

UNITED STATES CHART BOOK

23rd Nov. 2011



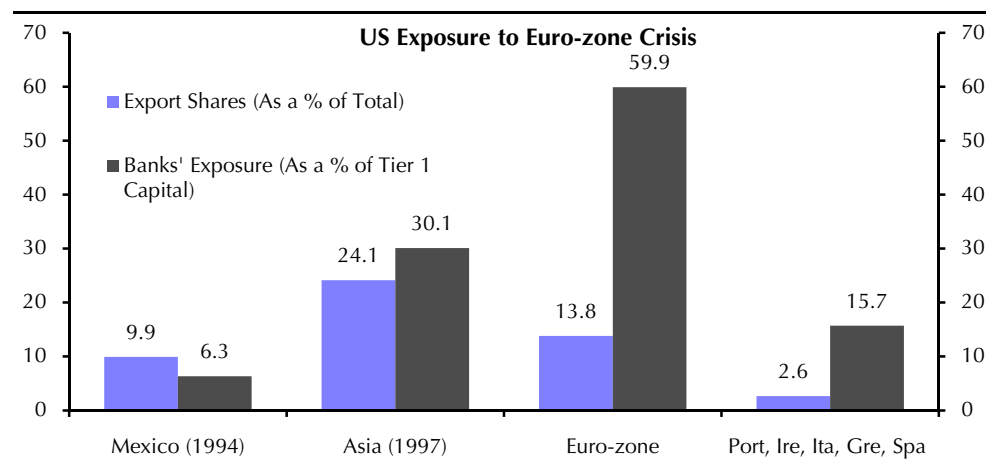
Euro mess is by far the biggest risk to US outlook

- There is an incredible amount of uncertainty surrounding what impact a euro-zone recession and the potential break up of the single currency could have on the US economy and financial markets. The trade links with the peripheral euro-zone countries are small, with the US less exposed than it was to either the Mexican Peso crisis in late 1994 or the Asian crisis in 1997. (See Chart.) The financial links are also pretty limited, at least as long as the crisis is restricted to those same peripheral countries. But if the crisis were to badly damage the banking system in the core euro-zone countries, then the impact on the US would be much greater. In a worst case scenario, the collapse of the euro could paralyse US credit markets and push the economy back into recession.
- **Output and activity indicators** show that manufacturing activity remains solid in the US, even as the euro-zone factory sector stagnates. (Page 2.)
- **Consumption indicators** suggest that spending growth remains strong even though confidence is still unusually weak. (Page 3.)
- **Investment indicators** imply that business investment is still growing at a rapid rate in the fourth quarter. (Page 4.)
- **External indicators** show that the nascent recession in the euro-zone will contribute to a slowdown in the overall growth of US exports. (Page 5.)
- **Labour market indicators** reveal a modest improvement in conditions. (Page 6.)
- **Inflation indicators** suggest that headline inflation has peaked. (Pages 7 & 8.)
- **Financial markets indicators** show that the Treasury market is still benefiting from strong safe haven flows as the euro-zone crisis mounts. (Page 9.)

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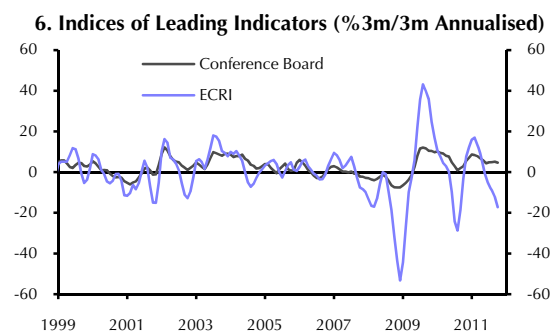
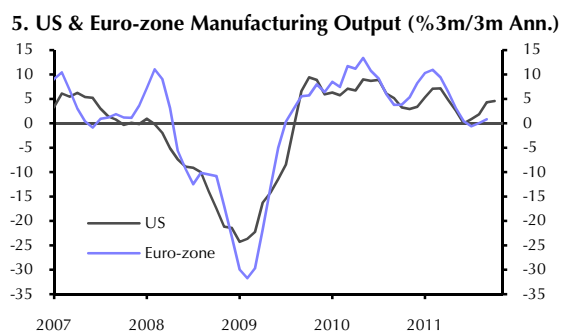
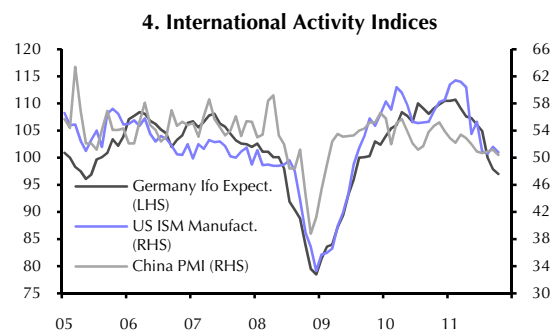
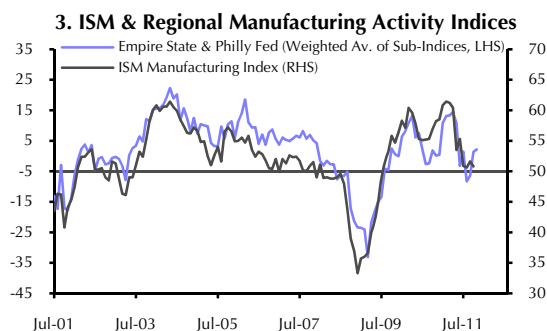
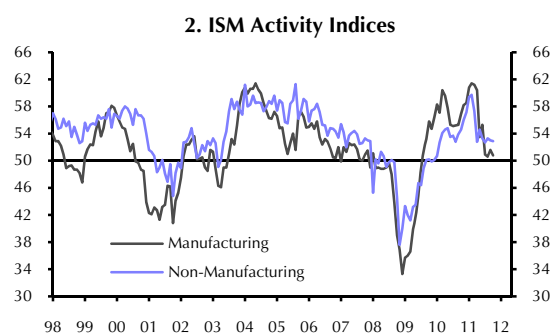
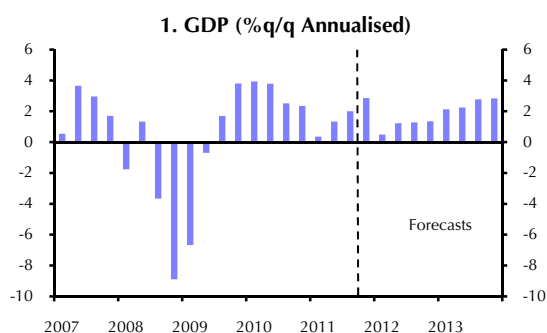
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Output and Activity Indicators

- The latest incoming data suggest that GDP growth will accelerate to about 2.5% annualised in the fourth quarter, up from 2.0% in the third (1). However, we're still concerned about a sharp slowdown in the first quarter of next year, particularly if the payroll tax cut is not extended, which looks less likely after the failure of the deficit reduction super committee.
- The activity indices are certainly at relatively low levels (2), although the latest regional evidence for November is a little more encouraging (3). Furthermore, the decline in the US activity indices has been more modest than that seen in the euro-zone (4). US manufacturing output has also been growing solidly over the past few months, whereas output has been broadly stagnant in the euro-zone (5).
- The ECRI index of leading indicators is still markedly more downbeat when compared with the Conference Board's index (6). More generally, the ECRI index has suffered some wild swings over the past few years.

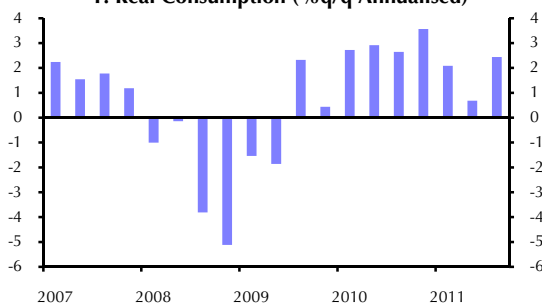


Sources – Thomson Datastream, Capital Economics

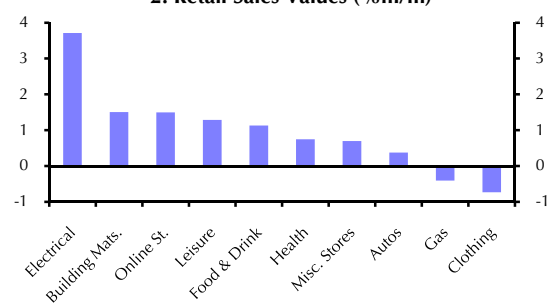
Consumption Indicators

- Annualised real consumption growth accelerated to a decent 2.3% in the third quarter, up from a meagre 0.7% in the second (1). And growth in the fourth quarter may come in at around the same pace.
- The 0.5% m/m gain in retail sales in October was mainly driven by strong discretionary spending (2). Despite that, real spending grew by a more modest 0.1% m/m (3). Spending does have some momentum ahead of Black Friday. But, contrary to popular belief, the strength in sales on the day after Thanksgiving may not be a reliable indicator of sales during the entire holiday season (4). Even so, if real spending increased by 0.1% m/m in both November and December, fourth-quarter consumption growth would still match the third quarter's 2.3%.
- But this can't be sustained when real incomes are weak (5). Moreover, the failure of the deficit reduction super committee means that the payroll tax cut is now more likely to expire at the end of the year. Meanwhile, in the three months to October, 15% of banks reported a rise in the demand for mortgage lending (6). Most of this, however, probably reflects demand for refinancing rather than new borrowing.

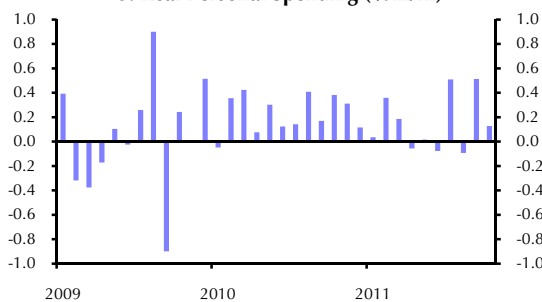
1. Real Consumption (%q/q Annualised)



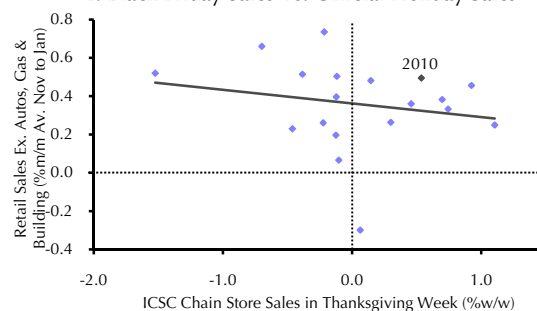
2. Retail Sales Values (%m/m)



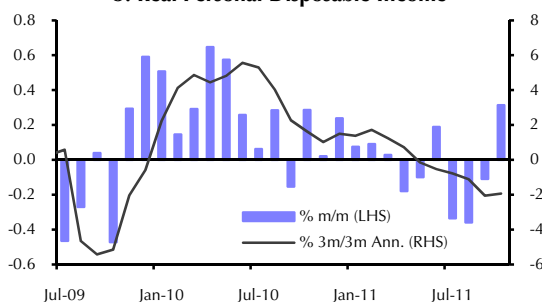
3. Real Personal Spending (%m/m)



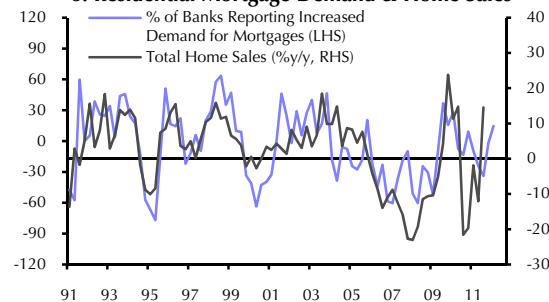
4. Black Friday Sales Vs. Official Holiday Sales



5. Real Personal Disposable Income



6. Residential Mortgage Demand & Home Sales

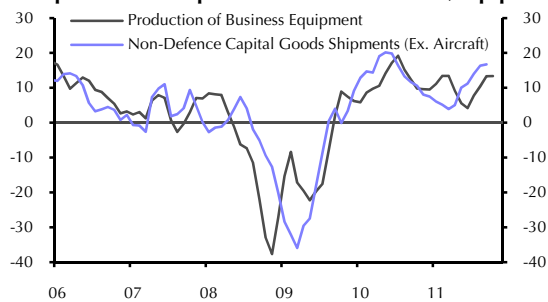


Source – Thomson Datastream, Capital Economics

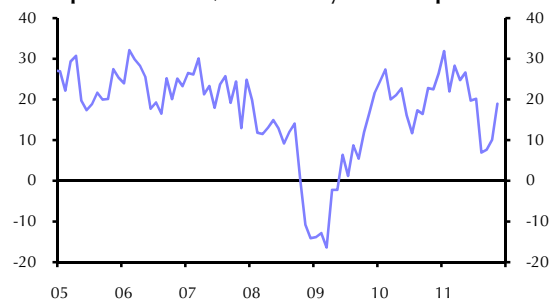
Investment Indicators

- The monthly data on capital goods shipments suggest that business investment in capital equipment has stalled in the fourth quarter, even before the scheduled expiry at the end of this year of the temporary accelerated depreciation allowances. The latest data on the production of business equipment is a little more encouraging, however (1), and the survey evidence on capital expenditure intentions has improved (2).
- The still depressed level of the Architects' Billings Index suggests that the recent surge in non-residential construction spending will prove to be short lived (3). The rebound in housing starts points to modest growth in residential construction spending (4).
- Inventories ended up subtracting as much as 1.6 percentage points from overall annualised third-quarter GDP growth, as inventory growth ground to a complete halt towards the end of the quarter. The survey evidence even points to a small run down in inventories in the fourth quarter (5). But, aside from the autos sector, inventories don't look elevated relative to sales so we don't anticipate a more severe decline (6).

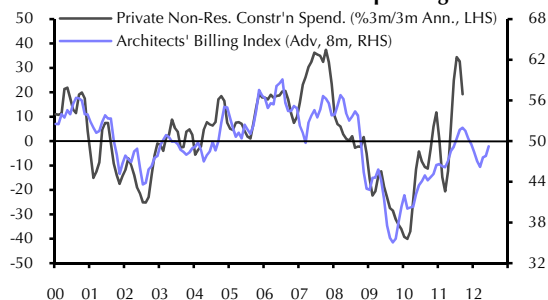
1. Capital Goods Shipments & Business Invest. (%q/q Ann.)



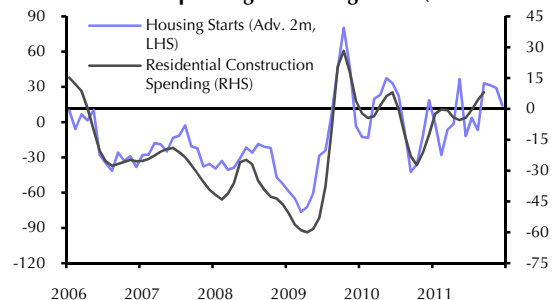
2. Capex Intentions (Ave. of Philly Fed & Emp. St. Indices)



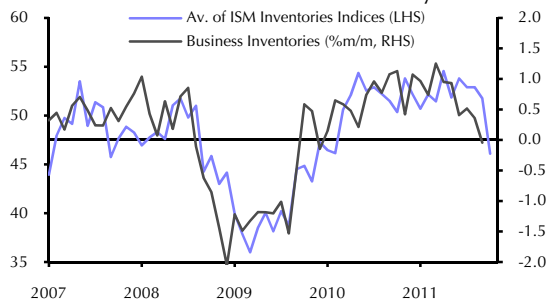
3. Non-Residential Construction Spending & ABI



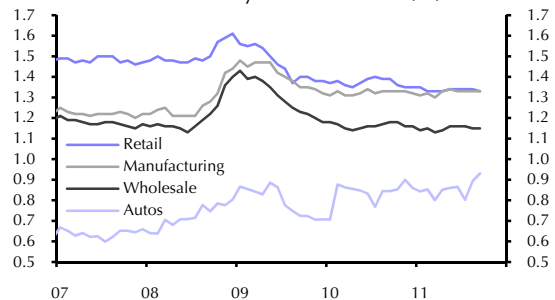
4. Resi. Constr'n Spending & Housing Starts (%3m/3m Ann.)



5. Business Inventories & ISM Inventory Indices



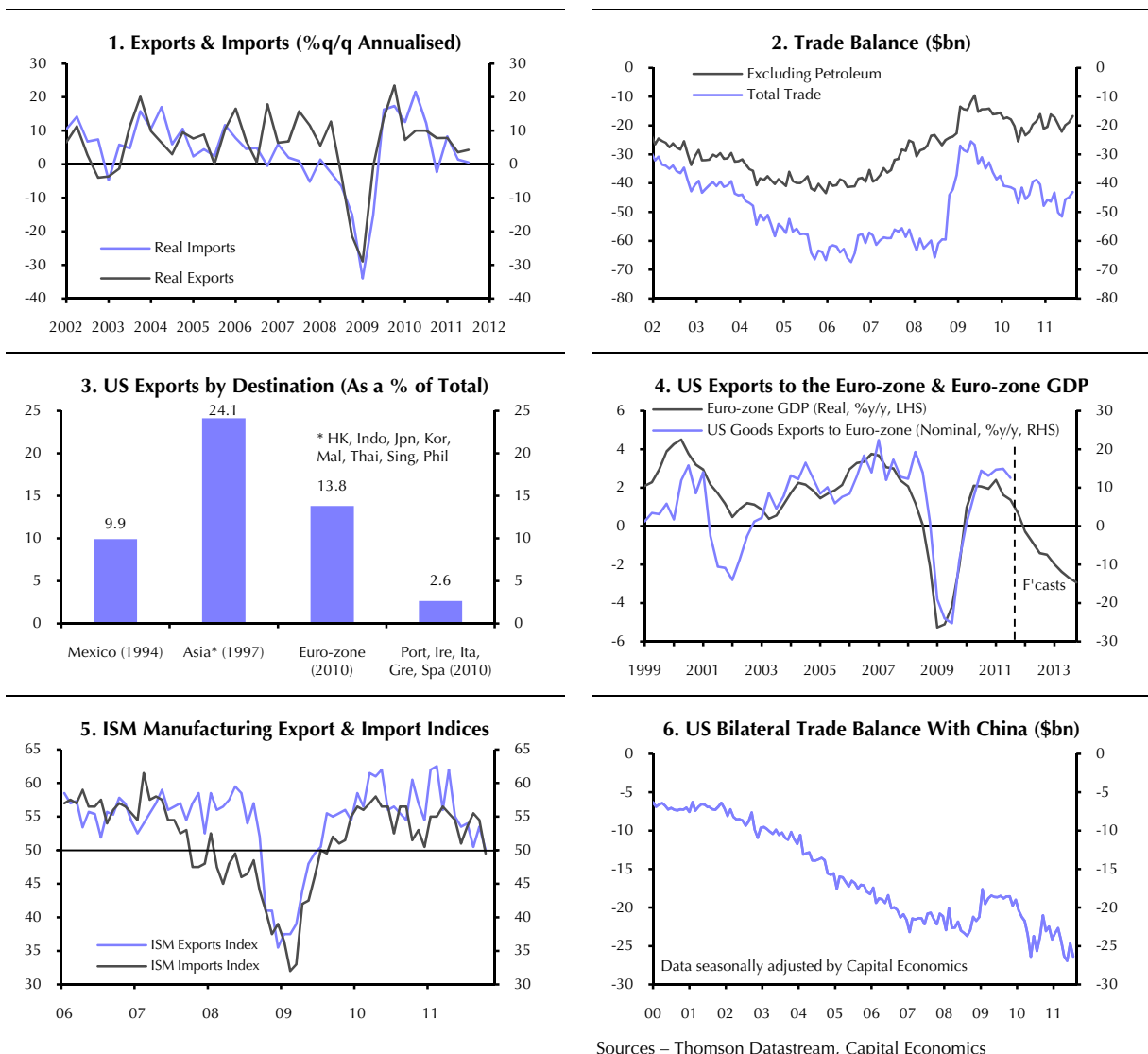
6. Inventory-To-Sales Ratios (%)



Source – Thomson Datastream

External Indicators

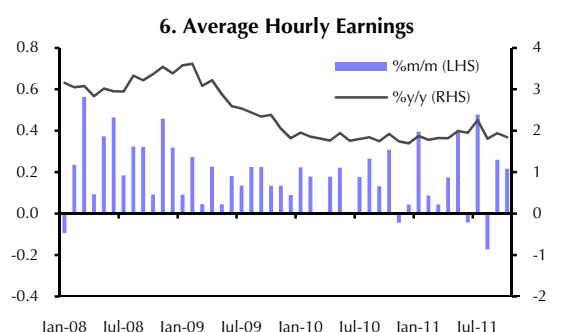
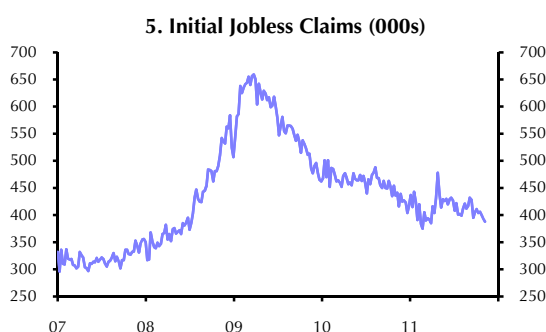
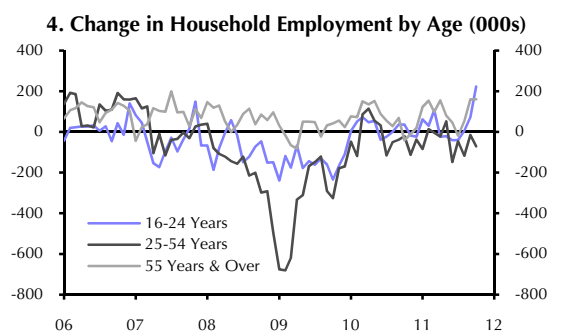
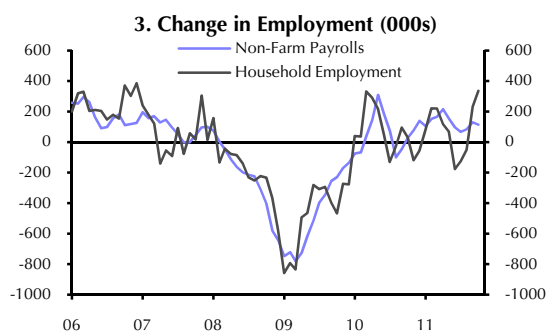
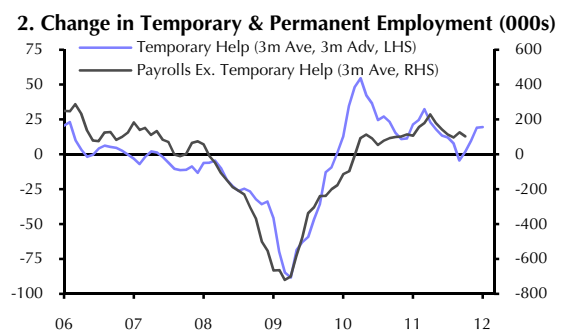
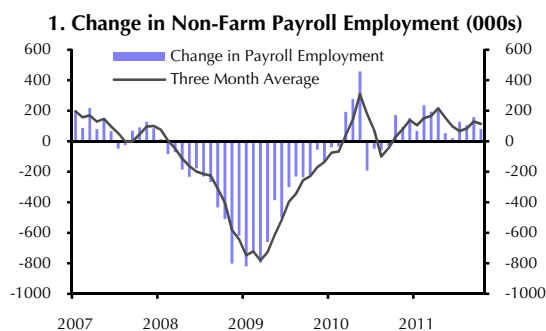
- The external sector has performed reasonably well in recent months, with exports rising at a faster rate than imports in the third quarter and the trade deficit narrowing to a nine-month low in September (**1 & 2**). It is only a matter of time, however, before the recession in the euro-zone puts a small dent in US exports.
- Thankfully, the US sends just 14% of its exports to the euro-zone and less than 3% to the weakest peripheral nations. That exposure is smaller than the US had to the Asian financial crisis in 1997 (**3**). US exports to the euro-zone will still fall sharply (**4**). But that might not be enough to drive down overall exports, which should continue to grow, albeit at a fairly modest rate.
- Import growth has already weakened, as shown by the fall in the imports index of the ISM activity survey (**5**). The recent strength of consumption and investment growth is consistent with a rebound in import growth. Meanwhile, after applying our own seasonal adjustments, in September the bilateral trade deficit with China remained close to a record high (**6**).



Sources – Thomson Datastream, Capital Economics

Labour Market Indicators

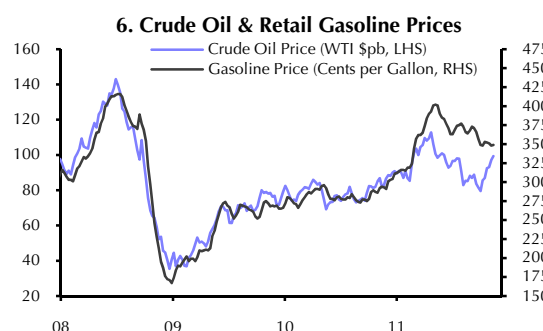
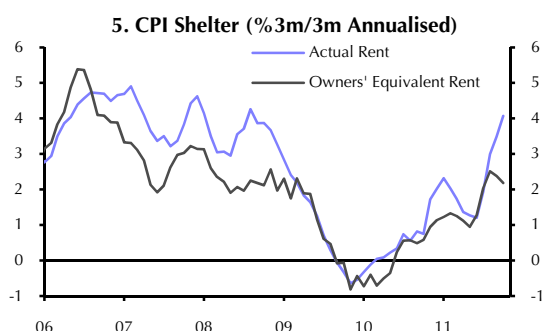
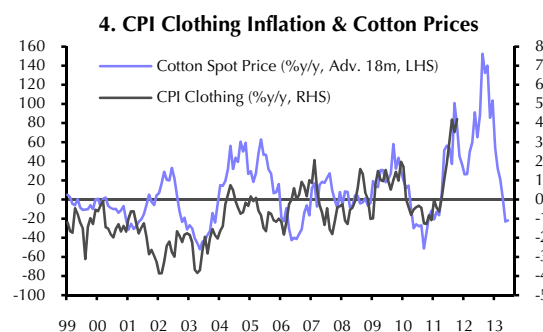
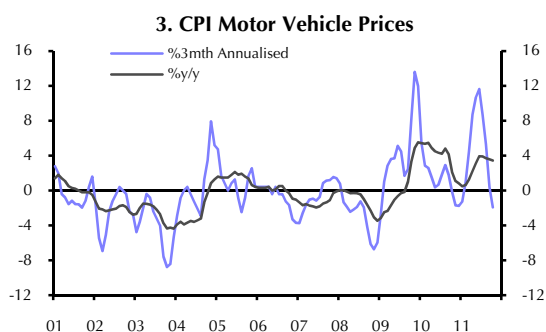
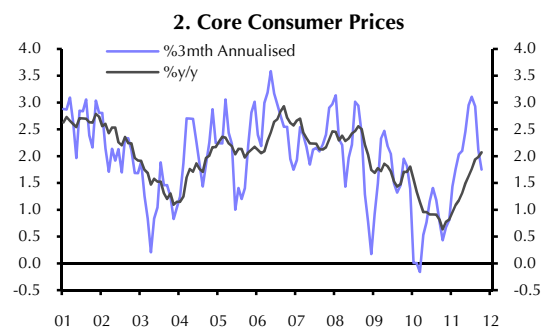
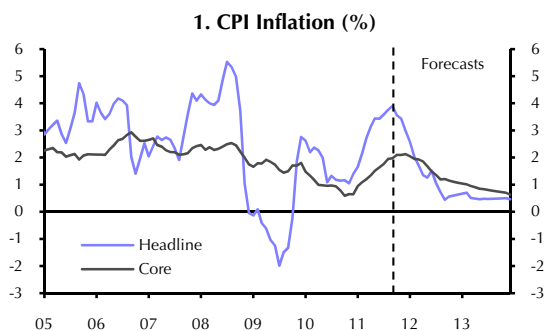
- The recent acceleration in economic growth has led to a modest improvement in labour market conditions. The unemployment rate, however, was still 9.0% in October and is unlikely to fall much next year when GDP growth is set to weaken again.
- Although payroll employment increased by a fairly modest 80,000 in October, it was the upward revisions to previous months' data that provided a clearer sign that conditions have improved. The initial estimate that payrolls were unchanged in August has since been revised to a 104,000 rise (1). The recent rebound in temporary employment suggests that payrolls will continue to rise at this rate in the coming few months (2).
- The alternative household measure of employment has been even stronger (3). This reflects the hiring of young workers (4). Other indicators have also improved, with the employment balances of the ISM activity surveys rebounding back to July's levels. And in the first few weeks of November, initial jobless claims fell below 400,000 (5). Average hourly earnings have risen too, although at 1.8% in October the annual rate remained low (6).



Sources – Thomson Datastream, Capital Economics

Inflation Indicators

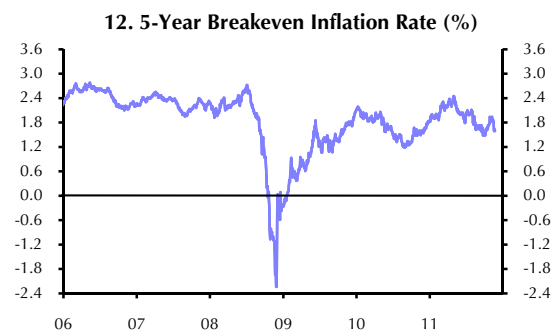
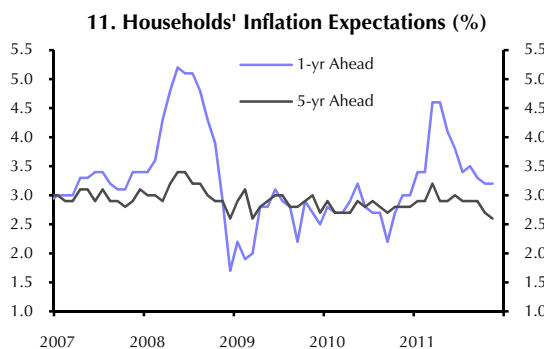
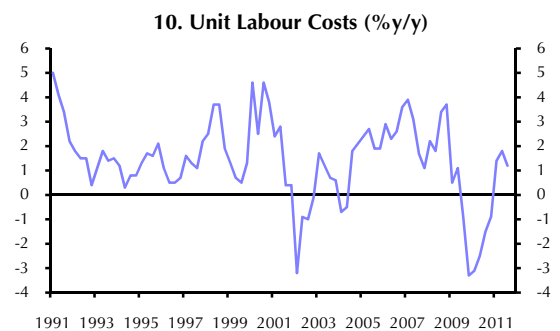
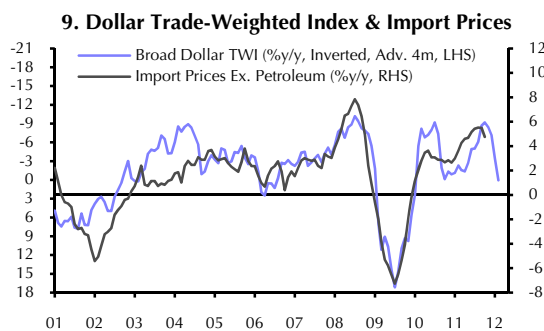
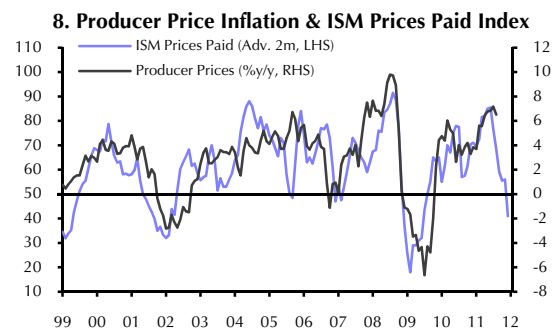
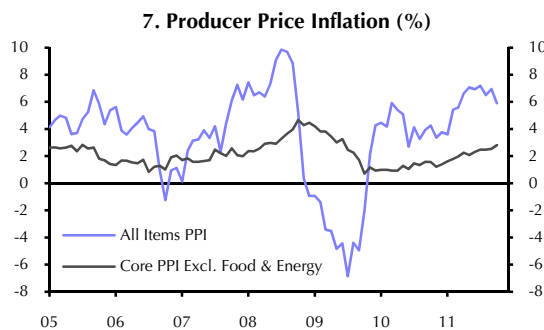
- We expect headline CPI inflation to fall sharply early next year, as the past increases in food and energy prices begin to be reversed (1). Admittedly, the annual rate of core inflation edged up to 2.1% in October, but the three-month annualised rate fell back to 1.8% and should continue to decline in the coming months (2).
- The biggest turnaround has been the reversal of the spike in motor vehicle prices, which were initially boosted by Japan-related supply disruptions (3). CPI clothing prices are still being pushed up by the original surge in cotton prices. But the most recent drop back in cotton prices points to a sharp drop in CPI clothing inflation in 2013 (4).
- We expect core inflation to drop back next year, but it is hard to see deflation becoming a threat again unless the growth rate of the CPI housing costs components slows, simply because housing is such a big part of the core CPI (5). Finally, the recent rebound in the WTI price of crude oil shouldn't boost retail gasoline prices because the link between the two has been a lot weaker recently. Retail gasoline prices have been moving more closely in line with the price of Brent crude oil, which has continued to trend lower (6).



Sources – Thomson Datastream, Capital Economics

Inflation Indicators (Continued)

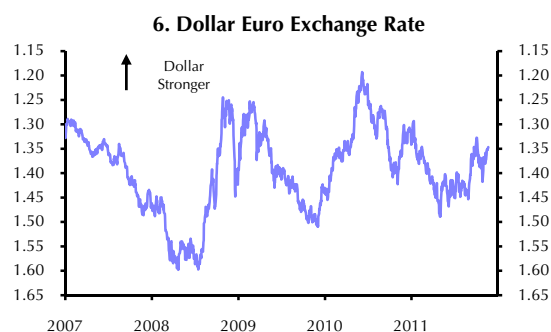
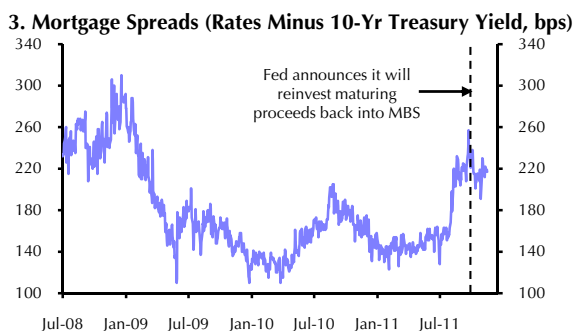
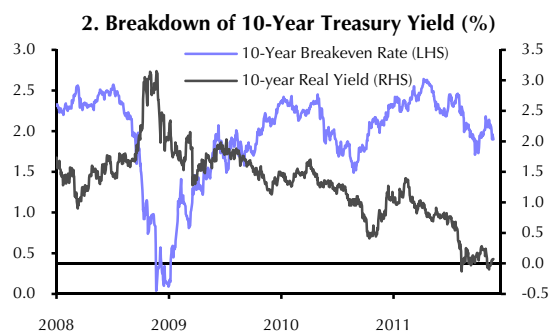
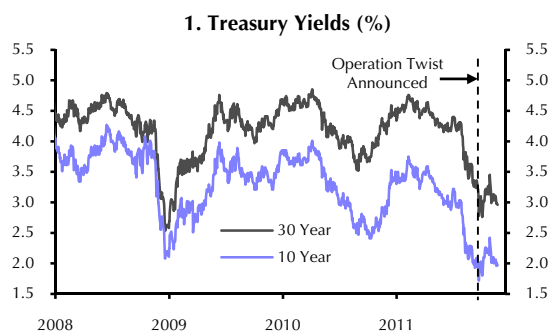
- Producer price inflation has now peaked, although core producer price inflation continues to edge higher (7). The most recent collapse in the ISM manufacturing prices paid index points to a very sharp drop in producer price inflation by the end of this year (8).
- The recent strength of the dollar is also consistent with a sharp moderation in the growth rate of non-energy import prices (9). The growth rate of unit labour costs remains modest (10).
- Households' inflation expectations remain close to historical norms, but have fallen a little in recent months (11). Breakeven inflation rates, derived from the spread between inflation-protected and nominal Treasury yields, are also slightly below the long-term average (12).



Sources – Thomson Datastream, Capital Economics

Financial Market Indicators

- Despite the failure of the congressional deficit reduction super committee to agree on a bigger package of deficit reduction measures, Treasury yields have actually fallen back in recent days, as the mounting euro-zone crisis boosted safe haven demand **(1)**. Looking at the breakdown of the 10-year Treasury yield, it is the fall in the real yield that explains more of the decline since the financial crisis began in 2008 **(2)**.
- Mortgage spreads remain elevated, although the gap between mortgage rates and Treasury yields is still smaller than it was after the collapse of Lehman Brother in 2008 **(3)**.
- US stock markets have hardly had the best of years, but the decline this year has been very modest when compared with the much bigger sell off in European equity markets **(4)**.
- Surprisingly, US bank stocks have been hit almost as hard as European bank stocks, suggesting that investors are nervous about the global financial system **(5)**. The euro-zone crisis has so far had only a limited weakening effect on the euro, however **(6)**.



Sources – Thomson Datastream, Bloomberg