Research Coordinator:

Dimitris Malliaropulos
Research Advisor

Olga Kosma
Economic Analyst
okosma@eurobank.gr

The US economy continues to surprise on the upside, despite gloomy global growth prospects

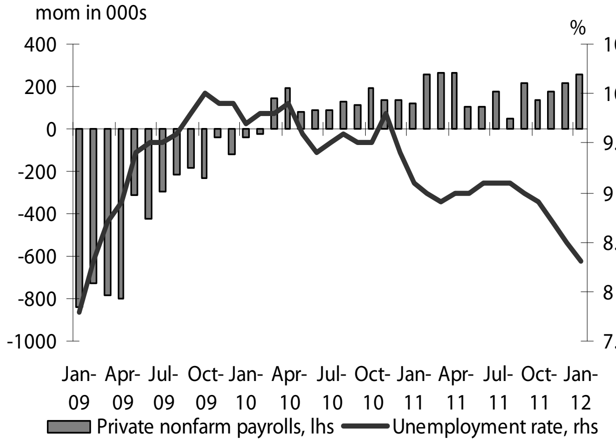
- Real GDP reported in Q4 11 its strongest gain since Q2 10, supported by strong inventory accumulation and decent personal consumption growth.
- High-frequency data reveal an upward momentum in personal outlays at the beginning of 2012, supported by gains in employment and income growth. However, the deleveraging process of US households points to a subdued pace of consumption growth around 2.0% throughout 2012.
- Although business investment growth will likely rebound again in Q1 12, we expect it to decelerate to 6.5% in 2012 from 8.6% in 2011, as the labor productivity slowdown underscores further deceleration in corporate profit growth.
- Housing conditions are improving, pointing to a continued rebound in residential construction spending and investment, but the recovery process will be rather gradual.
- We expect a narrower trade deficit in 2012. Nevertheless, net trade is not expected to be a strong impetus for real economic activity, as global GDP growth is expected to slow further in 2012.

Overview

Incoming economic data suggest that the recent improvement in economic momentum that we saw at the end of 2011 has continued into the first part of 2012. Private sector employment growth has accelerated, with the unemployment rate falling to 8.3% at the beginning of the year (Figure 1), while manufacturing activity has rebounded sharply in recent months (Figure 2). According to our estimates, real GDP growth is expected to hover around 2.5% q-o-q saar in Q1 2012, close to the growth rate reported in Q4 2011 (2.8%), supported by robust domestic momentum. Softer consumer price inflation and further gains in employment should underscore further growth in real disposable income. However, a sharp rebound in personal consumption growth is not on the cards, with US households focusing on reducing their existing debts. Despite stronger short-term momentum in US economic activity, our longer-term view of the US economy includes a below-trend growth around 2% in 2012 as a whole, mainly due to fiscal retrenchment and spillovers from the European sovereign debt crisis. Given the agreement that has been reached between the House of Representatives and the Senate to extend the payroll tax cut and the emergency unemployment benefits through the end of 2012, the average fiscal effect on 2012 real growth is expected to be around 0.6-0.7%[1], marginally higher than the average fiscal drag on 2011 growth (Figure 3).

[1] *See Eurobank EFG Research, Global Markets Special Focus Report "The fiscal drag on US GDP growth", January 26, 2012.*

Figure 1

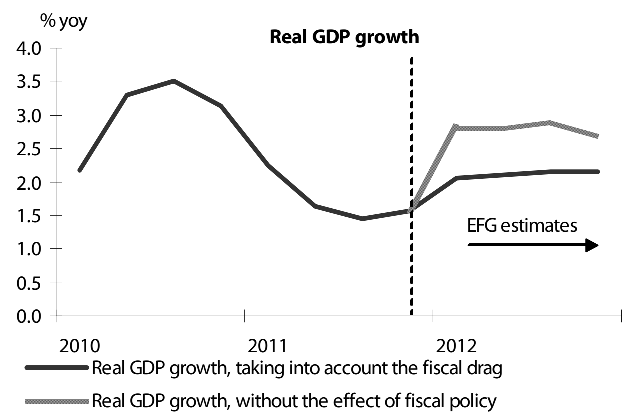


Source: US Bureau of Labor Statistics

Figure 2

Source: Bloomberg, The Conference Board

Figure 3

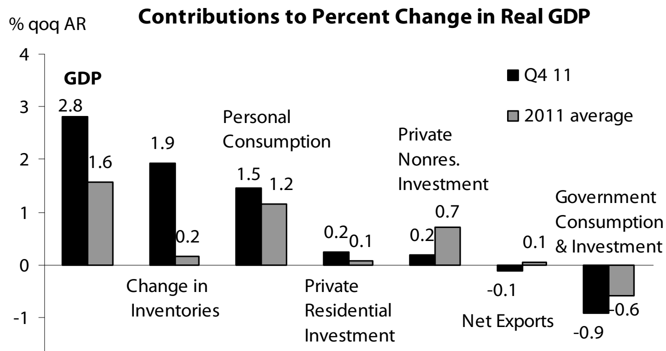


Source: US Bureau of Economic Analysis, EFG estimates

Inventories and consumption are the main drivers of growth in Q4 2011

According to the advance estimate of the Bureau of Economic Analysis (BEA), real GDP accelerated to 2.8% q-o-q saar in Q4 2011 from 1.8% in Q3, slightly below our forecast and the consensus estimate (both equaled 3.0%). Although real GDP growth in the final quarter of 2011 was the strongest reported gain since Q2 2010, the majority of the gain was due to a faster pace of inventory accumulation and personal consumption growth, adding 1.9% and 1.5% to real GDP growth, respectively. Given that the public sector consolidation is a prevailing headwind for the US economy, the government sector was the major drag on growth, reporting the largest decline since Q1 2011 and, hence, subtracting 0.9% from real economic activity (Figure 4).

Figure 4



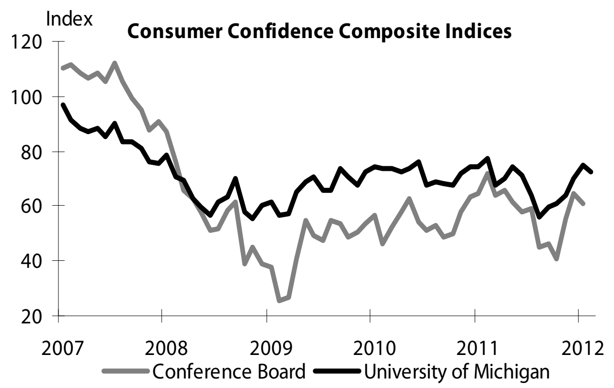
Source: US Bureau of Economic Analysis, EFG estimates

Private consumption on a decent upward trend

Real personal consumption spending increased by 2.0% in Q4, slightly higher than the 1.7% reported growth in Q3. As expected, the strong pick-up in durable goods spending (from 5.7% qoq saar in Q3 to 14.8% in Q4) was driven by motor vehicles consumption, as auto spending has finally rebounded from the hit by supply constraints due to the events in Japan. However, the rebound in durable goods was almost completely offset by much weaker services spending, with declines in the housing and utilities and financial services components.

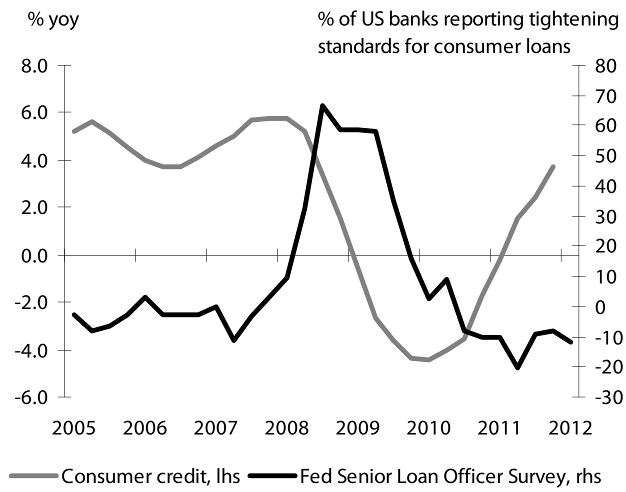
According to our estimates, real consumption growth will cruise around 2.0-2.3% q-o-q saar in Q1 2012, as high-frequency data suggest that the poor performance of private spending at the end of last year (-0.1% m-o-m in December) will be followed by an upward momentum at the beginning of 2012, supported by the recent improvement in employment and income growth. Indeed, core retail sales[2] increased by a solid 0.7% m-o-m in January after a 0.4% decline in December, while unit vehicle sales rebounded to their highest level in more than two years in January. Meanwhile, while both consumer confidence indices fell by an average of 4.5% over the past month[3], they still remain about 40% above their recent troughs reported in H2 2011 (Figure 5). Hence, the recent drop in consumer sentiment is relatively small to change our view for a medium-term momentum in personal spending as the labor market conditions improve. In addition, on the positive side, a majority of US banks have loosened their credit standards for mortgage and consumer loans, while consumer credit has been recently increasing at its fastest pace since the recession began (Figure 6). However, the deleveraging process of US households as they try to bring their finances back on a firmer footing suggests that real personal consumption growth will remain subdued around 2.0% throughout 2012, close to the 2.2% annual average growth reported in 2011.

Figure 5



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

Figure 6



Source: Federal Reserve

Business investment set for a rebound in Q1 2012

Confirming our projections[4], real business investment decelerated significantly in Q4 to 1.7% q-o-q saar from 15.7% in Q3, with structures investment falling by 7.2% after a 14.4% increase in Q3 and equipment and software easing to 5.2% from 16.2% in Q3. Hence, although real non-residential investment was the main driver of growth over the last couple of quarters, it contributed a mere 0.2% to real GDP growth in Q4. However, the recent improvement in several business surveys (Figure 7) suggests that non-residential investment growth will rebound again in the first quarter of the year. According to our estimates, real non-residential investment will accelerate towards 6.0% q-o-q saar from 1.7% in Q4, as the recent improvement in financial markets will help businesses become less cautious to invest. Reinforcing our view, the rebound in core capital goods orders and shipments in December, following declines in the previous two months, should be supportive for equipment and software spending ahead. Furthermore, the recent improvement in the US architecture firms' billing index is an encouraging sign for non-residential construction spending that has slowed after its surge in H2 2011. Nevertheless, we expect real non-residential investment growth to decelerate to an average of 6.5% in 2012 from 8.6% in 2011, as the labor productivity slowdown underscores further deceleration in corporate profit growth. Meanwhile, the Fed's Senior Loan Officer Survey in January suggests that credit standards have tightened for commercial and industrial loans (Figure 8). A severe tightening of credit conditions and a loss of business confidence in the US triggered by the European sovereign debt crisis looms as a significant risk factor for business investment in 2012.

Gradual recovery in residential investment

Residential investment growth rebounded to 10.9% q-o-q saar in Q4 from 1.3% in Q3, reporting the biggest contribution (+0.23%) since the second quarter of 2010. Housing starts and building permits have been on an upward trend in recent months, while the National Association of Home Builders (NAHB) index of home builder sentiment has reached a cyclical high in February (highest reading since May 2007), pointing to a corresponding surge in housing starts. House prices have shown signs of stabilization, with the median price of existing homes increasing by a total of

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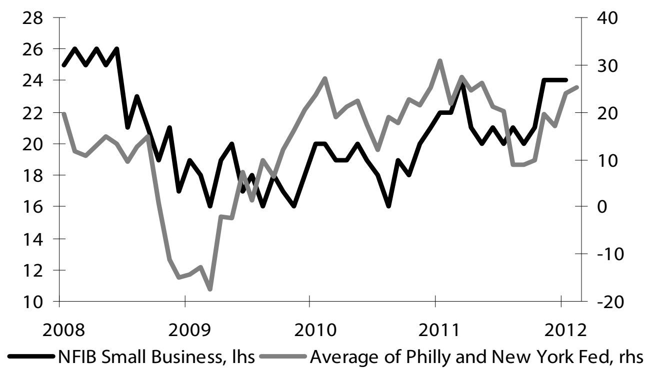
[2] Core retail sales exclude gasoline, vehicles and building material sales, components that do not affect real personal consumption.

[3] The Conference Board's consumer confidence declined from its peak of 64.8 in December to 61.1 in January, and the University of Michigan's consumer sentiment fell from its peak of 75.0 in January to 72.5 in February.

[4] See Eurobank EFG Research, Global Markets Special Focus Report "US: Stronger near-term momentum, albeit weak growth trajectory ahead", January 13, 2012.

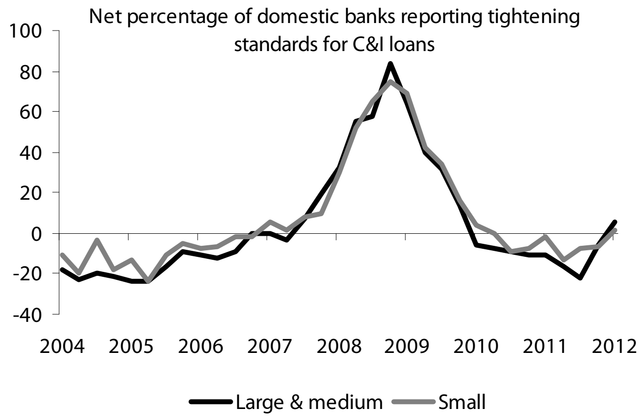
2.3% in November and December 2011. Although house price declines in states with high foreclosures continue to weigh on headline home price indices, with the S&P/Case-Shiller house price indices contracting on a m-o-m basis (Figure 9), the decline in the supply of unsold homes gives a hope that prices may finally stop falling. Hence, although housing conditions are improving, pointing to a continued rebound in residential construction spending and investment, the recovery process will be gradual, with residential investment picking up from an average of -1.4% y-o-y in 2011 to 8.0% y-o-y in 2012.

Figure 7: Capital Expenditures Intentions



Source: National Federation of Independent Business, Federal Reserve Banks of Philadelphia and New York

Figure 8: Credit standards tighten modestly for C&I loans

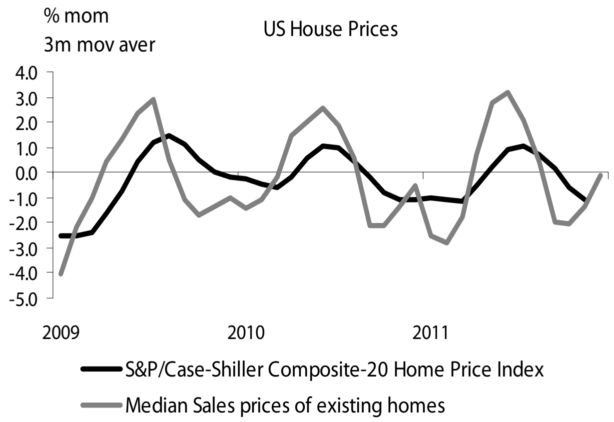


Source: Federal Reserve

Net trade not a strong impetus for real GDP growth

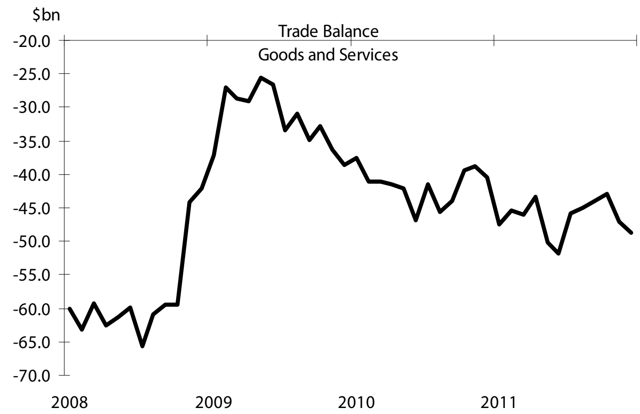
As far as external demand is concerned, real export growth continued at a slow rate of 4.7% q-o-q saar in the last quarter of 2011, while import growth accelerated to 4.4% q-o-q saar from 1.2% in Q3 (Figure 10). As a result, net exports subtracted 0.1% from overall GDP growth in Q4, after a positive contribution of 0.4% in Q3 2011. Although we do expect a narrower trade deficit in 2012, net trade is not expected to be a strong impetus for real economic activity, as global GDP growth is expected to slow further in 2012. Although robust demand in emerging Asian economies is expected to partly offset the deceleration of US export demand to euro area countries, the deceleration of US personal consumption to a lower growth trajectory may affect global demand through global trade linkages, given that global growth remains highly dependent on US consumption[5].

Figure 9



Source: Standard & Poor's, Bloomberg

Figure 10



Source: US Census Bureau

[5] *See Eurobank EFG Research, Global Markets Special Focus Report "US export growth to be supported by demand in emerging markets", December 1, 2011.*

Research Team

Financial Markets Research Division

Platon Monokroussos: *Head of Financial Markets Research Division*
Paraskevi Petropoulou: *G10 Markets Analyst*
Galatia Phoka: *Emerging Markets Analyst*

Sales Team

Nikos Laios, Head of Sales
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Economic Research & Forecasting Division

Dimitris Malliaropulos: *Economic Research Advisor*
Tasos Anastasatos: *Senior Economist*
Ioannis Gkionis: *Research Economist*
Vasilis Zarkos: *Economic Analyst*
Stella Kanellopoulou: *Research Economist*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*

Eurobank EFG, 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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