Recent economic and leading indicators ease concerns of a renewed US recession

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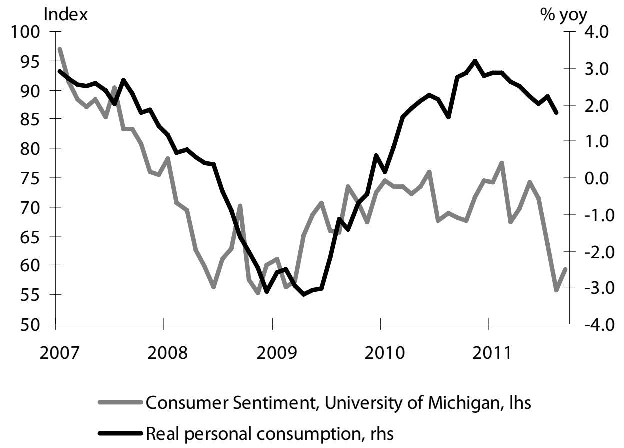
- After a fairly negative picture of the US economy over the past few months, recent US data have been marginally stronger than expected, calming investors and easing risks of a return to outright recession.
- Consumer sentiment seems to have stabilized -albeit at low levels- and manufacturing surveys have improved, pointing to subdued but steady growth in industrial production ahead.
- The temporary drag from elevated energy prices and supply chain disruptions is gradually fading, leading to a rebound in H2 2011. Key for the momentum of the US economy will be developments in the US labor market.
- We continue to expect below-trend growth through next year, averaging at around 2.0% from 1.6% in 2011.

Personal consumption is set for a rebound in Q3

Despite continued market stress and widespread pessimism over the global economic outlook, incoming US economic data over the last week are consistent with a modest acceleration in real economic activity. According to the third estimate of the US Bureau of Economic Analysis (BEA), Q2 2011 real GDP growth was revised up to 1.3% q-o-q saar from 1% in the second estimate, which was a small positive surprise to the market expectation for a 1.2% quarterly growth. The upward revision was largely driven by stronger personal services consumption, stronger structures investment and a larger boost from net trade. In particular, growth in personal consumption for Q2 2011 has been revised up in each release, from 0.1% q-o-q saar in the advance estimate to 0.4% and 0.7% in the second and the third estimate, respectively. Particularly encouraging was that this improvement was entirely due to a rebound in services spending, as the services component has risen by a sharp 1.9% q-o-q saar in Q2 2011 from 0.8% in the previous quarter, reporting its strongest reading since Q2 2010. Thus, the weakness in Q2 personal spending is mainly due to durable orders, driven by a sharp slowdown in the automotive sector that is expected to reverse somewhat in Q3 as supply constraints ease. Although real consumer spending remained essentially flat in August (Figure 1), after a strong reading of 0.4% m-o-m in July (reflecting a decline in wage and salary income), we believe that lower energy prices and a further rebound in auto sales should boost real income in the coming months, leading real personal consumption to a modest rebound of around double the pace of Q2 (0.7% q-o-q saar). Meanwhile, the final reading of consumer confidence from the University of Michigan revealed a slightly bigger rebound in September (+3.7), after its 18.6 plunge over the last three months (Figure 1). It should be noted that the increase was not only driven by an increase in the current conditions component, but also by a rebound in consumer expectations for the economic outlook (to 49.4 from 47.4 in August).

Figure 1



Source: US Bureau of Economic Analysis (BEA), Thomson Reuters/University of Michigan

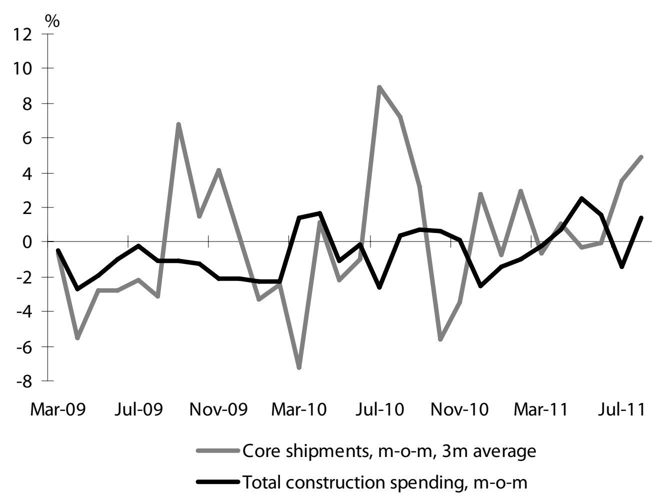
Construction spending and core durables point to stronger investment growth in Q3

On the investment front, total construction spending increased 1.4% mom in August, after a downward revised 1.4% in July (Figure 2). The improvement in August was broad-based, with increases in both residential construction spending (0.9%) and nonresidential outlays (1.6%). The biggest surprise came from state and local construction spending, which surged 3.5% mom after a 1.2% decline in the previous month, reporting its largest monthly increase since February 2009. In addition, the August durable orders report was generally favorable, although new orders for durable goods fell by 0.1% mom in August, following an upwardly revised 4.1% increase in July. The main source of weakness came from defense orders, which fell 5.7% in August, after declining 6% in the previous month. However, non-defense aircraft orders increased 23.5% mom, after a 49.9% surge in July, on the back of strong growth in Boeing orders. The significant reading in the month was much faster than expected strength in core capital goods orders. Non-defense capital goods orders excluding aircraft rose 0.9% mom, with a positive revision to July's reading (-0.3% from -0.9% previously). The positive tone was also reflected in core shipments, which feed directly into the business investment component of GDP. Core capital goods shipments increased 2.8% in August, following an upwardly revised 0.3% gain in July (Figure 2). The large increase in core shipments over the last few months has been mainly attributed to machinery shipments, which are currently growing by nearly 50% on a three-month annualized basis.

The mid-cycle slowdown in the manufacturing sector has probably run its course

The strength in core durable orders and shipments, as well as construction spending, is not only a hint for stronger investment in Q3 2011, but also a sign that the recent softening in manufacturing activity may prove to be temporary. Indeed, the ISM manufacturing index rose to 51.6 in September from 50.6 in August, reporting its best reading in three months (Figure 3). Following gradual declines from the beginning of the year until August, the rise in September reflected improvements in the production index, the employment index and new export orders. While the new orders index was unchanged at 49.6, the declining inventory index fell from 52.3 to 52.0, leading to a modest improvement in the new orders/inventory difference, which is the most leading guidepost for the composite index. Following consecutive declines in the last five months, the production index rose noticeably to 51.2 from 48.6 in July. Moreover, the employment index increased for the first time since June (to 53.8 from 51.8 in July), signaling some progress ahead for the depressed US labor market. Last but not least, new export orders rose three points to 53.5 from 50.5, highlighting an improvement in export conditions. Overall, the report provides an encouraging sign that the mid-cycle slowdown in the manufacturing sector has probably run its course, and with robust capital investment and industrial production readings, we could see the ISM manufacturing index stabilizing around more positive figures.

Figure 2



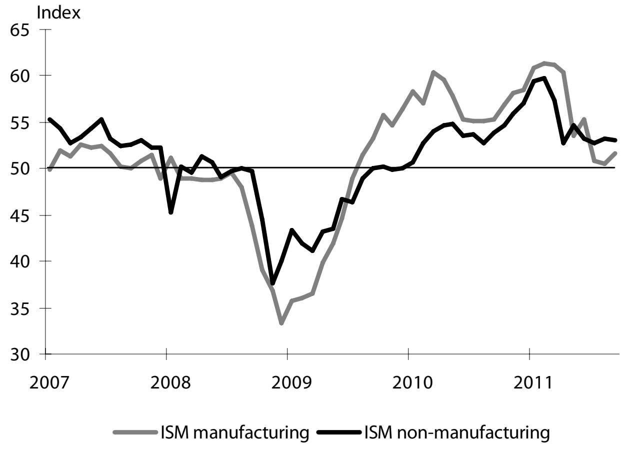
Source: US Census Bureau

Business activity sentiment and new orders suggest positive short-term growth momentum

In the services sector, the ISM non-manufacturing index declined only marginally from 53.3 in August to 53.0 in September, remaining above the threshold of 50 that indicates expansion (Figure 3). Strong gains in business activity sentiment (to 57.1 from 55.6) and new orders (to 56.5 from 52.8) are good signs for short-term growth momentum. Besides, the deterioration in the new export orders suggests that the improvement in new orders is mainly centered on domestic demand. However, the report revealed a sizable drop in the employment index (to 48.7 from

51.6), reporting its lowest reading since April 2010. Although this decline points to weak service sector employment ahead, the September ADP measure of private employment showed a monthly increase of 91k, suggesting upside risks to private nonfarm payrolls in September (to be released on October 7, 2011).

Figure 3



Source: Bloomberg

Overall, the US macro data and leading indicators have recently been marginally stronger than expected, with the US equity market increasing by about 4% over the last couple of days. After a fairly negative picture of the US economy over the past few months, consumer sentiment seems to have stabilized -albeit at low levels- and manufacturing surveys have stopped falling, pointing to subdued but steady growth in industrial production. It seems that the temporary drag from elevated energy prices and supply chain disruptions due to the events in Japan is gradually fading, leaving the worst for the US economy behind us and leading to a rebound in the second half of the year. Key for the momentum of the US economy will be developments in the US labor market, which remains one of the most worrying aspects of the economy. We continue to expect below-trend growth through next year, averaging at around 2.0% from 1.6% in 2011.

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