ECONOMIC UPDATE

USA

August 2016

US GROWTH DISAPPOINTS IN THE FIRST HALF OF 2016

The US economy expanded by just 1.2% (annualised) in Q2, disappointing expectations that the weak start to the year would prove temporary. Although consumer spending surged ahead, business investment contracted for a third successive quarter. The data suggest that sluggish global conditions and a depressed energy sector have taken a greater toll on growth than was previously assumed. Concerns over the global economy and volatility in financial markets following the UK EU referendum result kept the Fed in wait-and-see mode at its meeting in late July, but as long as the labour market continues to strengthen, another rate hike later this year will remain on the table.

Household spending underpinned growth in Q2

The weakness of US GDP growth in the second quarter took many economists by surprise. Incoming monthly data had pointed to a much stronger rebound in activity, after growth had dwindled to a two-year low of 0.8% in Q1. However, anaemic headline growth masked some much more encouraging trends. Personal consumption rose by an impressive 4.2%, the fastest rate for a year-and-a-half. There was a marked acceleration in spending on goods in particular, including recreational goods (14%), food and drink (8.6%), and household durables (8.3%). Spending on motor vehicles also rebounded (4.5%) after a weak start to the year, although volumes were lower than during the same period in 2015, with signs that the US car market is close to saturation.

The strength in consumer spending was offset by weak fixed investment, which fell by 3.2%—the steepest fall since the depths of the financial crisis in 2009. Business investment fell by 2.3%, the third consecutive quarterly decline, weighed down by falling spending on structures and equipment (which is probably only partly explained by falling investment in the energy sector). Residential investment also fell back (-6%) after strong gains over the previous two years, which was surprising given recent strength in housing indicators.

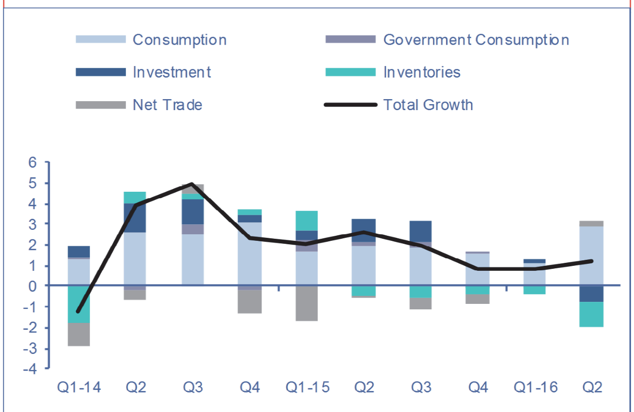
Meanwhile, inventory adjustments weighed on economic activity for a fifth consecutive quarter, shaving 1.2% points off headline growth. Surveys suggest that the current period of de-stocking may be coming to an end, which if borne out, could boost growth in the second half of the year. Stripping out inventories and net trade (which made a small positive contribution to growth), final domestic sales accelerated to 2.1% in Q2, from 1.2% in Q1, which paints a somewhat more reassuring picture of the strength of underlying demand.

The US economy still has room to grow

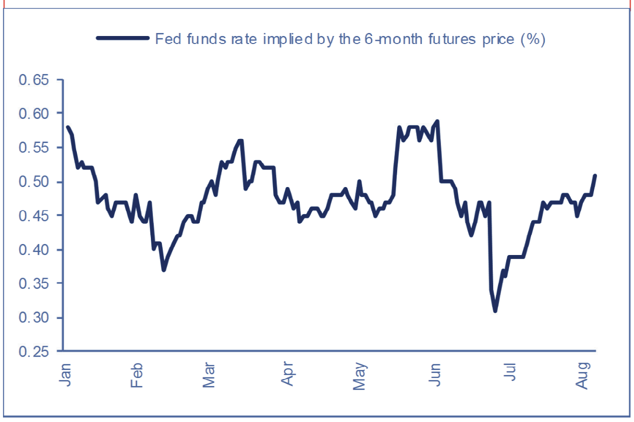
Doubts about the US economy have generally eased over the past few weeks. Confidence took a serious knock earlier in the summer when employment figures for May suggested that the labour market had all but ground to a halt. Soon after that the UK voted to leave the EU, roiling global financial markets. As a result, by the end of June, financial markets were actually pricing in a greater probability that the Fed would reduce interest rates this year, rather than raise them as had been expected previously (see chart).

Notwithstanding the disappointing growth Q2 figures, there are good reasons for believing that the ongoing upswing in the US remains on track. Spill-overs from the Brexit vote seem minimal so far and financial conditions have continued to ease after a difficult start to the year. The labour market continued to expand strongly in July and, amid stronger income gains, consumer spending remains solid. And there are relatively few signs of overheating or excess leverage that have preceded previous downturns. More generally, economic policy will remain supportive. Fiscal policy seems set to remain slightly expansionary in the near-term, whatever the outcome of November's presidential elections. Given fairly modest inflation, a strong dollar and an uncertain global environment, the Fed will adopt a gradual approach to raising interest rates. Overall, therefore, it appears that the US business cycle still has room to run.

US GDP growth



US interest rate outlook



Crucially, household demand in the US rests on solid foundations, with labour income rising. The economy topped expectations by generating 255k jobs in July, down slightly from 292k in June. On a rolling-six month basis, jobs growth stood at an average 189k per month, lower than the 230k a year earlier, but still well above the level (around 100k) needed to push the unemployment rate down further (from 4.9% in July). Wage growth is also firming: average weekly earnings were up by 2.3% year-on-year in July. Rising incomes, combined with a falling savings rate, should continue to support healthy growth in consumer spending through the second half of 2016.

Business surveys suggest the steady improvement in activity during the second quarter will persist. The ISM manufacturing index remained above 50 (the no change mark) at 52.6 in July, down slightly from a 16-month high of 53.2 in June, but still consistent with growth above 2%. The non-manufacturing index stood at 55.5 in July (from 56.5 in June). The forward-looking orders components of both indices remain well above 50, suggesting solid activity during the remainder of 2016.

That said, the manufacturing sector in particular is still facing headwinds from weak global growth, a strong dollar and subdued oil and gas activity. High frequency indicators, such as durable goods orders and investment intentions, softened further during Q2. And profit margins, although still historically high, have fallen from post-crisis peaks, reflecting higher labour costs and the hit to overseas earnings from the stronger dollar and slowdown in emerging markets. Combined with rising uncertainty ahead the run-up to the presidential election over the direction of economic policy (in particular trade policies), these factors are likely to hold back business investment in the months ahead.

Brexit so far remains a local, not a global event

While the global economic environment remains one of the main downside risks to the US outlook, the fall-out from the UK's Brexit vote has so far been fairly minimal. The dollar has appreciated by 13% against the pound since the UK's referendum on June 23rd, but on a trade-weighted basis the US currency is up by less than 3%, and is only marginally stronger than its year earlier level. In a recent update, the US Office of Financial Stability (OFS) appeared relatively relaxed about the economic impact via trade channels. Although the UK is the US's fourth largest trading partner, US exports to the UK account for just 0.7% of US GDP and a relatively small share of total exports (13% of US GDP).

Contagion via financial channels is a greater risk. The direct exposure of US banks to the UK is greater than to any other country, equivalent to 11.3% of US GDP. These claims could be vulnerable to currency losses and lower valuations, although US banks tend to match sterling assets and liabilities, which should minimise the impact on balance sheets. Rather, analysts' main concerns appear to relate to the consequences for banks' profitability if US interest rates remain lower for longer in the event of a weakening of the UK or wider European economy. The US economy would also inevitably be affected by any additional shocks to global economic confidence, with the OFS noting current high valuations of some "risky assets", including equities.

So far, however, US financial markets have recovered well from the initial jolt delivered by the UK's verdict on its EU membership. Equity prices resumed an upward trend, credit spreads have narrowed and long-term interest rates have moved lower, continuing to unwind the sharp tightening in financial conditions at the start of 2016. Overall, therefore, financial conditions should become progressively less of a drag on growth than at the start of the year.

What does this mean for Finance Directors?

- GDP growth should pick up in the second half of 2016, although in the absence of a stronger recovery of the global economy or in productivity, US growth is unlikely to rise much above 2%.
- Further financial market volatility and global economic weakness remain key downside risks to the US outlook.
- Caution over the prospects for the US economy mean that the risk of global monetary policy divergence may be being under-estimated. Central banks in the UK, Europe and Japan have an easing bias, while preventing the US labour market from overheating could require a steeper path for interest rates than is being priced in.
- ***Hedging against a renewed rise in the dollar is advisable.***

The Federal Reserve will be data-driven

As expected, the Fed left interest rates on hold in late July, but in its post-meeting statement noted that "near-term risks to the economic outlook have diminished." In particular, policymakers pointed to the ongoing tightening in the labour market. While the Fed will remain sensitive to putting further pressure on the dollar, at a time when many of the world's central banks are loosening monetary policy, its assessment of domestic conditions points to the prospect of a gradual withdrawal of monetary stimulus in the months ahead. Price pressures are slowly building as the output gap shrinks and the temporary drags from commodities and the dollar's past appreciation fade, with the Fed's preferred inflation measure (PCE) drifting up to 1% in May, from 0.3% a year earlier. Core PCE inflation (excluding energy and food) stood at 1.6%.

Recent comments by Fed officials have generally been dovish, highlighting that with inflation still low, the Federal Open Market Committee can afford to be patient about raising rates. However, in early August, two members of the FOMC suggested that financial markets were being far too complacent—in the wake of the Q2 growth figures, expectations of another rate hike before the end of 2016 diminished, with markets pricing in probabilities of just 18% and 30% that this would occur in September or December, respectively. More strong jobs reports in the coming months could push the Fed to act.

But the Fed will also continue to monitor the fall-out from Brexit. The risk of a second leg-up for the dollar cannot be discounted, as the consequences for the UK and Europe become clearer. All else being equal, this could stay the Fed's hand.

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