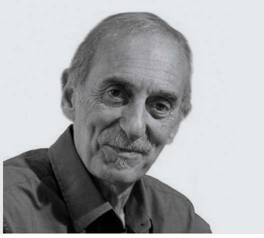

Thematic Report

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Monthly Report
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The US economy is better looking, but the key question is whether it's also looking better?

In this issue:

- **The US economy is relatively better looking than most other major economies, but steps have been faltering**
- **It is arguably better positioned than most in terms of employment, financial standing and innovation**
- **Unpredictability may accompany the consequences of the Fed's expected move to start raising policy rates**

We can say without equivocation that in the long shadows thrown up by the financial crisis, the US economy is better looking than pretty much any other major developed economy, and a fairly exhaustive list of emerging economies too. Its cyclical performance has been relatively stronger, and thanks to falling energy import dependency and robust technology trends, the US is also in relatively good shape structurally. But the key question is whether the US economy is also looking better both after a very weak start to the year, and in terms of its sub-par economic performance since the 2010 bounce-back.

The 'looking better' issue is key to the Fed's behaviour, and to financial markets in view of the potentially pivotal role that the first rise in policy rates since 2006 may have in, and far beyond, the US. For finance professionals and others, this latter statement is quite something: younger cohorts have come into the finance business never having experienced a rise in US interest rates, and most of the rest of us have forgotten what it feels like. The last tightening cycle began even earlier, in 2004.

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The issue of whether the Fed will or should raise rates is contentious. Those who think it shouldn't – including, curiously, the IMF – cite continuing weaknesses in the US economy and the risk of relapse. But there's a cynically stronger case not to expect higher interest rates in the institutionalisation of low interest rates in the US, courtesy of the height of successive Fed chairpersons. Paul Volcker, who raised interest rates to 20%, was 6'7" (2.10m). Alan Greenspan, who raised interest rates a few times by 2-3%, was 5'11" (1.8m). Ben Bernanke was a bit shorter at 5'8" (1.73m), and raised rates less than 1% when he took over at the Fed, and then never again. Janet Yellen is a mere 5'0" (1.6m). If you like patterns, this is the one for you.

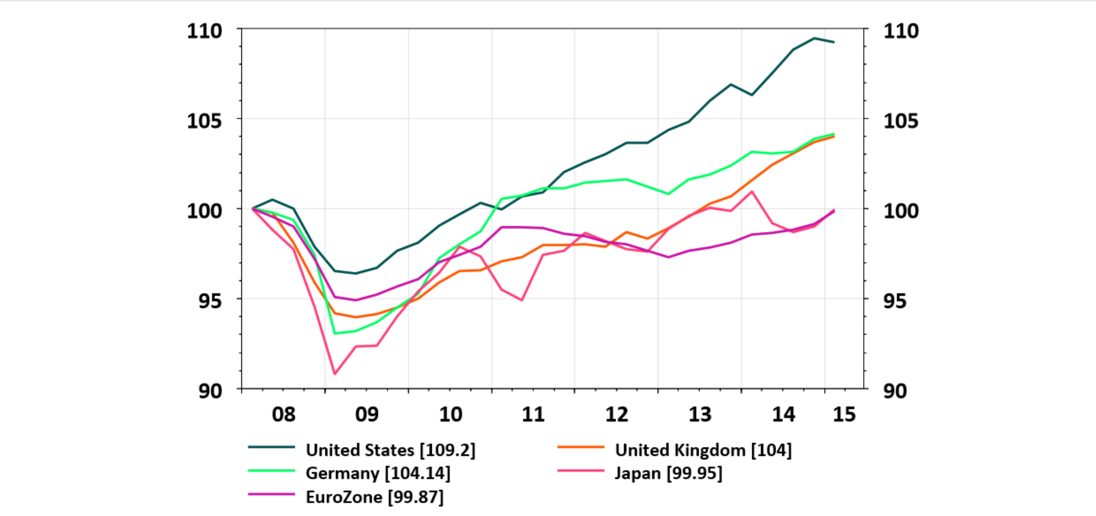
"... the case for the Fed to start leaving exceptional monetary policies behind is compelling..."

I will argue below, though, that even if the US economy has given as much cause for disappointment as hope over the last few years, the case for the Fed to start leaving exceptional monetary policies behind is compelling, if not absolutely certain. The Fed's and the market's expectation that the first rise in policy rates could come in September looks about right. But the Fed's officials are nothing if not cautious – even scared – and the key issues are the path of tightening ahead, which looks likely to be shallow to begin with and protracted, and the effect of higher policy rates on bond yields. There would have to be some, if the tightening is to have any traction.

Better looking

There is no question that the US economy is better looking compared to its peers. If we look at real GDP, indexed back to the last peak at the start of 2008, for example, the US is way ahead of the pack.

US and G4 Economies Real GDP rebased to peak in 2008



Source: The ECU Group plc; Datastream

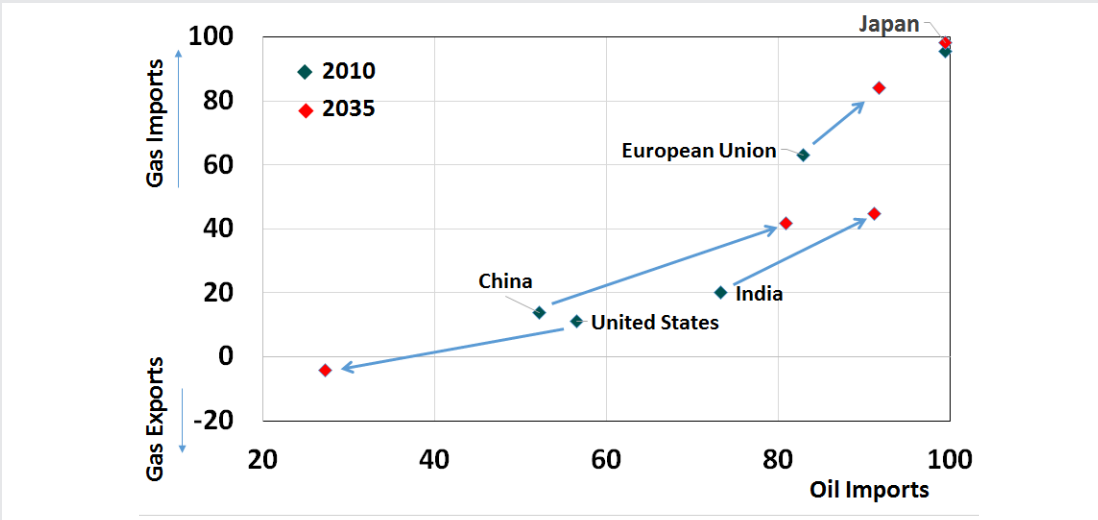
As is well known, the US has continued to make strides towards full employment, kept the threat of deflation at arm's length, and experienced a moderate but sustained rise in both private capital spending and in bank lending to industrial and commercial corporations. If one of the major fears we have nowadays is the embedding of secular stagnation, according to Larry Summers' warnings, then the US is probably one of the less likely candidates. There are other things that are giving the US edge.

It is pretty much peerless when it comes to running the global finance system – a property that confers huge authority and power. The Euro area competes, to be sure, but is still an 'also ran' in many respects, not least in terms of capital market depth and breadth, and because of a lingering sense that there's still a thin line between monetary union and a system of fixed, but 'attackable', exchange rates. China has pretensions to compete: the strategy of internationalising the RMB is proceeding apace from a very low base, and China expects to receive the IMF's blessing for the currency to be included in the SDR in a decision later this year. Yet, China's influence on global finance is minute by comparison and it is a matter of belief, as well as of many, many years as to whether China will be able to overcome the institutional and economic barriers that seem likely to limit the RMB's role as a reserve currency.

"... China's influence on global finance is minute by comparison..."

More tangibly, perhaps, the US is the only major country or region where net energy import dependency is predicted to decline, thanks to the significant rise in domestic oil and gas output and capacity.

Net Oil and Gas import dependency in selected countries



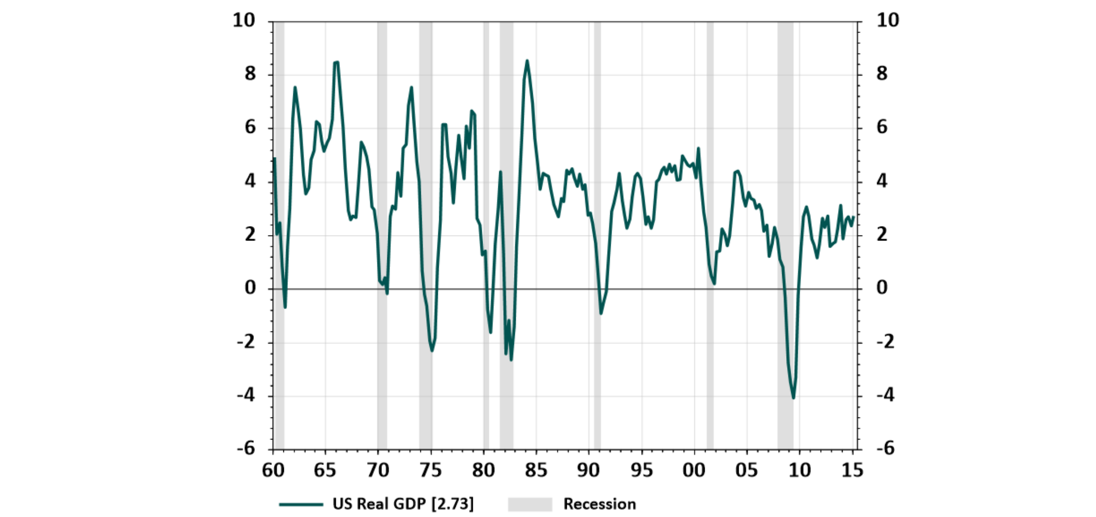
Source: The ECU Group plc; IEA

And while Europe and Japan boast some world class companies, the US can still claim to be one of the world's leaders in innovation and technology and with a reach that is longer than its biggest competitors. This at least, according to one survey with criteria that comprise R&D and high technology intensity, productivity, research concentration, manufacturing capability, tertiary sector attainment and efficiency, and cited patent activity.

But looking better?

In stand alone terms, though, the US economy's performance has been more equivocal. Economic forecasters have persistently brushed aside economic growth disappointments over the last few years in the hope that a 3% expansion would finally take hold... only for disappointment to set in again. To put this in perspective, it has been over a decade since the US was last able to string together more than a couple of quarters of 3% growth. This time, as they say, it really is different.

US Economic Growth - this time really is different



Source: The ECU Group plc; Datastream

"Even allowing for these explanations, however, the economy is not in full-blown recovery mode..."

The current year got off to a bad start, with real GDP falling 0.7% at an annualised rate. Inclement weather, the west coast port strike, the rise in the US dollar, and the oil price-induced plunge in energy investment spending were the principal factors. Net exports in the first quarter came in at -$548 billion, a deterioration of $70 billion from the prior quarter and $100 billion compared with a year earlier. From then on, the US dollar's uptrend really began. The rise in the trade weighted dollar since mid-2014 may have taken about 0.7% off GDP. Even allowing for these explanations, however, the economy is not in full-blown recovery mode, as we have understood it. While there's no question that the levels of unemployment on the one hand and employment and GDP on the other are markedly lower, and higher, respectively than they were at the launches of QE 1 (November 2008), QE2 (November 2010) and QE3 (September 2012), other indicators look lacklustre by comparison.

For example, the labour force participation rate in May was 62.9%, lower than at any time since 2008. The personal consumption deflator (ex food and energy) was 1.3% in April, lower than at any time since 2008. The annual growth in retail sales in April was 2.7%, also the lowest since 2008, and nominal GDP growth in Q1 was 3.6%, which compares favourably with a decline in 2008 but not so vis-a-vis the launches of QE2 and QE3.

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Bank lending to companies has revived, growing by around 12% in 2014, and a tad higher in the first quarter of 2015, but lending for residential mortgages, for example, remains very soft. The outstanding value of mortgage loans in March 2015 was still $1 trillion lower than in 2009.

Non-residential capital spending has grown by about 8% in real terms since the 2008 peak, but has been pegged back significantly by the impact of the crunch in oil prices on the energy sector. The number of rigs has plunged, according to the Baker-Hughes count, from a peak of 2050 in 2011-12 to 1750-2000 in 2013-14, and around 635 in the last few weeks. In the national income accounts, oil and gas investment fell by $20 billion in the first quarter.

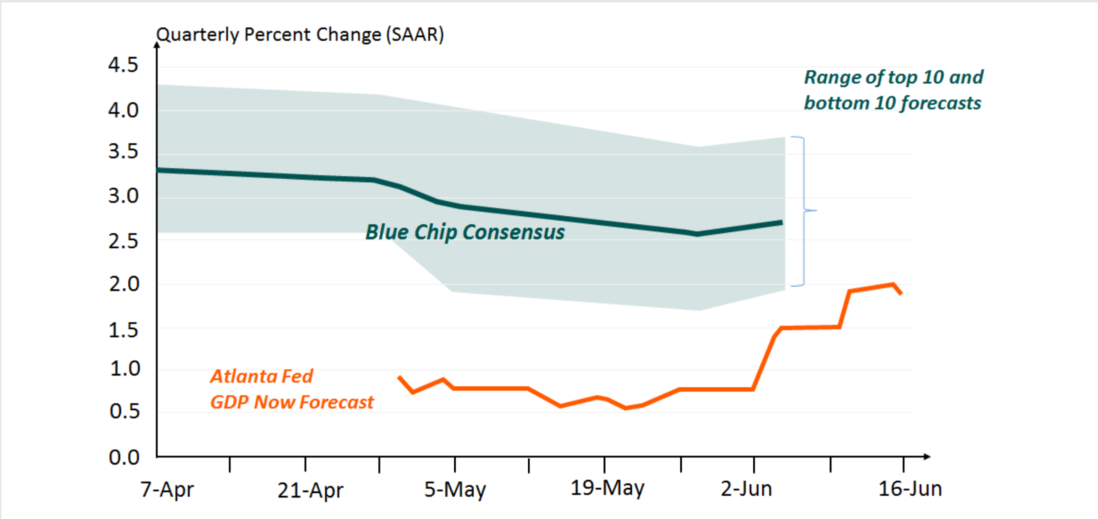
"So the US is a curate's egg economy: good in parts, but by no means across the board."

So the US is a curate's egg economy: good in parts, but by no means across the board. How should we think about the economy over the next several months and going into 2016? What happens will determine not only the outlook for policy rates, but how the economy, the bond market, the US dollar and corporate profits weather the shift in the monetary policy environment.

Better, maybe, from now on...

The good news, as the second quarter ends, is that economic activity certainly seems to have picked up again. The Atalanta Fed's 'nowcast' which had been tracking the economy at about 0.7% for several weeks in the second quarter has picked up to about 2% – still lower than the forecast consensus, but a definite improvement. Taking account of the latest trends in industrial production, real investment spending in energy, auto sales and housing starts, the economy seems to be coming back a bit.

Evolution of Atlanta Fed "GDP Now" Real GDP Forecast for 2015: Q2



Source: The ECU Group plc; Atlanta Fed

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Moreover, there are some additional developments that are tipping the scales towards hope or optimism. The US dollar remains in an uptrend, probably, but it hasn't soared as before. But of greater significance, there are early signs of a possible change in both private savings and wage and salary formation. According to the personal income report, the household savings rate in the first quarter jumped to 5.5% in the first quarter 2015, up about 0.8% from the prior quarter. But in the Flow of Funds accounts, where the calculations of the savings rate differ, the jump over the winter quarters was far greater, of the order of 7% of disposable personal income. The discrepancy is remarkable, even if the latter may still exaggerate the position. Nevertheless, it does appear that the US consumer did not spend the windfall gains brought about by the collapse in the price of oil. That's a good reason to expect a bit of 'catch-up' over the rest of the year.

"... US inflation, as measured by the CPI, is likely to hover around zero over the summer..."

Further, with full employment among some occupational cohorts, especially at the top end of the skill and income distribution, and the overall trend in unemployment, a turnaround in income formation may be at hand. The quarterly employment cost index showed that private wages and salaries had risen to 2.8% in the first quarter, while economists at the Atlanta Fed estimate that the underlying trend in median wages and salaries has risen to about 3.3%. Since we are starting to see 'movement' in wages and salaries, at least, as employment conditions tighten, it may be that finally we are going to see a bit more of a 'Philips curve' phenomenon over the next 12 months, in which wages and salaries respond more sensitively to tightening labour market conditions, as otherwise measured in the employment report. By way of background, US inflation, as measured by the CPI, is likely to hover around zero over the summer, but base effects alone are likely to lift annual inflation to around 2-2.5% or so by the early 2016.

And so...

If growth is steady, and wages and salaries continue to firm, it might not be so far into the future that the economic discussion is going to turn to upside inflation risks. It seems heresy at the moment, but if and when this happens, it will be sudden. Against this backdrop, we should be cognisant that interest rate risks are liable to become more volatile and two-way. This means the periodic pegging back or sanguine view of interest rate expectations will be joined by recurring re-assessments. If so, we should expect many 'interesting' consquences for markets and assets, not the least of which is that the US dollar baby bull market is due a period of growing up.

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Biography

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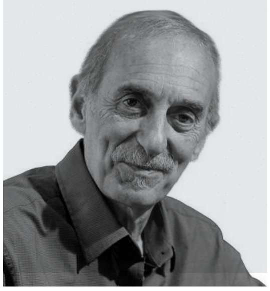
George Magnus
Chief Economic Adviser



George Magnus is a long standing and independent member of ECU's Global Macro Team, specialising in global macroeconomic trends and the global financial system.

George is Senior Economic Adviser at UBS Investment Bank, where he was previously Chief Economist for seven years. His former roles include Chief International Economist at UBS and Head of Fixed Income Research and Chief Economist at S.G.Warburg.

George is author of two highly acclaimed economic books: "The Age of Ageing" and "Uprising: will emerging markets shape or shake the world economy?"

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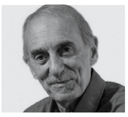
Professor Charles Goodhart, George Magnus

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