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GLOBAL ECONOMIC & MARKET OUTLOOK

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FOCUS NOTES

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US outlook: Sluggish growth but reduced risks of near-term recession

- Continued market stress and widespread business and consumer pessimism over the summer have raised concerns of a return to an outright US recession.
- In the short-term, we expect a rebound in real GDP growth to an annual rate about 2.0% in H2 2011 from 1.1% in H1 2011, on the back of a pick-up in personal consumption and favorable fundamentals for capex.
- However, our estimates suggest a below-trend growth of 2.0% in 2012 from 1.7% in 2011, as weak employment growth and persistent economic slack continue to weigh on personal income.
- Absent a severe European meltdown or other shock, the US slowdown should be a controlled mid-cycle descent rather than a recession, supported by additional Fed monetary easing if needed.
- A new round of quantitative easing, in the form of renewed asset purchases of long-term Treasuries as well as agency mortgage securities, would help inflate away some public and private sector debt, and therefore aid the deleveraging process.

Overview

US economic activity decelerated significantly from an annual rate of 2.8% in H2 2010 to 1.1% in H1 2011, mainly attributed to the temporary factors of higher oil prices and Japanese-related automotive supply disruptions. Meanwhile, continued market stress and widespread business and consumer pessimism since August -owing to the European sovereign debt crisis, the S&P downgrade of US sovereign debt and the debt ceiling debacle- have raised concerns of a return to an outright US recession. Consumer confidence indices have plunged by an average of 33% from their peaks at the beginning of the year, equity market indices have declined by about 20% from their peaks in late April, while the ISM manufacturing index has been hovering around the threshold of 50 that distinguishes industrial expansion from contraction.

Our baseline estimates suggest that the ongoing slowdown signifies a mid-cycle slowdown rather than the onset of a recession. Recent economic and leading indicators are consistent with a modest acceleration in real economic growth in the second half of the year, relative to the low bar set in H1. 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. We expect a rebound in real GDP growth to 2.0% q-o-q saar in Q3, from an upwardly revised 1.3% in Q2, as consumer spending growth will probably pick up due to the fading effects of auto disruptions and high gasoline prices. In addition, capex fundamentals generally remain favorable, given the continuing strength of corporate profits and the upward trend of capital equipment shipments over the summer. Overall, we have revised upwards our 2011 real GDP forecast to

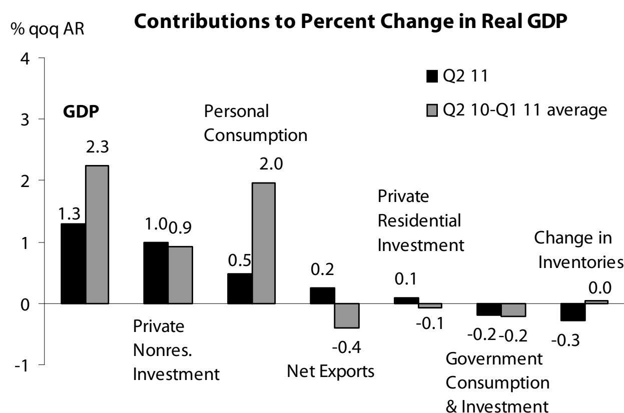
1.7% y-o-y from 1.5%, due to the government's upward revision to Q2 and better-than-expected incoming data for August and September.

Looking ahead, we expect below-trend growth through next year, averaging at around 2.0% from 1.7% in 2011, as weak employment growth and persistent economic slack will probably continue to weigh on personal income. The $447bn fiscal stimulus package proposed by the Obama administration, much of which is likely to pass in Q4 2011, represents a short-term removal of scheduled fiscal tightening. Thus, fiscal policy will probably be neutral for economic activity in 2012, boosting only modestly real GDP growth by about 0.2% in 2012. Key for the pace of the US recovery will be trends in the labor market, one of the most worrying aspects of the US economy, as well as future changes in household net wealth, including movements in house and equity prices. Absent a severe European meltdown or other shock, the recent US slowdown should be a controlled mid-cycle descent, supported by additional Fed monetary easing if needed. Should economic and financial conditions weaken further towards the end of the year, the Federal Reserve will act to prevent a faltering US economy from falling into a renewed recession. In such a case, a new round of quantitative easing, in the form of renewed asset purchases of long-term Treasuries as well as agency mortgage securities, would help inflate away some public and private sector debt, and therefore aid the deleveraging process.

GDP growth is set for a rebound in Q3, …

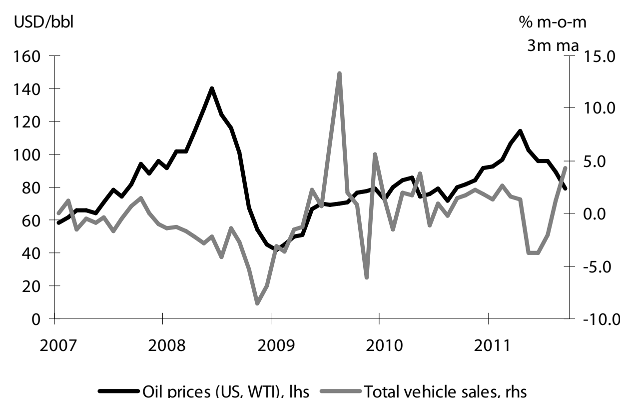
According to the third estimate of the US Bureau of Economic Analysis (BEA), Q2 2011 real GDP growth was revised up to 1.3% q-o-q saar from 1% in the second estimate. The upward revision was largely driven by stronger personal services consumption, stronger structures investment and a larger boost from net trade (Figure 1). As far as personal consumption is concerned, particularly encouraging was that the 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 in Q3 as supply constraints ease. Although real consumer spending remained essentially flat in August due to a decline in wage and salary income, after a strong reading of 0.4% m-o-m in July, we believe that lower energy prices and the solid rebound in auto sales in September should lead to a modest rebound of real personal consumption of around 2.0% q-o-q saar (Figure 2). Reinforcing our view, the final reading of consumer confidence from the University of Michigan showed signs of stabilization, increasing to 59.4 in September from 55.7 in the previous month, after a remarkable 18.6 plunge between May and August. In the medium to longer term, fiscal consolidation, combined with a weak labor and housing market, implies that consumption growth will be modest relative to historical averages for years to come. Our estimates include a 2.1% annual consumption growth in 2011 and 1.6% in 2012, half the average consumption growth during the post war II period since 1947 (Figure 3).

Figure 1



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

Figure 2

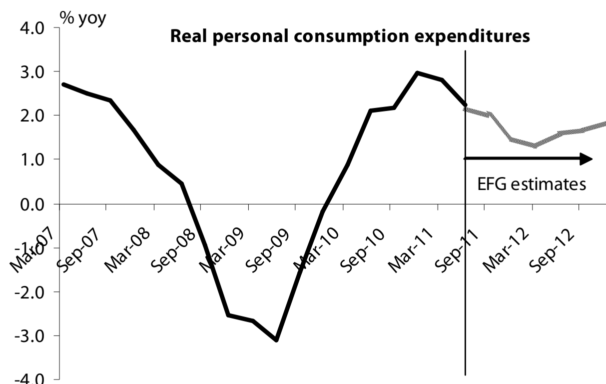


Source: US Bureau of Economic Analysis (BEA), Bloomberg

On the investment front, equipment and software, which accounts for three fourths of business capex, will probably continue to boost growth, supported by solid growth in corporate earnings and accelerated deductions for the cost of certain investments. Since the recovery began in Q3 2009, real spending for equipment and software has accounted for one-third of real GDP growth. The upward trend of core capital goods shipments over the last few months (Figure 4), the most important input for estimating equipment and software spending, suggests that business investment will continue to be a positive contributor for real economic activity in Q3. However, as business surveys indicate, there could be some easing in the pace of spending growth towards the end of the year and in 2012.

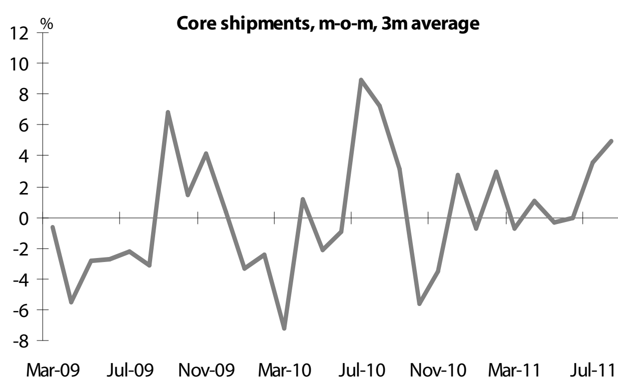
Thus, we expect real non-residential investment growth to gradually decelerate from an annual average of 7.5% in 2011 to 4.5% in 2012, close to levels seen in 2010.

Figure 3



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

Figure 4

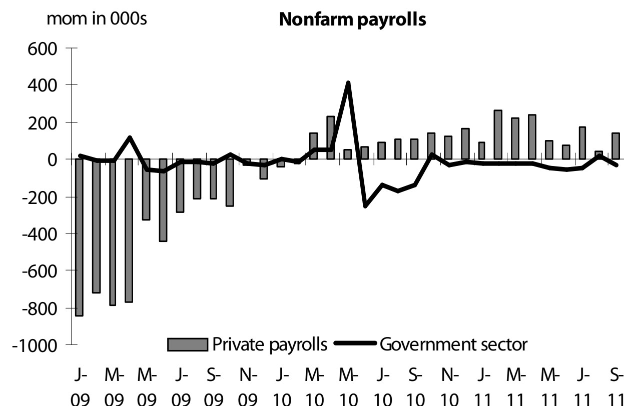


Source: US Census Bureau

…but more persistent factors will continue to weigh on the pace of the recovery

Apart from the temporary factors that will probably boost real GDP growth in the second half of the year, the key for a sustained economic recovery is the performance of the US labor market and its effect on personal income and spending. The September employment report was generally positive, reporting a 103k increase in total nonfarm payrolls -almost twice the consensus expectation- and a 99k upward revision to payrolls in the prior two months (Figure 5). However, the jobs increase was barely enough to keep up with trend labor force expansion. Thus, the unemployment rate remained stable at 9.1%, as the rise in the labor force more than offset the increase in the household employment. Although the report was much better than expected, suggesting that the labor market is showing durability in the face of the various global risks on the horizon, it still points to a weak labor market.

Figure 5



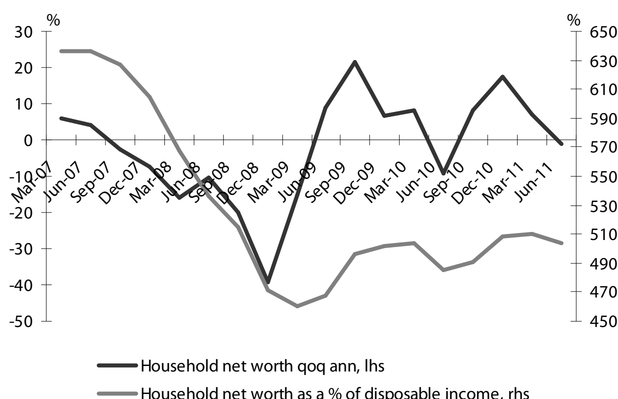
Source: US Bureau of Labor Statistics

Excluding the effect of the return of striking workers of about 45k, private payroll growth has been below 100k. Should this trend continue, combined with the ongoing declines in state and local government sector, we could see a slow rise in the rate of unemployment. With a stable labor participation rate, the US economy has to create about 125k jobs per month in order to keep the unemployment rate steady at current levels. If payroll growth does not show signs of improvement in the following months, the unemployment rate could surge again towards 10% in 2012. Meanwhile, the median duration of unemployment has ranged between 20 and 22 weeks since mid-2010, with about 6 million people being out of work and looking for a job for more than six months. As Chairman Bernanke and other Fed officials have recently said, FOMC participants have become increasingly concerned about long-term unemployment, as it constitutes not only hardship for many US households, but also a risk to supply-side potential of the economy. Weak employment growth and persistent economic slack are holding back employees' wages, denting households' disposable income. The trend in hours and earnings is softer relative to previous trends, with average weekly earnings of all private employees slowing to 0.9% on a quarterly annualized basis in Q3 from 3.1% in Q2. According to our baseline forecasts, given the slowdown to a lower US growth trajectory, weak payroll growth over the next few months is expected to be sufficient to push the unemployment rate down only marginally towards 8.7% by year-end 2012, keeping the year average at the high level of 8.8% in 2012 from 9.1% in 2011.

In addition, the substantial erosion of household net worth seems to be contributing to a subdued pace of recovery. The Federal Reserve's Flow of Funds report revealed that household net

worth -the difference between the value of assets and liabilities- shrunk about $150bn in Q2 2011, reporting a 1% q-o-q annualized decline (Figure 6). Household debt has been steadily decreasing since Q3 2008, primarily reflecting declining levels of mortgage debt. Moreover, households and nonprofit organizations realized a significant loss in their financial assets. In particular, global financial shares have fallen about 20% from their peaks in early May, sparked by the Eurozone sovereign crisis, the US debt ceiling debacle and the downgrade of the US's AAA credit rating. Moreover, the significant decline in real estate property provides evidence for the negative wealth effect between changes in house prices and total consumer demand for goods and services. The strength of the housing market in the 1996-2006 decade has allowed millions of homeowners to borrow extra money secured on the value of their property. The housing market dip that followed had exactly the opposite effect, with mortgage equity withdrawal turning negative in 2008. The double-dip in US house prices in 2010-11 has affected the willingness of people to make major spending commitments and, consequently, the prospects of the US economy. Although the annual rate of US house prices will probably fall further in coming months due to base effects from the boost to prices from government stimulus last year, underlying price dynamics suggest a broad stabilization in home prices on a monthly basis. Given that the share of distressed properties as a percent of total sales starts to moderate, we believe that the worst for the US housing market are behind us. However, the weak housing sector will continue to weigh on household net worth, until we see a substantial improvement, sufficient to lead to positive mortgage equity withdrawal.

Figure 6

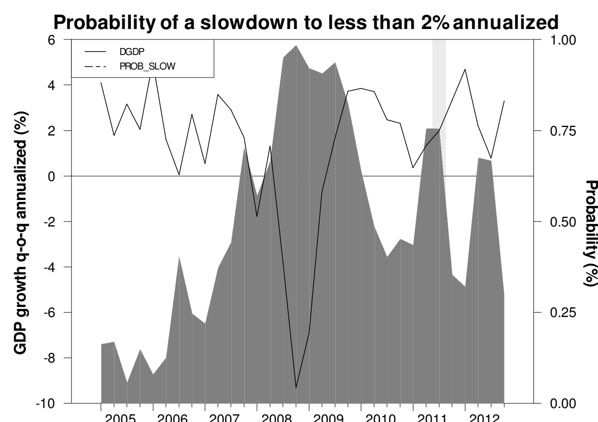


Source: Federal Reserve

Risks for a weaker growth trajectory are skewed to the downside

Given the labor market deterioration and the erosion of household net worth, our estimates suggest that the risk of a slowdown of GDP growth to a lower trajectory remains high for the remainder of 2011 and in 2012. In order to assess this risk, we use our GDP probit model, linking the probability of a slowdown to less than 2% q-o-q annualized to the quarterly change in nonfarm payrolls, real house prices and the ISM manufacturing index. Using the latest available data, the probability stays above 30% for H2 2011 and 2012, skyrocketing to about 70% in mid-2012 (Figure 7). 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. According to our research, 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.

Figure 7



Source: EFG estimates

The sub-trend pace of real economic activity suggests that the US economy remains particularly vulnerable to external shocks, such as losses in equity markets due to sustained tensions from the Euro area sovereign debt crisis, upside risks on commodity prices and a more protracted house price recovery than currently assumed. Even in such a case, the downturn in real GDP growth would probably be relatively shallow and short-lived (lasting about 1-2 quarters), given that the US economy is already operating at a reduced level of resource utilization. The role of US fiscal authorities is of vital importance so as to come up with a fix plan for federal finances by this fall, a plan that puts public debt on a sustainable path in the medium-term, while supporting the short-term US recovery. If the Joint Select Committee on deficit reduction fails to reach an agreement before 23 November, an enforcement mechanism will be used imposing more front-loaded spending cuts than currently expected, putting further downward pressure on growth.

Fed to prevent the US economy from falling into a renewed recession

Worried about the weak state of the US economy, the FOMC announced another round of monetary easing implemented between October 2011 and June 2012, in order to put downward pressure on long-term interest rates, create more accommodative financial conditions and support the mortgage market. Under its Maturity Extension Program ("Operation Twist"), the Federal Reserve plans to sell $400bn short-term Treasury securities with remaining maturities 3 years or less, and reinvest the proceeds in longer-term Treasury securities with remaining maturities of 6 to 30 years. Furthermore, the FOMC announced the reinvestment of principal payments on agency debt and agency mortgage-backed securities rather than Treasury debt. According to our estimates, the implementation of this "twist" will extend the total duration of securities holdings on the Fed's balance sheet by about $400bn in ten-year equivalents. This is close to QE2, when the Fed absorbed almost $390bn in ten-year equivalents. Hence, the impact of the maturity extension program on 10y Treasury yields will likely be comparable to QE2, in the range of 15-20 bps. The cumulative effects would correspond to a federal funds target rate cut of roughly 45-60 basis points, with the potential to offer a modest benefit of about 0.3% to headline growth over the next year.

Should economic and financial market conditions weaken further towards the end of the year, the Fed could announce a third round of quantitative easing (QE3) so as to expand further its balance sheet and, therefore, monetize its debt. In such a case, renewed asset purchases of long-term Treasuries, as well as agency mortgage securities in order to support the depressed housing market, could help inflate away some public and private sector debt, and therefore aid the deleveraging process.

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