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GLOBAL ECONOMIC & MARKET OUTLOOK

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Eurobank EFG

FOCUS NOTES

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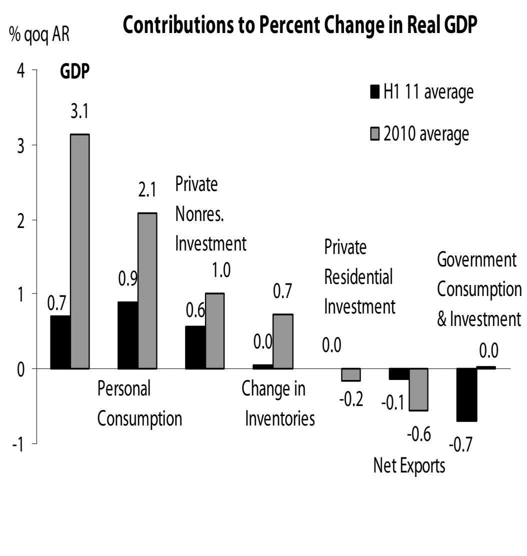
US: A mid-cycle slowdown rather than the onset of a renewed recession

- Real GDP growth slowed remarkably in the first half of the year, reflecting a large fiscal restraint, as well as a sharp drag from higher oil prices and Japanese-related supply chain disruptions.
- We expect the temporary drag from elevated energy prices and supply chain disruptions to gradually fade by year-end, leading to a rebound in H2 2011 relative to the low bar set in H1.
- Although the downside risks to growth have recently increased, our estimates suggest that the current slowdown of economic activity signifies a mid-cycle slowdown rather than the onset of a recession.
- Overall, GDP growth in 2011 is projected to decelerate to 1.5% y-o-y from 3.0% in 2010. Looking ahead, the automatic tightening of fiscal policy in 2012 is expected to subtract about 1.0% from US growth, leaving the average growth during 2012 at about 2.0%. However, the President's proposal of $447bn, if enacted in its entirety, would reduce the fiscal restraint in 2012 and, therefore, create upside risks to our growth forecasts.
- In the medium to longer term, we believe that fiscal consolidation, projected to reduce the federal budget deficit to 1.2% over ten years, will lead to a slower growth below trend of about 2.5%.

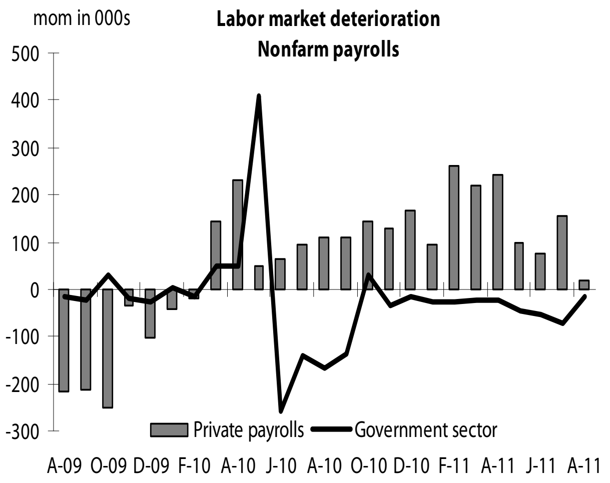
Real economic activity slowed remarkably in H1 2011, reflecting a large fiscal restraint at the federal, state and local level, as well as a sharp drag from higher oil prices and Japanese-related supply chain disruptions (Figure 1). According to the second estimate of the Bureau of Economic Analysis (BEA), real GDP rose 1.0% q-o-q saar in Q2 2011, after a downwardly revised 0.4% in Q1 2011, with GDP standing about 65 billions (of chained 2005 dollars, i.e. 0.5%) below its pre-recession level. The government sector retrenchment is illustrated by cuts in spending and investment -that exerted a drag on growth of 0.7% in H1 2011 (Figure 1)- and in payrolls, which have been declining by an average of about 36k in the first eight months of 2011 (Figure 2).

Figure 1



Source: US Bureau of Economic Analysis (BEA), EFG estimates

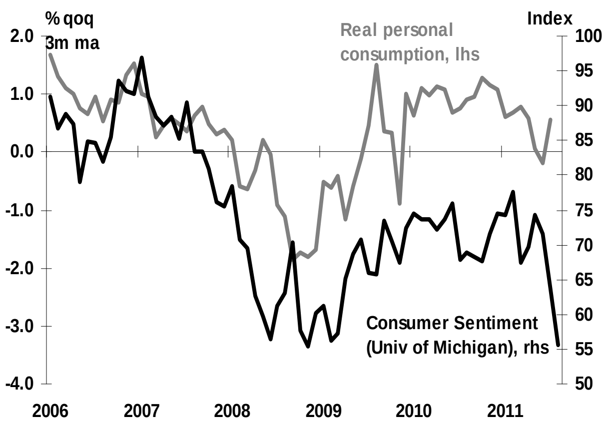
Figure 2



Source: US Bureau of Labor Statistics (BLS)

Survey-based leading indicators are close to levels historically associated with recession. The ISM manufacturing index has gradually declined from its recent peak of 61.4 in February 2011 to 50.6 in August (Figure 5), while the University of Michigan Consumer Sentiment and the Conference Board Consumer Confidence plunged by a total of 22 units to 55.7 and by 28 units to 44.5, respectively, from their peaks in February. However, 'hard' high frequency economic indicators, such as private consumer spending, retail sales, industrial production, durable goods orders and trade balance surprised to the upside in the first month of Q3, pointing out that real economic activity is holding up better than confidence indicators suggest (Figure 3).

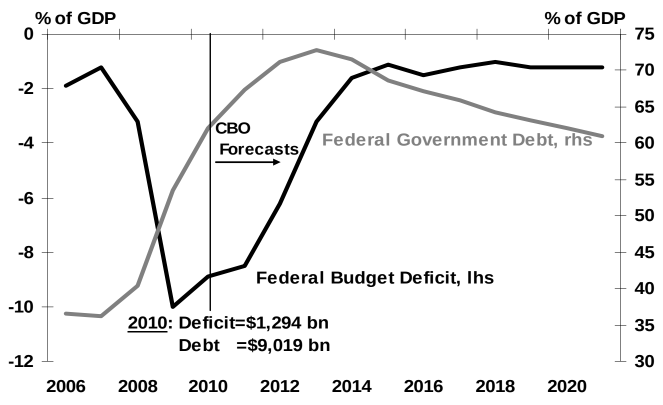
Figure 3



Source: BEA, University of Michigan

Looking forward at the prospects of the US economy, our central scenario suggests that the current slowdown of economic activity signifies a mid-cycle slowdown rather than the onset of a recession. We expect the temporary drag from elevated energy prices and supply chain disruptions from the events in Japan to gradually fade by year-end, leading to a rebound to around 2.0% q-o-q saar in Q4 2011 relative to the low bar set in H1. Overall, GDP growth in 2011 is projected to decelerate to 1.5% y-o-y from 3.0% in 2010. The automatic tightening of fiscal policy in 2012, designed to reduce the federal budget deficit from 8.9% of GDP in 2010 to 6.2% in 2012 (Figure 4), is expected to subtract about 1.0% from US growth. Assuming expiration of the payroll tax cut and the extended unemployment benefits at the end of 2011, the total drag from fiscal policy grows to about 1.5%, leaving the average GDP growth for 2012 at 2.0%. However, President Barack Obama proposed a $447 bn stimulus plan (3% of GDP) in the Republican-controlled House of Representatives, including payroll tax cuts, extended unemployment benefits, infrastructure development and aid to state and local governments. Hence, if the payroll tax cut (4.2% of employees' wages up to $106,800/year, from 6.2% previously) and the emergency unemployment compensation (EUC) which expire at year end are finally extended through 2012, we would boost out 2012 GDP forecast by at least 0.5% (Figure 5). However, as it is currently uncertain if Congress will enact the above-mentioned proposed stimulus measures, we are not changing any of our forecasts at the moment. In the medium to longer term, we believe that fiscal consolidation, projected to reduce the federal budget deficit to 1.2% over ten years[1], will lead to a slower growth below trend of about 2.5%.

Figure 4



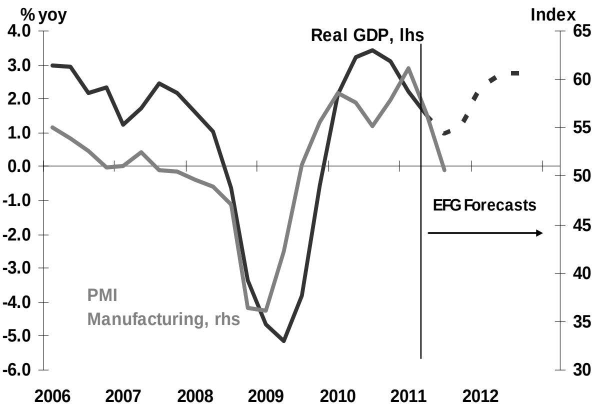
Source: CBO

Given the fiscal consolidation drag and the labor market deterioration during the past few months, the downside risks to growth have recently increased. According to our estimates, the risk of a slowdown of GDP growth to a lower trajectory close to zero increases substantially in 2011. In order to assess this risk, we have constructed a GDP probit model, linking the probability of a severe slowdown (defined as a deceleration of GDP growth to below 0.5% q-o-q annualized) to indicators from the labor market

[1] *See "The Budget and Economic Outlook", US Congressional Budget Office (CBO), August 2011.*

(the quarterly change in nonfarm payrolls), the housing market (the change in real house prices), as well as financial markets (the 2y/10y yield curve slope, the spread between the Moody's BAA and AAA corporate yield index and the quarterly return of the S&P 500 equity index). Using the latest available data, the probability of a slowdown below 0.5% q-o-q annualized increases to about 20% in Q3 2011. Should we incorporate into the model the ISM manufacturing index, the probability of a slowdown below 0.5% skyrockets to about 70% in Q3 2011 (Figure 6). The ISM manufacturing index is the main driver of the sharp increase in the likelihood of a slowdown, as it currently stands slightly above the threshold of 50, indicating a deceleration in the goods-sector economy. Using the traditional definition of a recession of two consecutive quarters of negative growth, the probability ranges only between 0-25%, depending on whether we use the ISM leading indicator of the manufacturing activity (Figure 7). As we previously noted, many survey-based measures (ISM Manufacturing Index, New York Empire State Manufacturing Survey, Philadelphia Fed Manufacturing Index, University of Michigan Consumer Sentiment, Conference Board Consumer Confidence) -in contrast to many hard economic and financial conditions indicators- have deteriorated sharply in recent months, pointing to a higher probability of a recession.

Figure 5



Source: Bloomberg, EFG model estimates

The bottom line of our analysis is that there is a fairly low probability that the US economy is currently heading into a renewed recession. However, the risks for a weaker growth trajectory are skewed to the downside. The historical experience of the US economy seems consistent with the idea that after 2 years into recovery, it is very likely to have a mid-cycle slowdown that lasts between 1-3 quarters. Following the six out of ten US recessions in the post war II period, there was a slowdown after 2-2.5 years of expansion, with real GDP growth plunging to an average of 0.3% annualized, the unemployment rate increasing by an average of 0.4% and the ISM manufacturing and the industrial production declining by 12.4 and 12.6% y-o-y, respectively, without the slowdown marking the start of a recession (Table 1). Furthermore, in four out of the above mentioned six US recessions (1948-49, 1953-54, 1960-61, 1990-91), we have seen a temporary deterioration in the labor market, as indicated in the monthly change in both the unemployment rate and nonfarm payrolls (Figure 2). The ongoing slowdown seems to be in line with previous slowdowns, in terms of the labor market deceleration and the decline in the ISM manufacturing index. Besides, industrial production index has been holding up relatively well, decelerating from 7.7% y-o-y in June 2010 to 3.7% y-o-y in July 2011.

Figure 6

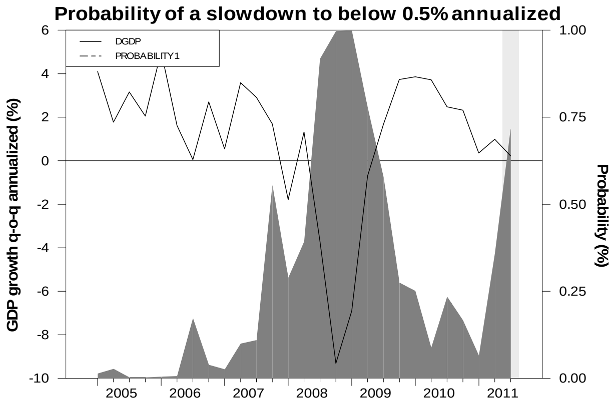
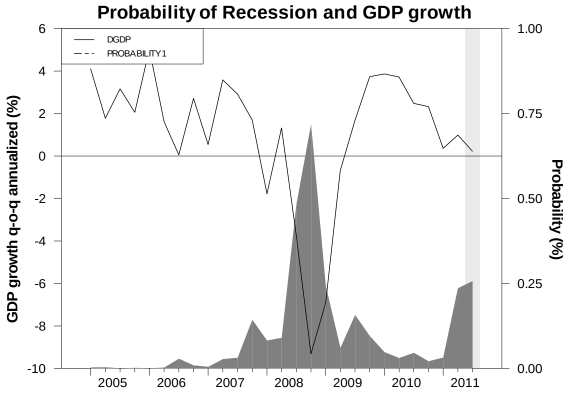


Figure 7



Source: EFG model estimates

Table 1: Mid-cycle slowdown 2-2.5 years into recovery

	Real GDP growth (q-o-q saar)	Increase in the **Unemployment Rate****	Decline in the **ISM Manuf****	Deceleration of y-o-y **IP** growth**
Average for the six US recessions*	**0.3%**	+0.4%	-12.4	-12.6%
2008-09	**0.4%**	+0.3%	-10.8	-4.0%

* 1948-49, 1953-54, 1960-61, 1973-75, 1981-82, 1990-91
** Changes in the above-mentioned indicators from peak to trough of each business cycle

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