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US: Stronger near-term momentum, albeit weak growth trajectory ahead

- US economic data have recently surprised to the upside. Leading indicators point to accelerating economic activity in Q4, reinforced by a significant improvement in employment growth.
- We expect a rebound of real GDP growth in Q4 towards 3.0% q-o-q saar from 1.8% in Q3, on the back of stronger personal spending and inventory accumulation.
- Despite stronger short-term momentum, our longer-term view of the US economy remains intact for a below-trend growth in 2012, averaging at around 2%.
- Apart from the fiscal tightening which is expected to build as we head towards 2013, the US economy is expected to be hit by the Euro area sovereign debt crisis through trade linkages, financial conditions and credit availability.

Leading indicators point to accelerating economic activity…

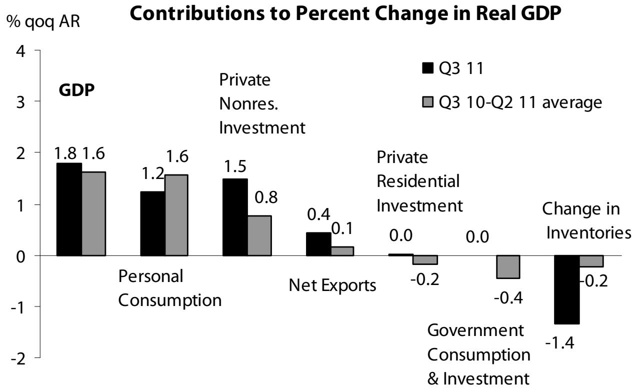
Over the past few weeks, the US economic outlook has generally surprised to the upside. Continuing the solid run of US economic data, the ISM manufacturing index rose to 53.9 in December from 52.7 in November, reporting the strongest reading in seven months (Figure 1). Gains were widespread between new orders, production and employment, providing evidence that growth momentum accelerated in Q4 2011, relative to the downwardly revised growth of 1.8% (q-o-q saar) reported in Q3 (Figure 2). Furthermore, consumer confidence indices continued their upward trend, surging to their highest levels for 6 months or more (Figure 3). In particular, according to the final reading of the University of Michigan's consumer sentiment, the composite index increased roughly 10% in December (to 69.9 from 64.1 in November), on the back of improvements in both consumers' assessments of current conditions and expectations. The surge in the Conference Board's consumer confidence index was even more pronounced, increasing by about 17% in December (to 64.5 from 55.2 in November) and by a total of 43% since its recent trough in August 2011. As we have highlighted in a previous research note[1], the Conference Board's index is more closely tied to labor market conditions, so the recent improvement in payroll growth has urged consumers to upgrade their assessments of the present economic situation and expectations about future economic conditions.

Figure 1

Source: Bloomberg

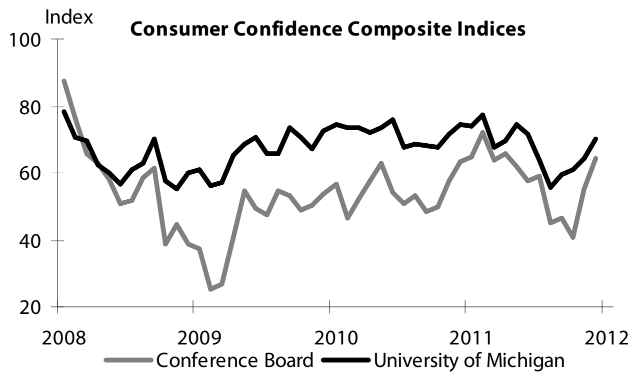
1 See "The predictive ability of US consumer confidence indices", Eurobank Research, Global Markets Special Focus Report, December 16, 2011.

Figure 2



Source: U.S. Bureau of Economic Analysis (BEA), EFG estimates

Figure 3

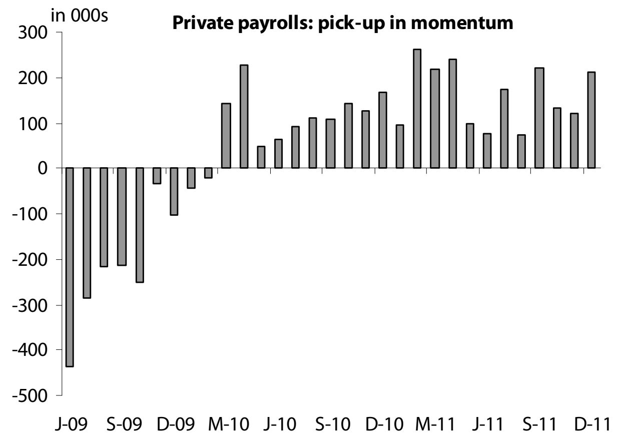


Source: The Conference Board, Thomson Reuters/University of Michigan, Ecowin

…supported by a significant improvement in the labor market conditions

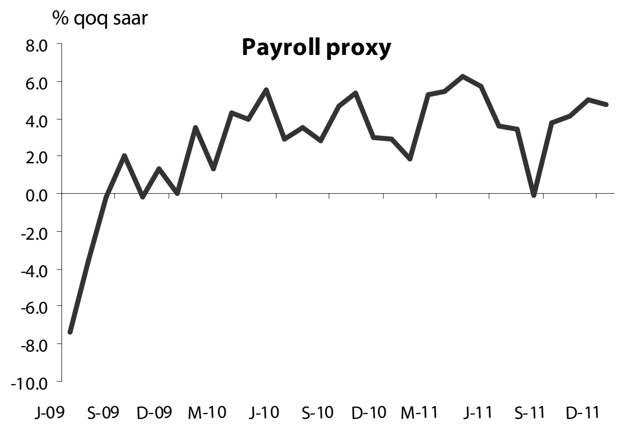
Indeed, the employment report took an even more bullish tone in December, signaling that employment growth accelerated significantly into year-end (Figure 4). Nonfarm payrolls doubled their pace of growth, increasing by a total of 200k after a 100k gain in November. The rise in payrolls was mainly driven by an increase in service employment of 164k. Meanwhile, the manufacturing sector marked its strongest rise since July (+23k), while the construction sector added 17k after consecutive declines in the previous two months. The government sector continued its downward trend, shedding 12k jobs, slightly less than an average of -20k in the last couple of months. The household survey was also upbeat, with civilian employment rising 176k and the unemployment rate falling to 8.5% from 8.7% in November. Given that the civilian labor force declined by 50k in December, it is worth noting that roughly 80% of the decline in the unemployment rate was attributed to employment growth and only 20% to the labor force decline. Moreover, the trend in the payroll proxy for labor income, i.e. the product of weekly hours, hourly earnings and private payrolls, continues its upward trend, increasing by an annualized rate of 4.8% q-o-q through December from 3.8% in Q3 (Figure 5).

Figure 4



Source: U.S. Bureau of Labor Statistics

Figure 5



Source: U.S. Bureau of Labor Statistics, EFG estimates

Real GDP growth is set for a rebound in Q4, on the back of stronger personal spending and inventory accumulation

According to our estimates, real economic activity has accelerated in Q4 2011, supported by an increase in real consumer spending growth and inventory accumulation. We expect real GDP to cruise around 3.0% q-o-q saar in Q4 from 1.8% in Q3, with an annual average of 1.8% in 2011. In particular, strong vehicle sales and an easing of headline consumer price inflation should provide a significant boost to personal outlays, with real personal consumption growth accelerating towards 2.5% q-o-q saar in Q4 from 1.7% in Q3. Furthermore, the significant contraction in inventories, which subtracted 1.4% from real GDP growth in Q3, should translate into greater stock piling in the final quarter of the year. Reinforcing our view, factory orders in November revealed a 0.5% monthly increase in manufacturing inventories, following a 0.9% surge in October. Business inventories also rose 0.3% m-o-m in November, with wide spread strength across sectors. The acceleration in hours and earnings in Q4 relative to the previous quarter is in line with the above-mentioned view that production accelerated in Q4 to offset the significant contraction in inventories reported in Q3.

On the investment front, real non-residential investment, which was the main driver of growth in Q3 contributing 1.5% to real GDP growth, seems to have eased in Q4. Core capital goods shipments, the most important input for estimating equipment and software, declined 0.8% m-o-m in November following a 0.9% fall in October. The recent deceleration in core capital goods orders and shipments indicates some easing in the pace of equipment and software growth in Q4 relative to the previous quarters. In addition, nonresidential private construction remained unchanged in November and was revised downwardly to show a decline of 0.6% m-o-m in October, pointing to a softer pace of structures investment growth. Hence, we expect some easing in the pace of business fixed investment growth in Q4, reporting about half the pace of growth realized in Q3 (15.7% q-o-q saar).

Below trend growth ahead due to fiscal policy and spillovers from the European crisis

Despite stronger short-term momentum, our longer-term view of the US economy remains intact for a below-trend growth in 2012, averaging at around 2%. Our 2012 GDP forecast supposes the extension of the payroll tax cut and emergency unemployment benefits through 2012. Congress has extended those provisions only for the first two months of the year so far, but we believe that legislators will continue with a full-year extension with some fiscal offsets. However, according to the Congressional Budget Office (CBO) estimates, the House bill may reduce the annual amount of emergency unemployment benefits by about $15bn through early 2013 (from $50bn previously to $35bn). Should we incorporate this into our calculations of the fiscal policy effect on real economic activity in 2012, we estimate that the fiscal drag[2] on real GDP growth in 2012 will be quite as much as in 2011 (about -0.6%).

Apart from the fiscal tightening which is expected to build as we head towards 2013, the US economy remains particularly vulnerable to the Euro area sovereign debt crisis. Europe seems to be heading into recession, and this could have a lagged long lived impact on US growth through the direct effect of trade, the financial market conditions channel as well as the bank lending channel. As far as trade linkages are concerned, the US is a relatively closed economy, with exports accounting for roughly 15% of GDP. About 33% of US exports go to North America (Canada and Mexico), while US exports to the Euro area account for roughly 14% of total US exports. Given that the elasticity of US exports to the Euro area with respect to US growth is about 2-2.5, a 1% decline in Euro area's real GDP could be a relatively small drag to US real GDP growth, no more than 0.05pp. But there are also indirect effects via trade, as the appreciation of the dollar relative to the euro due to the escalation of the European crisis and the unfavorable growth outlook for the euro area could lead to a loss of competitiveness of US exports. Meanwhile, the financial and banking linkages to the US are very important and could have a significant negative impact on US growth. Although the exposure of US banks to European peripheral debt is relatively low compared with the rest of the world, the main risk for the US centers on a potential increase in risk aversion in capital markets and a corresponding tightening in financial conditions. Last but not least, European financial stress could affect US growth through restricted availability of credit, weighing in turn on business investment and consumer spending.

[2] The expected effect of fiscal policy on real GDP growth includes Federal, State and Local government.

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