US ECONOMIC UPDATE JUNE 2019

The Fed is close to cutting rates

NAB Group Economics

Trade disputes continue to cast a shadow over the US economic outlook. While recent data suggest some upside risk to our Q2 GDP forecast, business surveys point to a slowing economy. The Fed is getting ready to cut rates; we expect two 25bp reductions in the federal funds rate, with July and September now the most likely dates. There is considerable event risk around these projections – including the upcoming meeting between the US and Chinese Presidents. Risks still appear slanted towards the Fed making more rather than fewer cuts.

Overview

Trade developments continue to play a major role in shaping sentiment over the US economic outlook.

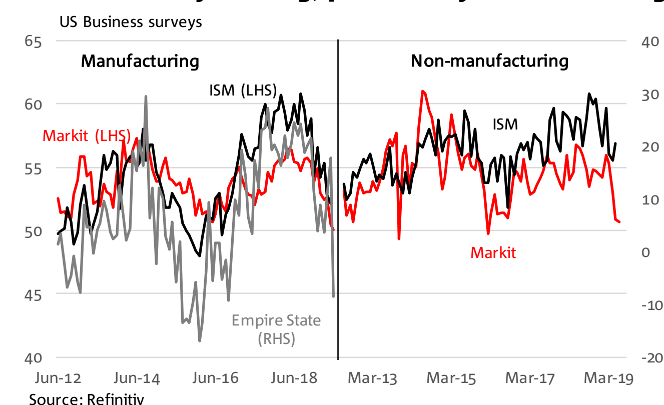
Since the end of May the US President has threatened to impose tariffs on all imports from Mexico over immigration issues, but then withdrew the threat after discussions between the two countries. The rhetoric around the US-China dispute also grew more heated, but the US and Chinese Presidents appear to have agreed to discuss trade issues at the G20 summit later this month renewing some hope that the dispute could still de-escalate.

The trade issues are not just limited to US and China/Mexico. The US removed India's status as 'beneficiary developing country' (resulting in loss of duty exemptions) and India has retaliated with a range of tariffs on US imports. The US has also signalled that it will be looking more closely at currency 'manipulation' – the US Department of Commerce has proposed a new rule to impose countervailing duties on countries that undervalue their currency relative to the USD, the US Treasury's country list for FX monitoring has been expanded, and the US President indicated that he saw a dovish speech from the head of the ECB as a sign of currency manipulation. Adding to the concern over the latter comment is that it ties in with the possibility that the US may sometime down the track place tariffs on auto imports – for which the Euro-zone is a significant source.

The Mexico tariff threat – which seemingly came out of nowhere – illustrates that what will happen on the trade front is hard to predict. Our projections are based around measures currently in place but assume that there will be an elevated level of trade uncertainty going forward which we expect to be a headwind to business investment in particular. As a result, in recent months we have downgraded our US growth forecasts for the rest of 2019 and beyond.

That said, recent indicators have shown some improvement relative to our expectations. In particular, retail sales have grown strongly in recent months, including May, and are already 1.6% higher than in Q1. As a result, the Atlanta Fed's GDP nowcast for Q2 is now around 2% which is above our current forecast for the quarter. However, we suspect the recent strength reflects some further catch up from the plunge in retail sales in December last year (and which remained weak in January and February) and is unlikely to be sustained.

Business surveys easing, particularly manufacturing



Source: Refinitiv

Outside of signs of consumer strength in Q2, the data suggest conditions have softened. Business investment indicators are weak, and while there are some signs of residential investment stabilising – supported by the shift down in mortgage rates – growth will likely remain soft.

US business surveys are also pointing to growth easing, particularly in the manufacturing sector which is highly exposed to trade disputes and a weakening in business investment. There was a very large fall in

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the Empire State survey in June; many survey responses were collected while the tariff threat hung over Mexico and so it provides some indication of how an escalation in trade disputes could affect business sentiment and activity. The services sector also appears to be easing although the two main national surveys are sending mixed messages about the extent.

We are forecasting US GDP growth of 2.4% in 2019, but this largely reflects the end 2018 and early 2019 strength. On a quarterly basis we expect GDP growth to be somewhat below its longer-term trend in the second half of 2019. For 2020 and 2021 we expect year average growth of around 1.7% per year. As noted previously, this does not allow for any further significant increase in trade barriers. If, for example, tariffs were extended to all Chinese imports or to auto imports then these forecasts would be marked down further.

Monetary policy implications

Our growth forecasts suggest that the underlying tightening in the US labour market that has been evident for a while will soon come to an end. The risk is that unemployment may edge higher, although it is likely to remain below the Fed's assessment of its longer term sustainable level (currently 4.2%).

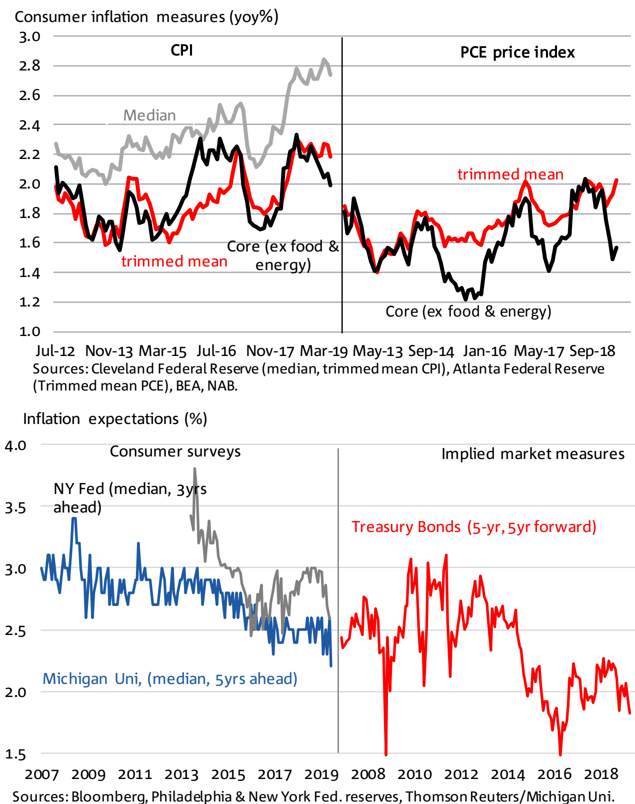
While the Fed may be comfortable with the labour market outlook for now, its preferred measure of inflation – core PCE inflation – has been more subdued. While other inflation indicators have not fallen to the same extent the Chairmen of the Federal Reserve described inflation as 'muted' after last week's FOMC meeting and noted that the Fed had concerns about how quickly inflation would return to 2%. This concern links to the relatively low levels of inflation expectations and the resulting risk that a below target level of inflation becomes entrenched.

The Fed is giving clear signals that it is getting ready to cut interest rates. The reference to the Fed being 'patient' was removed from the meeting statement, most Fed members see the next move as down rather than up, and the Chair's statement that "…the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion…" indicates a readiness to act.

However, the Fed Chair also noted that the baseline outlook was reasonable and that they needed to further assess whether some of the cross currents and uncertainties weighing on the outlook would be sustained. Clearly one of the key uncertainties in this regard is the US-China trade dispute.

The meeting between the US and Chinese Presidents later this month at the G20 summit may provide some further clarity around trade risks. How this will play out is highly uncertain but there are a range of possibilities.

Inflation indicators mixed but Fed also concerned about low inflation expectations



If talks were to breakdown then this would confirm that trade uncertainty would persist and a July rate cut would be guaranteed. A follow up cut in September would probably follow, with the likelihood of further cuts if new tariffs or other trade barriers were announced.

If talks were successful with a deal reached – or there was a clear process towards a future agreement – then the Fed would face less urgency to cut and may be more inclined to wait and see how the data pan out. This could ultimately lead to delayed, or less need for, rate cuts. However, even in this scenario we do not see a complete unwinding of trade tensions – the US-China trade dispute is not the only show in town, and 'success' with China could see US attention turn to autos, currency 'manipulators' or Japan/Euro trade talks so even in this case rate cuts may occur.

Of course, there is the possibility of an outcome somewhere in between these two extremes. For example, if the meeting ended with further talks between officials to occur but with no clarity about whether they will be successful or not then this would still leave uncertainty elevated (dragging on sentiment and investment). Faced with an underlying concern about progress on its inflation mandate, the Fed could well still cut rates sooner rather than later. With inflation subdued the Fed may well perceive there is little downside risk from cutting rates.

At the time we moved to incorporate rate cuts we pencilled in September and December as the most likely dates (with reductions of 25bp at each

meeting), but we noted that the risks were that they would happen sooner rather than later and that there would be more rate cuts rather than fewer.

While it is possible that there will be a significant breakthrough at on the US-China trade dispute later this month, experience suggests that this is not the most likely outcome.

The chance of a July cut has certainly increased following the Fed's meeting and market pricing is in little doubt that it will be in July with a cut fully priced in.

If the Fed were to ease in July it suggests that it is trying to be more pre-emptive rather than reactive so a September cut would also be likely. Of the eight Fed members who included rate a cut for this year in their June meeting projections, seven had a 50bp reduction and only one a 25bp cut. This suggests the Fed sees little point in a single 25bp rate cut. One Fed member (the head of the Minneapolis Fed) has even made the case for a single 50bp cut to re-anchor inflation expectations, but this appears unlikely absent a significant and rapid deterioration in conditions.

For these reasons we now expect the Fed to reduce the federal funds rate by 25bps in both July and September. As noted above there is a lot of event risk around this – not just for the timing of Fed action but also the extent. Given the uncertainty around the direction of the global economy and the risk of future trade actions (if not US-China then elsewhere), as well as the Fed's concern over subdued inflation and inflation expectations, the risk is that the Fed will end up cutting rates by more, rather than less, than we are projecting.

The Fed is currently reducing the size of its balance sheet – quantitative tightening (QT) – by not reinvesting principal payments of maturing Treasury securities or principal payments of agency debt and mortgage backed securities (MBS), except where the amounts exceed specified caps. This process is currently planned to run until end September. If the Fed were to cut rates in July we would expect that QT would also come to an end at that time to avoid conflicting signals about the direction of monetary policy.

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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	2.6	2.4	1.8	1.7	0.9	0.9	0.6	0.3	**0.8**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Private fixed investment	5.2	1.9	1.6	1.7	1.6	0.3	0.8	0.2	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Government spending	1.5	1.9	2.0	1.8	0.6	0.6	-0.1	0.6	**0.7**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Inventories*	0.1	0.2	-0.2	0.0	-0.4	0.7	0.0	0.2	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Net exports*	-0.3	0.0	0.0	0.0	0.3	-0.6	0.0	0.3	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**2.4**	**1.7**	**1.7**	**1.0**	**0.8**	**0.5**	**0.8**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Note: GDP (annualised rate)					*4.2*	*3.4*	*2.2*	*3.1*	*1.5*	*1.6*	*1.6*	*1.7*	*1.7*	*1.7*	*1.7*
US Other Key Indicators (end of period)															
PCE deflator-headline															
Headline	1.9	1.6	2.1	2.0	0.5	0.4	0.4	0.1	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**	**0.5**	**0.5**
Core	1.9	1.7	2.0	2.0	0.5	0.4	0.4	0.3	**0.4**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**3.6**	**3.7**	**3.7**	**3.9**	**3.8**	**3.8**	**3.9**	**3.6**	**3.6**	**3.6**	**3.7**	**3.7**	**3.7**	**3.7**
US Key Interest Rates (end of period)															
Fed funds rate (top of target range)	2.5	2.0	2.0	2.0	2.0	2.3	2.5	2.5	**2.5**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**
10-year bond rate	2.7	1.9	2.3	2.4	2.9	3.1	2.7	2.4	**2.1**	**1.9**	**1.9**	**2.0**	**2.1**	**2.2**	**2.3**

Source: NAB Group Economics

*Contribution to real GDP growth

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