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www.eurobank.gr/research
research@eurobank.gr

GLOBAL ECONOMIC & MARKET OUTLOOK
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FOCUS NOTES

Olga Kosma
Economic Analyst
okosma@eurobank.gr

US Q3 GDP acceleration due to inventory build but final domestic demand remains weak

- Real GDP accelerated to 2.8% q-o-q saar in Q3 from 2.5% in Q2 2013, on the back of higher inventory accumulation and stronger net exports.
- We remain cautious on the apparent US economic acceleration, given that final domestic demand growth actually slowed from 2.1% in Q2 to 1.7% in Q3.
- Core growth categories of private consumption and investment have been relatively weak, owing to a restrictive fiscal policy and a generalized economic and political uncertainty that made households and businesses more reluctant to consumer and invest, respectively.
- We expect a deceleration to 1.5-2.0% q-o-q saar in the final quarter of the year due to a negative payback from previous inventory accumulation and a temporary negative effect of the government shutdown.
- The housing recovery and the increased household financial wealth are expected to contribute the most to a growth pickup in 2014, as the negative drag from the fiscal consolidation fades over time.
- Fed tapering remains data-dependent and could begin in the following months provided that economic activity shows signs of sustainable growth. The October FOMC minutes revealed that strengthening of the forward guidance by adding qualitative guidance is on the Fed's agenda. A cut to the interest rate paid on excess reserves is also seen by most participants as worth considering at some stage.

According to the advance estimate of the Bureau of Economic Analysis (BEA), real GDP accelerated to 2.8% q-o-q saar in Q3 from 2.5% in Q2 2013, well above the consensus forecast of a modest 2.0% increase (Figure 1). The acceleration was entirely attributed to inventory building which contributed 0.8pp to real GDP growth, following a 0.4pp contribution in the previous quarter. In addition to inventories, stronger net trade boosted growth by 0.3pp after two consecutive quarters of negative contribution, as growth in exports (4.5%) exceeded that in imports (1.9%). The report does not alter our view on the US economic outlook, and we remain cautious on the apparent acceleration in economic activity. Final domestic demand growth (GDP excluding net trade and private inventories) actually slowed from 2.1% in Q2 to 1.7% in Q3, as both private consumption and business fixed investment have been relatively soft. As far as the government sector is concerned, sequester furloughs of federal government employees led to a 1.7% decline in federal government spending, but this drop was offset by a 1.5% gain in state and local government spending. The above mentioned 1.5% increase was actually a four-year high after many quarters of negative growth, and this increase left the overall contribution of the government sector at +0.2pp, given that state and local government spending represents about two thirds of total government spending.

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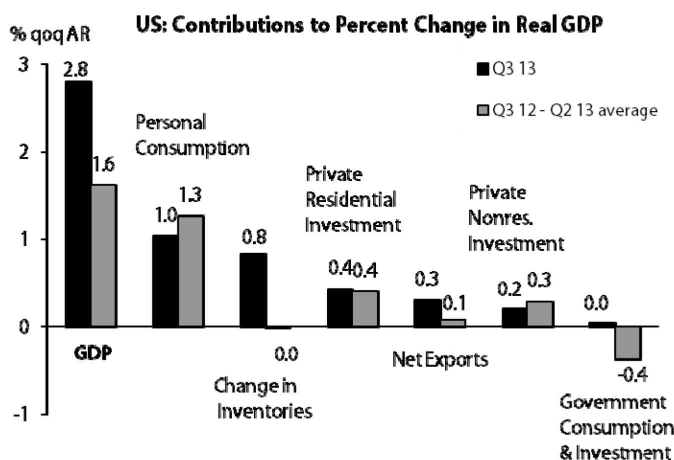
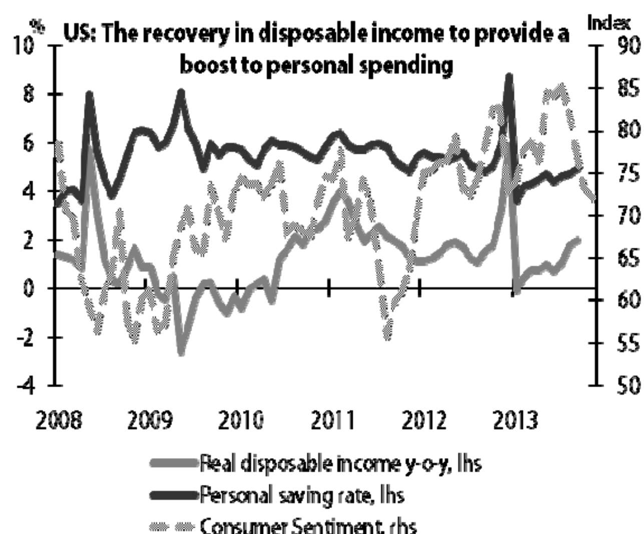
Figure 1



Source: US Bureau of Economic Analysis, Eurobank Research estimates

Figure 2



Source: US Bureau of Economic Analysis, University of Michigan

Subdued personal consumption growth

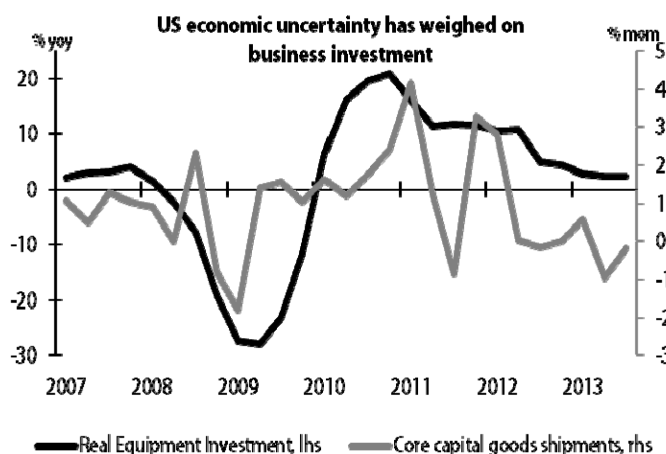
Real personal consumption expenditures decelerated from 1.8% in Q2 to 1.5% q-o-q saar in the third quarter, as the increase in durable and nondurable goods was more than offset by the decline in services consumption. This was the weakest quarterly growth since Q2 2011, and is probably the result of a lagged response to $200bn tax increases set in effect at the beginning of 2013. Both the University of Michigan's index of consumer sentiment and the Conference Board's index of consumer confidence have been on a downward trend since their near-term highs in July, reflecting fiscal consolidation measures as well as the uncertainty stemming from the government shutdown in October. However, real disposable income increased by a healthy 0.4% m-o-m in both August and September, lifting the annual growth to 2.0% in September from an average of 1.0% in the previous quarter. As a result, the personal savings rate increased to 4.9% in September from 4.4% in June. Looking ahead, the October retail sales data provide an encouraging sign that real consumer spending growth will accelerate somewhat in Q4. In particular, core retail sales (excluding food, gasoline, building materials and autos) increased 0.4% m-o-m and this positive momentum may well be maintained by the Christmas shopping season that starts the upcoming week with Thanksgiving Thursday and Black Friday. Furthermore, the recent recovery in real disposable income should provide a boost to real personal spending in the coming months, in combination with the waning effect of tax hikes (Figure 2). Meanwhile, positive trends in the US labor market should be pivotal to the outlook for personal income and, consequently, personal consumption. We expect a modest acceleration in real consumption growth to about 2.0% in Q4 2013. The recent improvement in household finances and the recovery in the housing market should be supportive of stronger consumption growth in 2014 towards the area of 2.5%.

Businesses pull back capital expenditures despite gains in corporate profits

Real business investment growth slowed to 1.6% q-o-q saar in Q3 from 4.7% in the previous quarter, as equipment investment contracted by 3.7% q-o-q saar after three consecutive quarters of positive growth. Capex spending has been weak so far this year across the board, averaging just 0.2% growth per quarter. The durable goods orders report in September ended Q3 on a rather soft note, as core shipments –which are the main input for the GDP estimate- declined by 0.2% m-o-m in September and growth in August was downwardly revised (Figure 3). The general weakness in the economy, the restrictive fiscal policy and the temporary government shutdown has weighed on capital expenditures, making businesses more reluctant to invest. Meanwhile, the National Federation of Independent Business (NFIB) index of small business optimism declined to 91.6 in October from 93.9 in September, reflecting a decline in the net percentage of respondents expecting the economy to improve and a fall in the net percentage expecting higher sales. Looking ahead, the fundamentals for real business investment are relatively strong, as corporate profits have gradually risen and credit conditions continue to improve. According to the Fed's Senior Loan Officer Opinion Survey, lending standards to large, medium and small firms continued to ease in the three months to October, and terms of business loans revealed strong easing as well in line with their trend in more than a year. We expect real fixed investment to accelerate to about 6.0% in the final quarter of the year, on the back of increased consumer demand and an eventual pickup in equipment from its negative growth reported in Q3. According to our estimates, real nonresidential fixed investment is expected to accelerate to about 6.0% in 2014 from

2.4% in 2013 as fundamental drivers of capital spending are particularly encouraging.

Figure 3

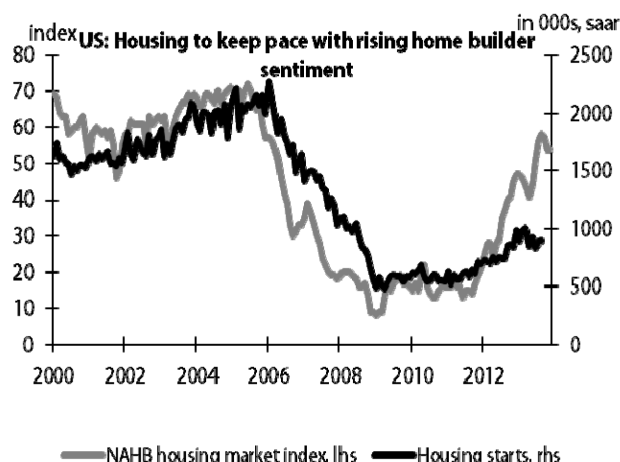


Source: US Bureau of Economic Analysis, US Census Bureau

The housing market: a key driver of growth

Despite sluggish private consumption and business investment, real residential investment accelerated to 14.6% q-o-q saar in Q3 from 14.2% in the previous quarter, reflecting partly a temporary surge in home sales when mortgage rates started to increase. We believe that a slowdown in housing activity is on the cards for the final quarter of the year due to a considerable increase in mortgage rates from May to September and a potential payback from the rapid increase in the housing sector earlier this year. The National Association of Home Builders (NAHB) index of US home builder sentiment has come down from its peak, while housing starts and home sales- which had continued to surge until the summer- have recently been weakening. Although the recent increase in mortgage rates could restrain the housing recovery in the short term, real estate sector should continue to be a significant tailwind for the US economic recovery in 2013. Mortgage rates have already declined 40bp from their recent peak in September, helping to ease financial conditions. We expect housing activity to keep pace with the recent upward trend in home builder sentiment (Figure 4). In our view, there is significant potential for catch-up growth as current levels of housing activity are still low relative to historical standards. Residential investment comprises about 3.2% of GDP as of Q3 2013, while its historical average surpasses 5.0% of GDP so there is a long way to go until housing activity returns to average. Improving household income prospects and an increasing housing demand should underpin further improvement in house prices and sales volumes. According to our estimates, we expect a modest deceleration of residential investment to about 10.0% in Q4 from 14.6% in Q3. The housing sector will continue to constitute a significant positive factor for economic growth in 2014, with an annual average growth of about 10.0% in 2014 from 14.0% in 2013.

Figure 4



Source: US National Association of Home Builders (NAHB), US Census Bureau

Low US growth trajectory in Q4

Although the US economy should gradually accelerate in the medium to longer term as the fiscal drag from the sequester and the tax increases starts to dissipate, we expect a deceleration to roughly 2.0% q-o-q saar in the final quarter of the year. The large inventory accumulation over the last three quarters suggests that a negative payback is on the cards for Q4. Should inventory accumulation decelerate by $10bn, it would shave about 0.3pp from Q4 GDP growth (all else equal). The temporary government shutdown in October is expected to have a negative impact of about 0.25pp on real GDP growth in Q4, without taking into account any indirect economic impact stemming from a decline in household and business sentiment. Looking ahead, rising real estate sector and higher household financial wealth are expected to contribute the most to a more sustained economic recovery in 2014 as the negative drag from the fiscal pinch dissipates over time and consumers pick up spending (Figure 5).

Fed tapering likely in coming months on better economic data

Both the October FOMC minutes and Chairman Bernanke's comments at the National Economists' Club highlighted that the path of large scale asset purchases (LSAPs) remains data-dependent. Tapering could very well begin in the following months provided that economic activity continues to improve

along the line of the Committee's projections for the US economy. Strengthening of the forward guidance is on the agenda when the first tapering is finally announced so as to offset the effects of reduced asset purchases without signaling a tightening of monetary policy. On strengthening forward guidance, most FOMC participants seem to prefer qualitative rather than quantitative measures. That said, a lower unemployment threshold or a floor for inflation do not seem very likely any time soon. Instead, qualitative information concerning the Fed's intentions and expectations of future short-term interest rates after one of the economic thresholds in the current guidance is reached seems the most likely outcome. Furthermore, a potential cut to the interest rate paid on excess reserves (IOER) -which currently stands at 25 bps- was discussed at the latest FOMC meeting in October, and was seen by most participants as worth considering at some stage. However, benefits of such an action are likely to be small, with the risk of impairing money market function. We continue to believe that the most likely time for Fed tapering to begin is in March 2014, even though the chances of a December 2013 or a January 2014 modest reduction of asset purchases have increased on the back of a solid October employment report.

Figure 5

Source: US Bureau of Economic Analysis, Eurobank Research estimates

Economic Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Economic Research

Economic Research & Forecasting Division
Tasos Anastasatos: *Senior Economist*
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Vasilis Zarkos: *Economic Analyst*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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