure. Other measures have shown a more modest decline. While household measures of inflation expectations have held up, measures derived from financial markets have declined.

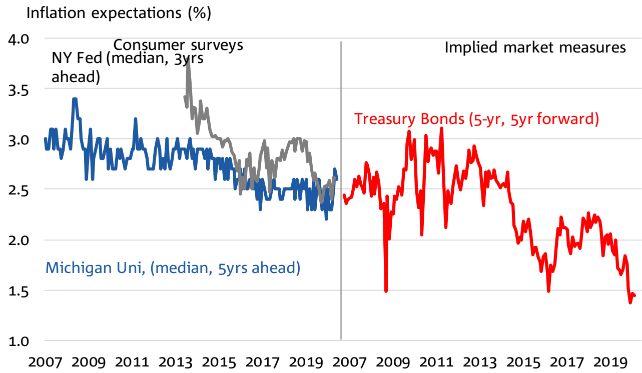
One topic of debate has been whether supply disruptions and increased business costs (e.g. changes to operations to manage virus spread) would lead to higher inflation or whether the weakness in demand would prevail leading to dis-inflation. We think the latter factor will be more significant and have lowered our inflation forecasts from their pre-COVID levels.

Inflation down (extent varies by measure) and…



Sources: Cleveland Federal Reserve (median, trimmed mean CPI), Atlanta Federal Reserve (Trimmed mean PCE), BEA, NAB. CPI data to May, PCE data to April 2020.

… inflation expectations stable or falling



Sources: Bloomberg, Philadelphia & New York Fed. reserves, Thomson Reuters/Michigan Uni.

The Fed's most recent monetary policy statement states that it expects to maintain the fed funds rate target range at current levels "…until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." However, the April meeting minutes strongly indicate that the Fed is considering expanding its forward guidance, either to be outcome based (e.g. unemployment must fall below a certain level before rate rises) or date based. Whatever form forward guidance takes, with inflation expected to remain below target over at least the next several years, the bottom line is that the target range for the feds funds rate is likely to stay at its current level out least out through to end 2022.

There is also at least some support for continuing asset purchases (QE) as well as, to a lesser extent, to target short-to-medium term US Treasury yields.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %					Quarterly Chng %											
						2020				2021				2022			
	2018	2019	2020	2021	2022	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components																	
Household consumption	3.0	2.6	-5.7	4.8	2.7	-1.7	-11.7	7.4	2.2	1.5	1.0	0.8	0.7	0.6	0.6	0.6	0.6
Private fixed investment	4.6	1.3	-7.3	4.9	5.2	-0.6	-8.8	-0.7	2.2	2.8	2.5	1.8	1.3	1.1	1.0	0.9	0.9
Government spending	1.7	2.3	-0.8	1.9	2.2	0.2	-2.0	-1.3	0.5	1.3	1.0	1.0	0.8	0.5	0.3	0.3	0.3
Inventories*	0.1	0.1	-0.7	0.5	0.0	-0.4	0.0	0.1	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	-0.4	-0.2	0.0	-0.6	-0.1	0.4	-0.7	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.9**	**2.3**	**-5.9**	**4.2**	**2.9**	-1.3	-10.3	4.2	1.9	1.9	1.2	0.9	0.8	0.7	0.6	0.5	0.5
Note: GDP (annualised rate)						*-5.0*	*-35.2*	*17.7*	*8.0*	*7.9*	*4.9*	*3.8*	*3.1*	*2.7*	*2.5*	*2.2*	*2.2*
US Other Key Indicators (end of period)																	
PCE deflator-headline																	
Headline	1.9	1.4	0.5	1.6	1.6	0.3	-0.6	0.3	0.4	0.4	0.5	0.3	0.4	0.4	0.4	0.4	0.4
Core	1.9	1.6	0.6	1.5	1.7	0.4	-0.4	0.2	0.3	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4
Unemployment rate - qtly average (%)	**3.8**	**3.5**	**9.4**	**7.2**	**6.7**	3.8	13.1	10.4	9.4	9.0	8.0	7.5	7.2	7.0	6.9	6.8	6.7
US Key Interest Rates (end of period)																	
Fed funds rate (top of target range)	2.50	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

Source: NAB Group Economics

*Contribution to real GDP growth

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