26 August 2016

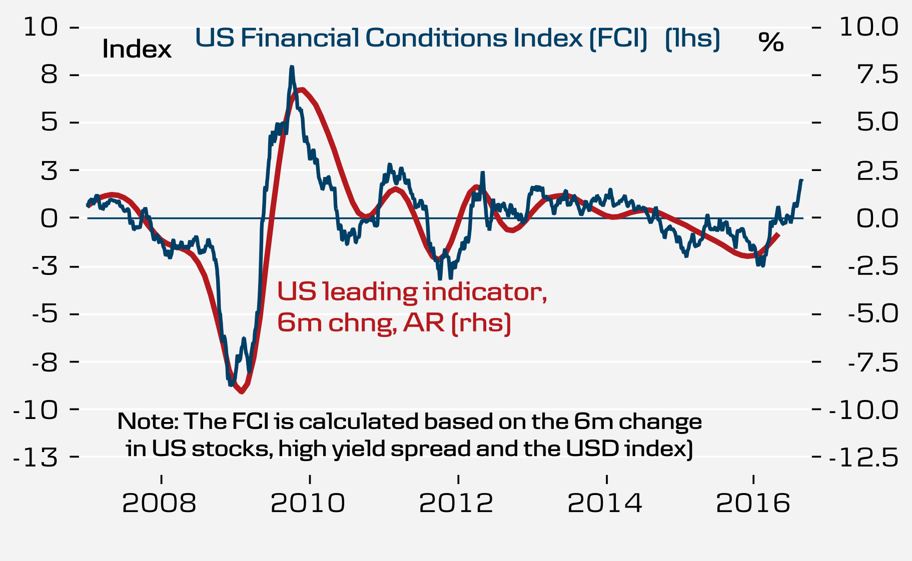
Strategy

A checklist for the US economy

With Brexit behind us and no imminent risk factors on the horizon, attention is increasingly on the scope for the next Fed hike. **The Fed will need US growth to be on a firm footing and global risks to be balanced to pull the trigger**. Below, we provide a short checklist on the status of the US economy.

- **GDP.** The *Federal Reserve Bank of Atlanta's GDP 'nowcast'* for Q3 stands at 3.4% q/q AR rebounding from 1.2% q/q AR in Q2. This would leave the average for the two quarters at 2.3%. This is above US trend growth and enough for slack in the labour market to diminish further.
- **Financial conditions.** Equity markets are higher, credit spreads much tighter, bond yields lower and the USD broadly sideways. This leaves financial conditions much more supportive of growth (see Chart 1)
- **Labour market.** Employment has been back on track in recent months with average monthly job growth of 190,000 over the past three months. This is above the interval that Fed Vice Chairman Stanley Fischer mentioned as the level needed to outpace the rise in the labour force, which he put at 75,000-150,000 in his speech this week. We look for some downside risk to the August payrolls following two strong months but the 3M average should stay close to 200,000. The unemployment rate at 4.9% is close to the level seen as the long-term unemployment rate (NAIRU).
- **Wage growth.** Wage increases have increased gradually to around 2.5% as slack is diminishing (see Chart 2).

Chart 1: US financial conditions have become much more supportive for growth

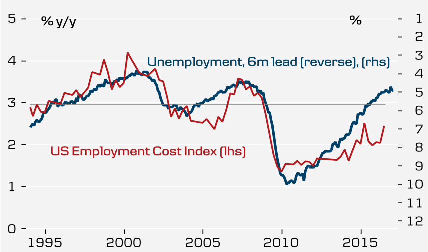


Source: Macrobond Financial

Key points

- The US economy is on a firmer footing as financial conditions are more supportive and the drag from the low oil price is fading.
- The Fed is eyeing the next hike – job growth and global risks are key for the timing.
- Euro area resilient to Brexit – we have revised GDP growth higher.
- Stocks supported by low yields and fewer risks. Bond yields low for longer, EUR/USD range bound.

Chart 2: Wage growth moving gradually higher as slack diminishes



Source: Macrobond Financial, DBM

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- **Manufacturing.** ISM manufacturing and industrial production both rebounded in H1, suggesting that the worst is over for US manufacturing. Signals for August are mixed with regional indices mixed and PMI manufacturing also being less upbeat. This leaves some uncertainty about the state of manufacturing.
- **Investments.** Following a long decline in durable goods orders in 2015, the report for July this week pointed to a further bottom in investment growth. It suggests that one of the main drags for the US economy is starting to ease. A rebound in the oil price and easer financial conditions provide support for investments in coming quarters.
- **Private consumption**. Retail sales rebounded strongly in Q2, showing the strongest growth in two years. It is probably too strong and July retail sales were on the soft side. However, looking through the noise, consumers seem to be on a firm footing.
- **Housing.** New home sales jumped higher in July and rose to the highest level since 2007. It points to rising activity in the construction sector in H2 and shows that lower yields are feeding through to economic activity.
- **Global risks.** With a robust performance in emerging markets, calm on the China front and the effects of Brexit apparently more muted than feared, the risk picture is looking more balanced currently.
- **Core inflation.** The Fed's preferred measure of inflation is the core PCE deflator. It has hovered around 1.6% y/y in 2016 up from 1.3% y/y in mid-2015. It is thus closing in on the Fed's inflation target of 2% but so far not there yet. Core CPI inflation has been above 2% for nine months.

Overall, the picture for the US economy has improved over the past quarter, which explains why Fed members have started to put a potential rate hike back on the agenda.

Fed vice chairman Stanley Fischer last week said: '*So we are close to our targets. Not only that, the behaviour of employment has been remarkably resilient… The unemployment rate is currently close to most estimates of the natural rate… Core PCE inflation at 1.6% is within hailing distance of 2%'*. Other prominent members have also highlighted that a rate hike is drawing closer.

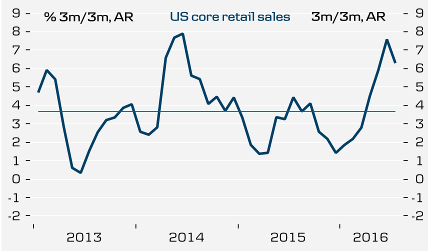
The communication around the next hike has been a bit blurred by a separate discussion within the Fed on the long-term neutral rate. Most members agree that this level has come down – partly due to lower productivity growth. However, even if the neutral rate is lower, say 3%, it does not mean that the Fed will not raise the rate from the current level of 25-50bp, which is still far below the lower neutral level.

The question is just *how* close the Fed is to pulling the trigger. The Fed is likely to need further evidence that the labour market is in good shape, growth is on track and global risks balanced. However, the probability of a rate hike this year has clearly gone up. We will review our own forecast of a hike in June 2017 after the next employment report on Friday next week.

Euro area holding up following Brexit – we revise up GDP growth

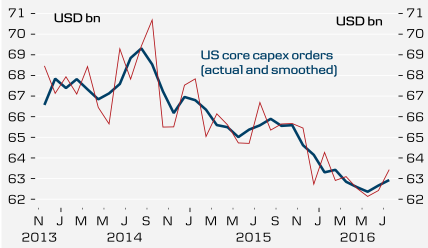
This week's data on Flash Euro PMI for August held up well once again further highlighting that the spill-over from Brexit to continental Europe is likely to be limited. We have thus revised higher our euro area GDP forecast as growth in H2 looks likely to be higher than expected than before (see *Flash Comment: Euro area – resilient PMIs – the recovery should continue*, 23 August 2016). The German ifo index fell back a bit in August but it still points to robust growth in Germany.

Chart 3: Robust US consumption despite softer July



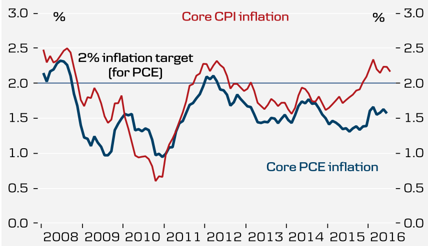
Source: Macrobond Financial

Chart 4: Capex orders bottoming as oil drag fades



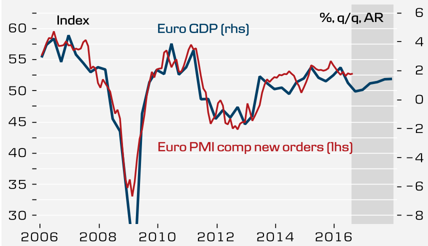
Source: Macrobond Financial

Chart 5: Core PCE inflation slightly below 2% target



Source: Macrobond Financial

Chart 6: Euro PMI holding up – moderate recovery set to continue



Source: Macrobond Financial

We have also changed our view on the ECB to remain on hold at the meeting in September (see *ECB preview: Still awaiting more information*, 24 August 2016). We believe that in the ECB's view, the incoming information since July does not warrant further easing. We still firmly believe the ECB will eventually extend QE purchases beyond March 2017 due to the lack of a sustainable path in inflation. However, for now, we expect it to keep its powder dry.

Stocks underpinned by low yields, EUR/USD range bound

Volatility in global stock markets has come down significantly, with daily swings very small compared with earlier this year. We still see stocks underpinned by record-low bond yields – and in the case of Germany and Japan, even negative 10-year yields. Global risks have come down and investor money is increasingly finding its way to the stock market in search of yield – even if global growth is sluggish. We look for more of this in the short term. Even if the Fed does hike this year, it will signal a very gradual hiking cycle which should not lead to a sustained decline in risk markets. In the medium to long term, we expect the stock markets to be restrained by weak profit growth and high valuations. The business cycle is also likely to lose some momentum in 2017, again driven partly by weaker Chinese macro momentum.

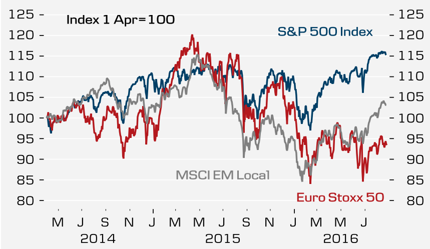
We expect government bond yields to stay low for a long time as negative rates will keep pushing investors out on the yield curve to find returns. Further easing from the Bank of Japan and an extension of the ECB's QE at some point will also underline that monetary policy should stay accommodative for a very long time. US short yields will push a bit higher if the Fed decides to move rates this year but the money market curve is likely to stay very flat and put a lid on the move.

In the FX market, we expect EUR/USD to stay in the 1.10-1.14 range bound in coming months before the cross moves higher as structural flows are supportive of the EUR and it is fundamentally undervalued on our medium-term models.

Chart 7: Lower German ifo still in line with decent German growth

Source: Macrobond Financial

Chart 8: Euro stocks have been lagging



Source: Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Short term (0-1 month): buy on dips Medium term (three-six months): underweight equities vs cash	The hunt for yield as a theme has led equity markets to bounce back after Brexit. Growth is above expectations but has still not broken out of the range. Risk of setbacks is high due to stretched valuations and still fairly weak earnings but central banks anchoring of bond yields provide a cushion for a setback; hence, our structurally underweight position in equities vs cash but still buy-on-dips stance on a shorter-term perspective.
Bond market	
Core yields: low for even longer with increased uncertainty	We expect the ECB to prolong the QE programme by another six months.
US-euro spread: wider but not before we see Fed hikes	Fed on hold until 2017.
Peripheral spreads: ECB support	QE buying and hunt for yield means further performance.
Credit spreads: neutral	ECB keeping spreads contained.
FX	
EUR/USD - 1.10-1.14 range near term, then higher	Valuations and CA differential support cross in the medium to long term; short-term downside risks from EU risks.
EUR/GBP - further GBP weakness in next few months	BoE monetary easing and financial account flows to send cross higher.
USD/JPY - risks skewed to the downside	BoJ easing limits downside potential stemming from fundamentals and relative current account flows.
EUR/SEK - to move gradually lower over coming months	To move lower on relative fundamentals, valuation and natural domestic sellers returning post summer lull.
EUR/NOK - risks skewed to the upside on Norges Bank easing	Global factors, oil price end Norges Bank to keep cross in range in coming months, then lower on valuation and fundamentals.
Commodities	
Oil price – consolidation in US oil sector leading to recovery	OPEC has lost leverage over oil price; sliding US dollar and supply disruption have added support recently.
Metal prices – positive outlook anticipating recovery in Chinese construction	Consolidation in mining industry puts a floor under prices, awaiting support from higher global economic growth.
Gold price – bouncing on repricing of Fed and other major central banks	Brexit risk leads to safe-haven flows and more dovish major central banks support demand for gold.
Agriculturals – support from disruptive weather, higher oil price	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

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None.

Date of first publication

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