Economic Research - United States Forecast

The Monthly Monitor

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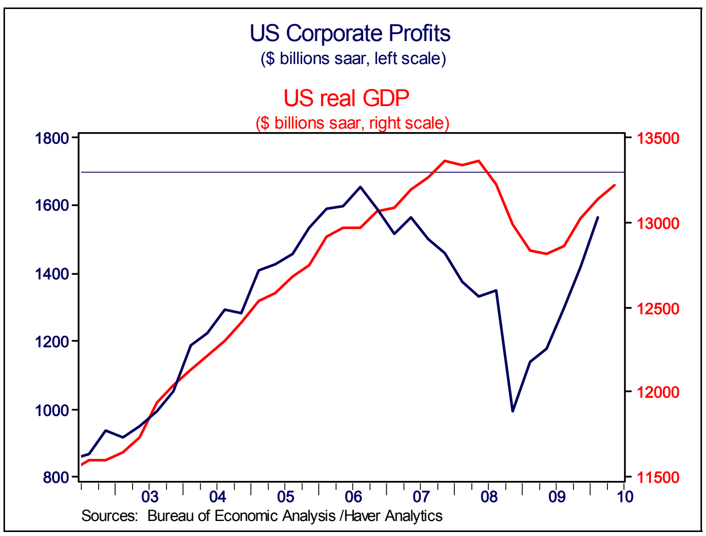
A problematic American recovery

The first phase of the US recovery is behind us. It was marked by unprecedented fiscal and monetary support. The recovery is undeniably slowing: US real GDP growth softened from 5.0% (q/q saar) in 09Q4 to 3.7% in 10Q3 to 2.4% in 10Q2. Given that the build-up in inventories contributed to a large extent of the recovery so far and that final sales growth was relatively soft – with the exception of the momentary blip of 10Q2 (4.1%) – the bold efforts did not meet with the success that was originally hoped for. As such, the unemployment rate remains high, and inflation is conspicuous by its absence. In this context, what is next for the US economy?

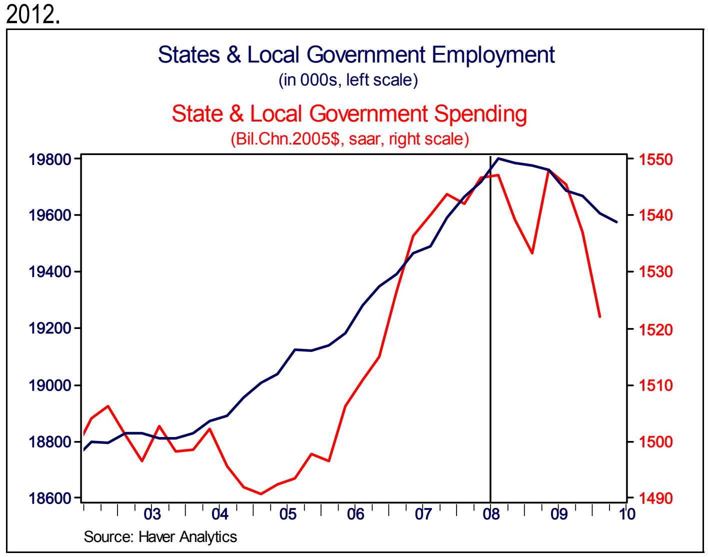


"*This time it's different,"* say Carmen Reinhart and Kenneth Rogoff in their study on the history of financial crises. We think they are on the right track. Businesses, households and banks have not yet emerged completely from their *after-Lehman* sluggishness: non-financial businesses would rather pile up billions of dollars in liquid assets than hire; banks are leaving billions of dollars sleeping in excess reserves at the Fed, instead of lending; and households prefer to save a larger chunk of their income than before due deleveraging needs and depreciated assets. In this edition of *The Monthly Monitor, LBS Economic Research* examines specifically three problems that are preventing the US economic expansion from accelerating: a prematurely restrictive fiscal policy, inadequate lending supply and demand, and long-term unemployment. This trio leads us to forecast slower economic growth in the U.S. over the next year and a half.

Houston, New York, California, etc.: We have a problem

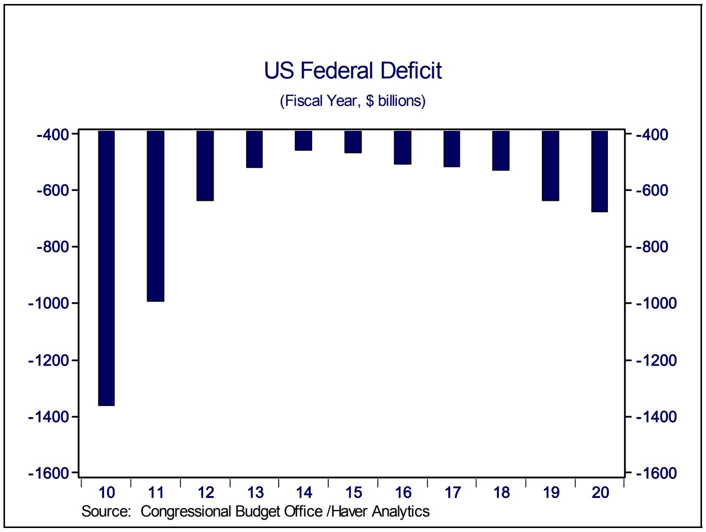
The austerity measures of the states and cities are arriving too early at this point of the economic cycle. Government spending by the states and cities accounts for a larger share of real GDP (9.5%) than federal spending (6.8%). For each dollar spent by Washington, the states and cities spend approximately $1.45. However, spending by local administrations is going to fall back, because they are faced with a deficit of approximately $140 billion for fiscal 2010 – 1% of GDP, according to the *Center on Budget and Policy Priorities*. With assistance from Washington gradually waning, many local governments have no choice but to reduce services, including essential ones. This wave of cost-cutting will continue to act as a drag on GDP growth, as it did in recent quarters. These measures notably have an adverse impact on the job market. Over 250,000 jobs have already been eliminated in local public administrations in the past two years, and the future does not look any brighter. Over 20 million Americans are employed by local governments—more than in the manufacturing, construction and retail sectors.

While the pendulum is already swinging towards austerity in New York, California and New Jersey, to name just a few, Americans could be hit by another wave of restrictive fiscal policy in the medium-term, this time from Washington. We already know that the stimulus stemming from the *American Reinvestment and Recovery Act* (ARRA) will fall as early as the 2011 fiscal year which will begin on October 1. The *Congressional Budget Office* estimates that the amount of spending and the tax cuts arising from the ARRA will plunge from $399 billion for the fiscal year 2010 to $124 billion for 2011, and a meagre $36 billion in 2012.



Naturally, suggestions are popping up from all over. Interventionists are calling for a second wave of fiscal assistance and for forgetting the G20's promise to reduce the deficit by half by 2013. Easier said than done, say others, since the bond vigilantes would probably not let a second tax stimulus program go by without demanding higher yields. Even though there are limits to Washington's debt load in our view —a debt/GDP ratio of close to 90% and a deficit/GDP ratio of nearly 9% for 2010, according to CBO—tightening the screws prematurely could be a mistake, reinforcing the risk of a double-dip.

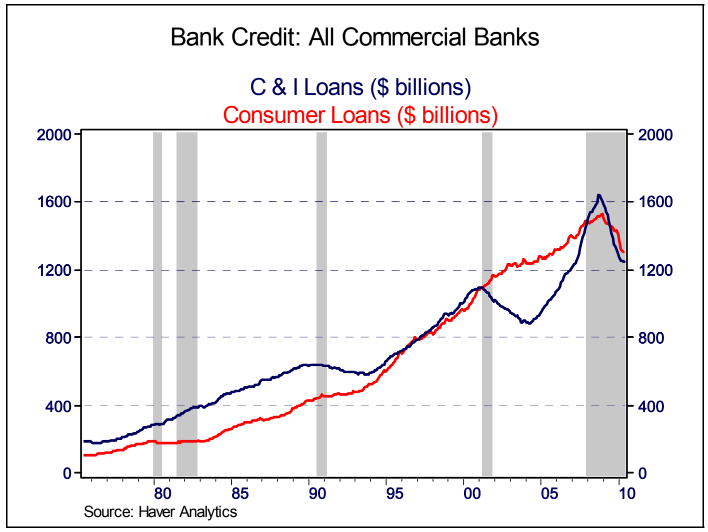
Honestly, no one can really tell exactly what policies will eventually be used to mop up the federal deficit. This uncertainty seems to be delaying decision-making for several economic agents at the moment. Some people think that budgetary cuts are the way to go. Others see tax increases ahead—a recipe used in the 1930s and in some European countries nowadays to reduce the deficit. Washington notably has no national sales tax and President Obama is thinking of letting the temporary tax cuts that the Bush administration had introduced for individuals earning more than $200,000 lapse. In short, nothing is carved in stone. Without knowing exactly what form it will take, the expansionist fiscal policy of the last few quarters may be replaced with a more restrictive fiscal regime at the White House—another factor that would hold real GDP growth in check.

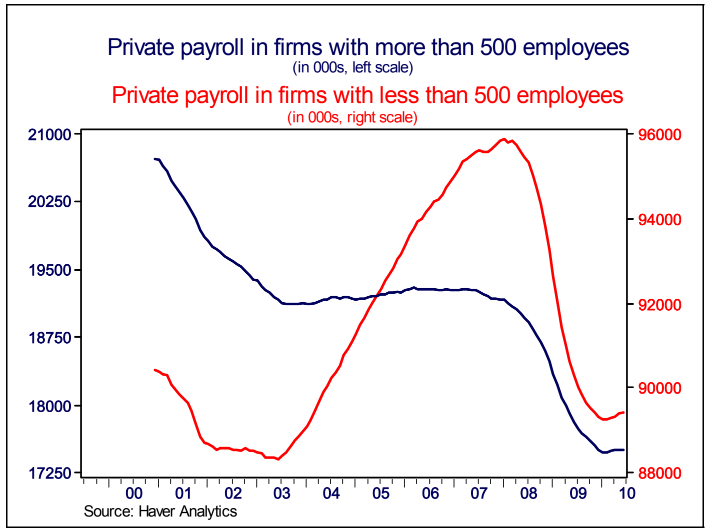


Inadequate bank credit: a big problem for small businesses

In addition to governments, the private sector is taking time to get back on its feet: banks, non-financial businesses and consumers seem unable to completely make up for the gradual withdrawal of fiscal stimulus.

One of the private sector's major problems is the implosion of bank credit. American financial institutions, both large and small, are reluctant to lend. Credit standards remained tight in most districts according to the July's Fed Beige Book. After initially wreaking havoc with the banks' balance sheets, the crisis of 2008-09 will leave further important regulatory changes in its wake even though a smoother reform path appears to emerge. Without adequate credit, it is difficult for small businesses to expand and to hire; yet small businesses of 500 employees or less hire 85% of the labour force. Therefore it comes as no surprise that private-sector employment has struggled to add a soft 600,000 jobs since the beginning of the year. Many jobs disappeared in the construction sector in 2008-09 and will not come back; this sector is characterized by an especially large number of small businesses. The future does not look promising: according to the most recent survey by the *National Federation of Independent Businesses*, a mere 10% of the small businesses surveyed plan to hire workers in the next three months. It is therefore a utopian dream to expect that the 2 million jobs eliminated in 2008-09 will be regained in the next two to three years. We therefore predict that the unemployment rate will remain above 9% over the next year.

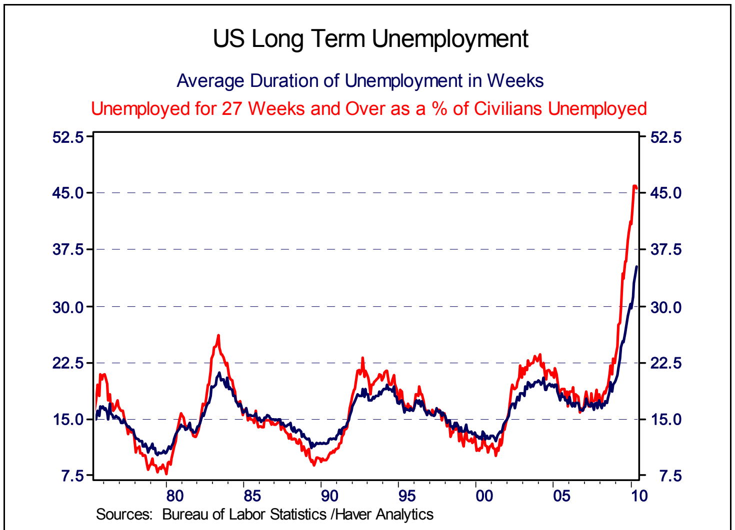




Long-term unemployment: A persistent problem for a growing number of households

For lack of any concrete improvement in job market conditions, the demand for credit, like the supply thereof, is tepid. In fact, the credit rating of many borrowers is unattractive for the banks because another problem is raging at present: long-term unemployment. Nearly half of the 14.6 million unemployed Americans have been so for 27 weeks or longer. This is a sign that the skills acquired in the industries that are in difficulty are not always transferable to the sectors that are thriving. The federal emergency unemployment benefits on which these unemployed workers count on were just renewed, good news for 4.9 million people who would have otherwise live without any income in upcoming weeks. These benefits enabled hard-up unemployed workers to catch their breath and spend a little in the past few quarters.

With the scarcity of job offers and long-term unemployment, it is not surprising that consumers' confidence is still shaky (the University of Michigan's consumer confidence index plummeted to 66.5 in July). Without strong confidence, it is difficult to carry out major projects. For example, new mortgage loan applications are at their lowest level in 14 years according to the *Mortgage Bankers Association*, a clear-cut sign that demand for credit is soft. In addition, some households are focusing their efforts on paying down the excessive debt they built up in past years. This long process started a few quarters ago and points toward a high savings rate (4-5%) for several years to come, notably in light of the depreciated value of their net assets. In short, the equation is very simple: in order for American households to pay off their debts, they must spend less than they earn. And as long as income growth remains weak, growth in household spending will also remain subdued, in the neighbourhood of 2% at an annualized rate.

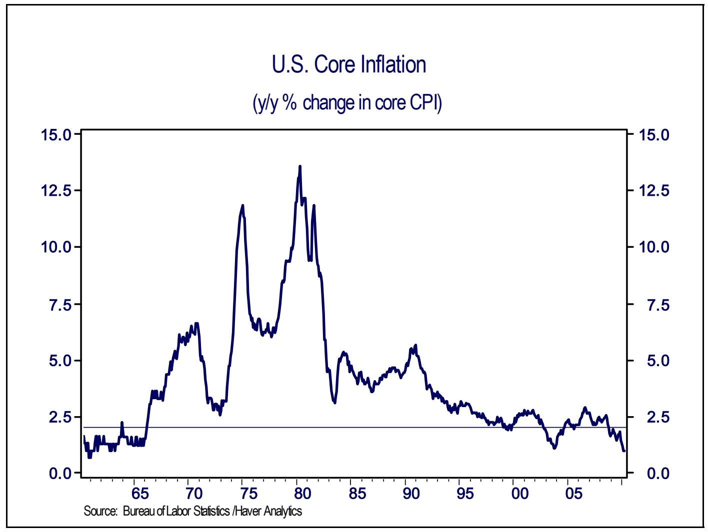


Deflation: A greater problem than inflation

So far, *LBS Economic Research* has identified three problems that can only hinder the American economic expansion: restrictive fiscal policy, lacklustre credit activity, and long-term unemployment.

Who will come to the rescue? The Fed? Once again, there are uncertainties about what the Fed could do, and about whether its actions would bear fruit. Certainly, the Fed will probably be called upon to play a greater role as events unfold, since there are limits to public debt. Even though Bernanke is in no hurry at this stage despite being unable to meet its dual mandate in the medium-term, it is still possible that the Fed may use other tools from its toolbox, an upside risk to our base-case scenario. The Fed's tools box – such as a more explicit commitment to keep the fed funds rate target exceptionally low for a longer time – will be discussed in more details in the next edition of the *Monthly Monitor*.

If the Fed proves unable to make credit work normally and to maximize employment, another problem may join to the list: deflation. Already, trend inflation is slipping month after month despite the money supply explosion: Core CPI inflation (total CPI excluding food and energy) sits below 1% for the first time since 1966. The same holds true for core PCE, the Fed's favourite. In our opinion, an absence of inflation remains the most likely scenario in the next few quarters, i.e. core CPI inflation in the neighbourhood of 0.5-1.0% and dangerously close to zero. In fact, the Fed needs to worry more about deflation than inflation at the moment, as that is, of course, the most serious threat after the events of 2008-09. History is also telling us that Japan has yet to emerge from its deflationary period after 15-20 years, and only World War II enabled the United States to return to inflation after the Great Depression of the 1930s.



That said, we are of the view that deflation remains a long shot over the medium-term. Firstly, deflation is not possible if expectations do not turn south. Fortunately, the FOMC minutes shows that Bernanke's management of inflation expectations appears to work well. For example, the 5-year breakeven rate is far from being in negative territory, sitting well above 1.50 percentage points over the past eight months. Furthermore, the fact that two thirds of the prices in the US CPI basket are rising is helping to support the public's perception that deflation is not present, therefore avoiding consumers to delay their purchases. In addition, deflation is out of the question without wage inflation. While labour income is not skyrocketing, modest positive growth is another reassuring sign on that front, supporting to some extent the downward nominal wage rigidity theory.

All in all, near-zero core inflation is our base-case scenario for the next two years, and probably beyond. For example, if the monetary multiplier ever emerges from the doldrums and inflation gets up a bit of steam—which we do not foresee—we will not hear any complaints from Washington or from debt-ridden households.

Some positive factors to offset the problems

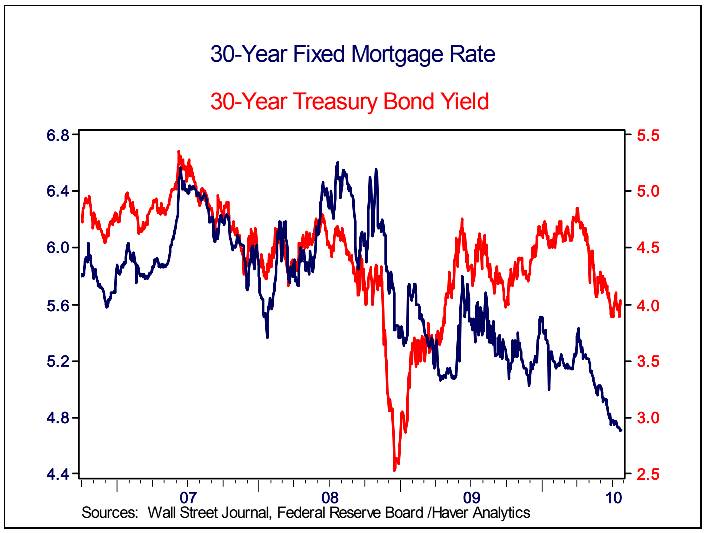
Given the three problems discussed above, the risk of falling back into recession admittedly exists. At least President Obama and Bernanke will not get the wrong impression that the expansion has taken off for good, as happened in the mid-1930s, which led to a premature tightening of macroeconomic policies and the Roosevelt recession of 1937-38. Even though the aforementioned problems will likely hold back real GDP growth, we believe that some encouraging factors will keep it in positive territory:

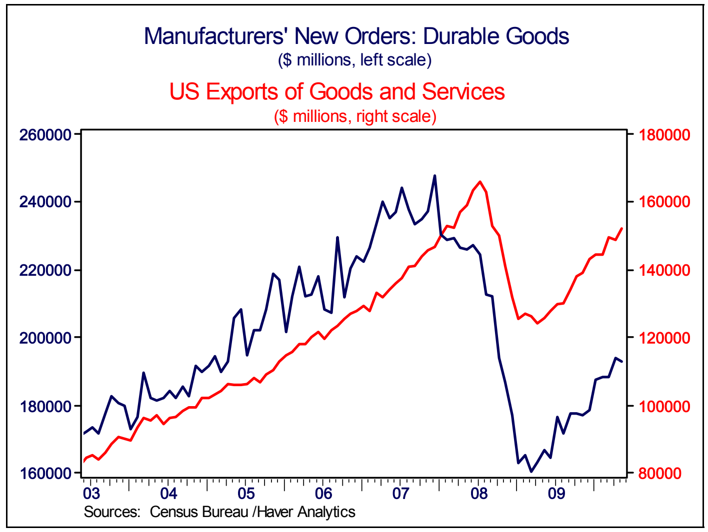
- First of all, interest rates are low. For example, the rate for a fixed 30-year mortgage fell near 4.6% recently, allowing many homeowners to refinance their mortgage at lower rates and generate positive cash flow. Refinancing applications were in late July at their highest level since May 2009.
- Secondly, large firms will continue to benefit from the global recovery as exports advanced by double-digit growth in the last four quarters. On one hand, exports account for just a small portion of the economy (12%), so the US will not be able to rely entirely on foreign trade to generate rock-solid growth in the future. On the other hand, US exports to Europe represent a tiny portion of real

GDP (less than 2%). As such, PIGS countries cannot derail the American economy.

- Thirdly, although business owners are hesitating to recruit workers, we are seeing a solid turnaround in capital spending, as shown by the recent surge in orders for nondefense capital goods ex aircraft. These investments should translate into healthy gains in productivity in the near future.
- Fourthly, crude oil prices are staying relatively low—below US$80 per barrel—good news for energy hungry America.

All in all, *LBS Economic Research* does not foresee a double-dip recession – the odds stand approximately at 20%. We forecast real GDP to advance by 2.9% in 2010 and 2.5% in 2011. This will result in more moderate growth in corporate earnings next year (8%) than this year (16%). In short, if no remedy is found for these three problems, the American economy will be unable to achieve two consecutive years of growth above 3%, as occurred in 2004-05 for example, when the real estate market was— despite its woes, we might add—the driver of the economy. A new engine of growth is precisely what is missing in order for the United States to return to prosperity for several years.





United States

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

							Annual Average			4th Qtr/4th Qtr	
	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2009	2010	2011	2010	2011
Real GDP (%)	**3.7**	**2.4**	**2.0**	**2.5**	**2.5**	**2.5**	**-2.6**	**2.9**	**2.5**	**2.7**	**2.8**
Consumption	1.9	1.6	2.0	2.0	2.2	2.4	-1.2	1.5	2.2	1.9	2.4
Private investment	9.4	17.6	10.4	6.9	7.8	8.1	-16.8	6.8	8.9	11.0	8.8
Non-residential structures	-17.8	5.1	4.0	3.5	4.0	5.0	-20.4	-12.2	4.4	-1.8	4.7
Machinery and equipment	20.5	21.9	12.5	8.0	9.0	9.0	-15.3	14.4	10.4	15.6	10.0
Residential construction	-12.3	27.8	0.0	3.0	3.5	2.5	-22.9	1.3	3.9	3.7	2.7
Government spending	-1.6	4.4	-0.8	-0.5	0.3	0.1	1.6	0.6	0.3	0.4	0.3
Exports	11.4	10.4	11.5	11.0	9.5	9.0	-9.5	12.7	9.7	11.1	8.6
Imports	11.2	28.8	5.2	4.0	4.0	4.5	-13.8	11.6	5.9	11.9	4.9
Inflation (%)											
Total (y/y)	2.4	1.8	1.4	1.2	1.0	1.3	-0.3	1.7	1.3	1.2	1.5
Core (y/y)	1.3	1.0	0.9	0.8	1.0	1.0	1.7	1.0	1.0	0.8	1.0
Unemployment rate (%)*	**9.7**	**9.7**	**10.0**	**10.0**	**9.8**	**9.7**	**9.3**	**9.9**	**9.6**	-	-
Housing Starts (000s)	**617**	**602**	**625**	**650**	**700**	**725**	**554**	**624**	**725**	-	-
Before-tax Corp. profits (%, y/y)	**37.6**	**13.0**	**9.7**	**9.5**	**5.0**	**7.5**	**-0.4**	**16.7**	**8.1**	**9.5**	**10.0**

* Average rate for the quarter or the year.

Forecasts as of July 28th 2010