

US ECONOMICS WEEKLY

27th Dec. 2011



Editors: Paul Ashworth and Paul Dales

What to watch in 2012

- **Just how US banks cope with the euro-zone crisis, which we believe will involve the departure of at least one nation from the currency union next year, could make or break the US economy in 2012.** As such, we will be watching very closely for any signs of stress in US funding markets, any indication that US banks are on the hook for losses and any hints that bank lending is declining once again. **We still expect US banks to emerge largely unscathed.** Our forecast that economic growth will slow to just 1.5% in 2012 has more to do with domestic, rather than external, forces. **But if the US does get dragged down by Europe, it will show up in those three areas first.** (See pages 2-3.)
- The first week of 2012 brings most notably December's employment figures, which we expect to show a healthy 150,000 rise in non-farm payrolls. Meanwhile, the minutes of the last FOMC meeting may provide some signs that the Fed is gearing up to launching QE3.
- **The next US Economics Weekly will be published on Friday 6th January. Capital Economics' offices will be closed for the holidays from Saturday 24th December and will reopen on Tuesday 3rd January. We wish all our readers a happy holidays.**

Data Previews (pages 4-6)

Conference Board Consumer Confidence (Tue. 27th Dec.) – *Jobs growth boosts confidence*

ISM Manufacturing Index (Tue. 3rd Jan.) – *Regional surveys point to rebound*

Fed FOMC Minutes (Tue. 3rd Jan.) – *Officials probably discussed potential communications changes*

ISM Non-Manufacturing Index (Thu. 5th Jan.) – *Hovering at a low level*

Employment Report (Fri. 6th Jan.) – *A decent end to the year*

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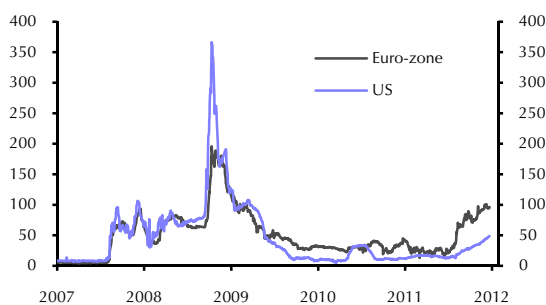
What to watch in 2012

Whether or not our forecast that the US will grow by around 1.5% in 2012 and 2.0% in 2013 proves correct largely depends on how the economy copes with a fairly deep recession in the euro-zone and any financial shockwaves flying over the Atlantic from one or two nations leaving the currency union. (See *US Economics Update* "2012 will be another year of sluggish growth", 19th Dec.) **With that in mind, there are three related issues that we will be watching particularly closely in 2012.**

Although the events in Europe could affect the US in a number of ways, such as through the hit to exports or declines in both business and consumer confidence, by far the greatest threat stems from the financial links.

There are still few indications that the problems in euro-zone funding markets are feeding through into US markets. As Chart 1 shows, although the spread of US three-month LIBOR lending rates over three-month overnight indexed swap (OIS) rates has risen, it is roughly half that seen in the euro-zone and an eighth of that seen when Lehman Brothers collapsed in September 2008.

CHART 1: SPREAD OF THREE MONTH LIBOR OVER THREE MONTH OIS RATE (BPS)

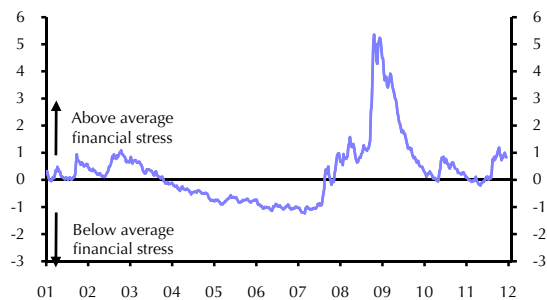


Sources – Thomson Datastream, Bloomberg

Of course, the three-month LIBOR interbank rate may not accurately reflect the lending rates US banks offer, not least as it is compiled by banks operating in London. But the St Louis Fed's financial stress index, which covers a host of indicators ranging from the Treasury yield curve to corporate

bond indices, shows that financial stress in US markets is still fairly low. (See Chart 2.)

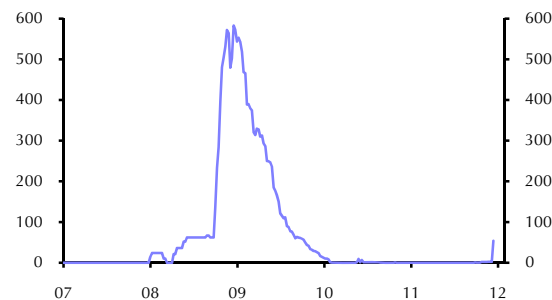
CHART 2: ST LOUIS FED FINANCIAL STRESS INDEX



Source – Thomson Datastream

As we have pointed out before, we believe that the Fed is well placed to prevent a repeat of the freezing in the funding markets that happened after Lehman failed. (See *US Economics Weekly* "Fed to the rescue?" 5th Dec.) It has a number of liquidity facilities that were established during the financial crisis that it can restart at a moment's notice if banks need short-term cash. Indeed, through the currency swaps with other central banks re-established at the end of November, the Fed is already helping to provide dollars to European banks. (See Chart 3.) **Nonetheless, we will be watching very closely for any evidence of a spike in illiquidity in US funding markets.**

CHART 3: CENTRAL BANK LIQUIDITY SWAPS OUTSTANDING (\$BN)

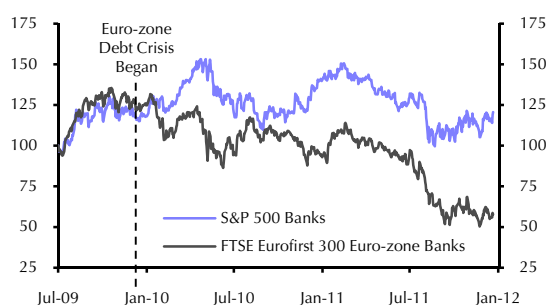


Source – Thomson Datastream

Even if there are no illiquidity issues, US banks could still suffer if it turns out that they are on the

hook for any losses linked to a debt default by one or more euro-zone nations or any subsequent European bank failures. Some comfort may be taken from the fact that equity prices of US and euro-zone banks have diverged during the euro-zone debt crisis. Since the start of 2010, equity prices of euro-zone banks have fallen by 55% while in the US they have declined by less than 4%. And even though US bank stocks fell by 15% in 2011, over the same period euro-zone bank stocks declined by 40%. (See Chart 4.)

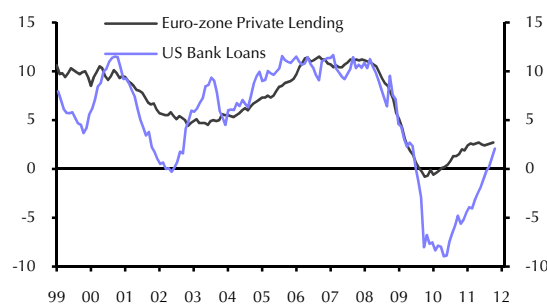
CHART 4: US & EURO-ZONE BANK EQUITY PRICES (JULY 2009=100)



Source – Thomson Datastream

This makes perfect sense given that US banks do not hold a large share of their assets in the euro-zone and hold an even smaller share in those euro-zone countries that are most in trouble. (See *US Economics Weekly* “Would US banks survive a euro collapse?” 26th Nov.) **But we will still be monitoring US bank stocks and their earnings reports very closely for any indications that they are in trouble and that their capital is being undermined.**

CHART 5: BANK LENDING (%Y/Y)

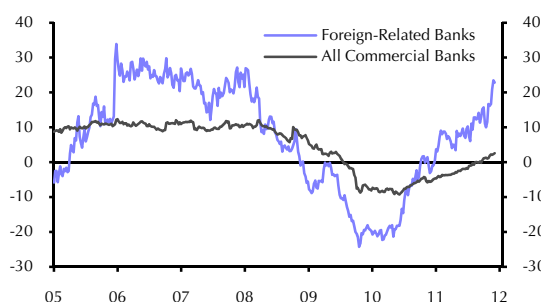


Source – Thomson Datastream

Finally, any serious threat to the liquidity or solvency of US banks would presumably prompt banks to pull in their horns. Since March, US banks have been increasing their lending. As Chart 5 shows, in November the total value of outstanding loans and leases of US banks was rising at roughly the same pace as bank lending in the euro-zone.

It is even the case that foreign banks located in the US are boosting their lending at a much faster rate than domestic banks. (See Chart 6.) It is possible that this reflects a boost in lending by Canadian and Japanese banks that is more than offsetting a pullback by European banks. Nonetheless, if European banks are in trouble, they are more likely to draw back first on lending in overseas countries than at home. And if US banks are concerned about their own situation, they may not be willing or able to fill the hole. **The last of our “must watch” indicators for 2012 is therefore the bank lending figures. Any sign that they are turning south again would be troubling.**

CHART 6: US BANK LOANS OUTSTANDING (%Y/Y)



Source – Thomson Datastream

Overall, we still expect US banks to come through the euro-zone crisis largely unscathed. Instead, the modest slowdown in economic growth that we expect next year has more to do with less support from fiscal policy and a belief that consumption won’t continue to grow at a faster rate than incomes. **But if we’re wrong and the US does get dragged down by the euro-zone, it will show up in one or all of these three indicators first.**

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Data Preview – Conf. Board Consumer Confidence (Dec.) 10.00 Tue. 27th Dec.

Forecasts	Previous	Median	Capital Economics
Headline Balance	56.0	58.0	60.0

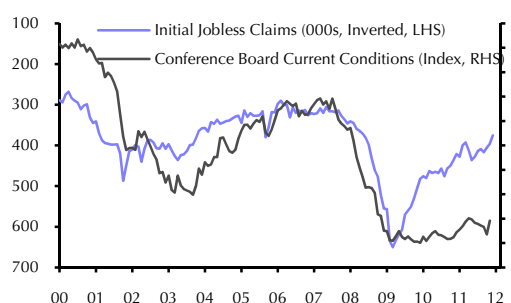
Jobs growth boosts confidence

Consumer confidence appears to be off its floor and the latest decline in initial jobless claims suggests that it rose further in December.

Despite the cloud of uncertainty cast over the US by the events in the euro-zone, the Conference Board measure of consumer confidence jumped to 56.0 in November, from 40.9 in October. Although the relationship between initial jobless claims and confidence has been loose, with equity prices having been broadly stable and gasoline prices having edged lower, the latest fall in initial jobless claims may have boosted confidence in December. (See Chart 1.) We have pencilled in a rise to 60.0.

Nevertheless, that would still leave confidence below the levels seen at the start of 2011 and well below the long-run average of 93.

CHART 1: CONFERENCE BOARD CONFIDENCE & INITIAL JOBLESS CLAIMS



Source – Thomson Datastream

Data Preview – ISM Manufacturing Index (Dec.) 10.00 Tue. 3rd Jan.

Forecasts	Previous	Median	Capital Economics
Headline Index	52.7	53.0	54.0

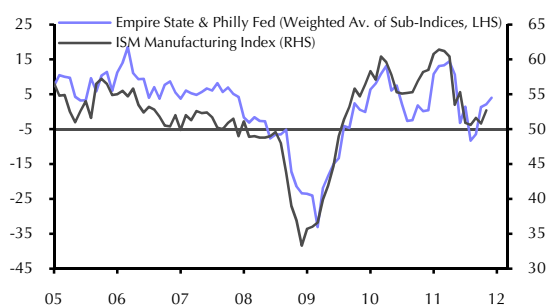
Regional surveys point to rebound

The improvement in the early regional manufacturing surveys points to a further pick up in the national ISM index in December. The Philly Fed index improved to 10.3, from 3.6, while the Empire State index climbed to 9.5, from 0.6. In both cases, that was the highest reading seen since the spring. (See Chart 2.)

The international survey evidence has also been a little brighter with Germany's Ifo business index improving over the past couple of months, led by a rebound in the key expectations index. As such, we have pencilled in an increase in the US ISM index to around 54.0, from 52.7 in November.

expect that US manufacturers will have a very challenging 2012.

CHART 2: ISM & REGIONAL PMI MANUFACTURING INDICES



Source – Thomson Datastream

Nevertheless, as Europe plummets into a potentially quite severe recession and growth slows in Asia, we

Preview – Fed FOMC Minutes (13th Dec. Meeting)

14.00 Tue. 3rd Jan.

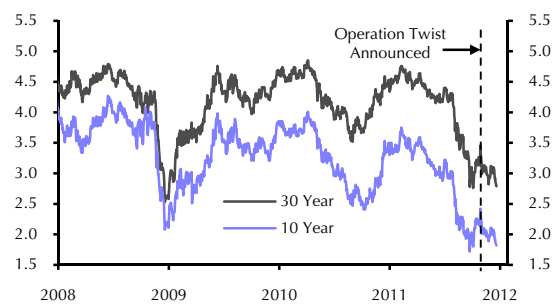
Officials probably discussed potential communications changes

The still relatively sombre statement issued after the FOMC meeting in mid-December suggested that Fed officials weren't buying into the idea that the slightly stronger tone to the incoming economic data meant that the economy was primed for take-off. Indeed, one official even voted for immediate action to boost the economy.

The minutes should reveal whether officials spent any more time discussing the proposed changes to the Fed's communications strategy, which we expect to be implemented at the next meeting in late January. In particular, officials are considering ways to make their long-term goals for inflation and the unemployment rate more explicit. They also appear to be giving serious consideration to

publishing forecasts for short-term interest rates in the Summary of Economic Projections that is produced quarterly. This idea is that this would further lower long-term interest rates. (See Chart 1.)

CHART 1: TREASURY YIELDS (%)



Source – Thomson Datastream

Data Preview – ISM Non-Manufacturing Index (Dec.)

10.00 Thu. 5th Jan.

Forecasts	Previous	Median	Capital Economics
Headline Index	52.0	53.0	52.5

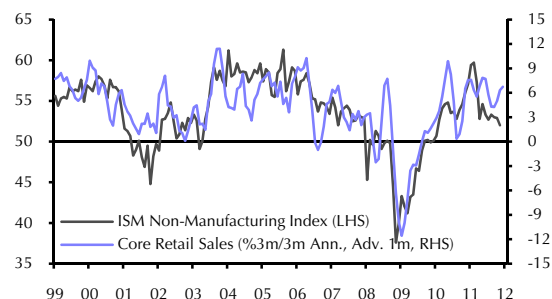
Hovering at a low level

The fall in the ISM non-manufacturing index in November to its lowest level since January 2010 suggested that, while the external sector is holding up well, the domestic economy is once again on the back foot. We are hoping for a stronger reading in December.

Few indicators provide a glimpse of trends in the non-manufacturing sector ahead of the ISM index. But retail businesses form a large part of the ISM non-manufacturing survey and the strength of retail sales in recent months is fairly encouraging. (See Chart 2.) Moreover, the recent rises in the NAHB homebuilding activity index and gains in housing starts suggest that even construction activity may have improved.

Our forecast that the ISM non-manufacturing index rose to 52.5 in December, from 52.0 in November, would reverse roughly half of the previous month's fall. That said, growth appears to be nothing more than modest.

CHART 2: ISM NON-MANU. INDEX & CORE RETAIL SALES



Source – Thomson Datastream

Data Preview – Employment Report (Dec.)

08.30 Fri. 6th Jan.

Forecasts	Previous	Median	Capital Economics
Change in Non-Farm Payrolls	+120,000	+140,000	+150,000
Unemployment Rate	8.6%	8.7%	8.7%
Average Hourly Earnings	-0.1%	+0.2%	+0.2%
Average Weekly Hours Worked	34.3	34.3	34.3

A decent end to the year

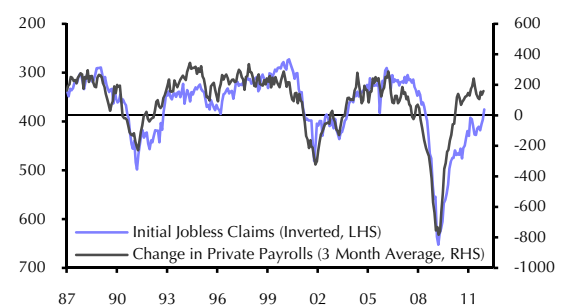
Our econometric model suggests that non-farm payrolls rose by around 150,000 in December, indicating that the labour market ended 2011 on a high note. This would be a marked turnaround from the stagnation in jobs growth in the summer and would beat November's 120,000 rise.

The most striking improvement in recent months has been the decisive fall in initial jobless claims below 400,000. Although history suggests that claims of just below 400,000 are consistent with payroll employment hardly rising at all (see Chart 1), the relationship may have shifted if the depth and length of the recession meant a greater share of the unemployed claimed benefits.

After falling by 315,000 in November, we have pencilled in a modest rebound in the labour force.

That could mean the unemployment rate nudged up to 8.7%, from 8.6% in November. Either way, there is little prospect of the unemployment rate falling significantly when GDP growth is likely to slow to just 1.5% in 2012.

CHART 1: INITIAL JOBLESS CLAIMS & CHANGE IN PAYROLLS



Source – Thomson Datastream

Latest Data & Main Forecasts

LATEST US ECONOMIC INDICATORS

Monthly Indicators %m/m(%y/y) unless stated	Sep	Oct	Nov	Dec
Consumer Prices	+0.3%(+3.9%)	-0.1%(+3.5%)	0.0%(+3.4%)	-
Core Consumer Prices (Excluding Food & Energy)	+0.1%(+2.0%)	+0.1%(+2.1%)	+0.2%(+2.2%)	-
Core PCE Deflator (Excluding Food & Energy)	0.0%(+1.6%)	+0.1%(+1.7%)	-	-
Producer Prices	+0.8%(+6.9%)	-0.3%(+5.9%)	+0.3%(+5.7%)	-
Change in Non-Farm Payrolls	+210,000	+100,000	+120,000	-
Unemployment Rate (%)	9.1%	9.0%	8.6%	-
Average All Employee Hourly Earnings	+0.3%(+1.9%)	+0.3%(+1.9%)	-0.1%(+1.8%)	-
ISM Manufacturing Index	51.6	50.8	52.7	-
Industrial Production	0.0%(+3.5%)	+0.7%(+4.2%)	-0.2%(+3.7%)	-
Retail Sales	+1.3%(+8.5%)	+0.6%(+7.5%)	+0.2%(+6.7%)	-
Core Retail Sales (Excluding Autos)	+0.5%(+7.9%)	+0.7%(+7.5%)	+0.2%(+6.6%)	-
Uni. of Michigan Consumer Confidence Index	59.4	60.9	64.1	67.7
International Trade Balance (\$bn)	-44.2	-43.5	-	-
Quarterly Indicators %q/q ann(%y/y) unless stated	Q4 2010	Q1 2011	Q2 2011	Q3 2011
GDP	+2.3%	+0.4%	+1.3%	+2.0%
Consumption	+3.6%	+2.1%	+0.7%	+2.3%
Productivity, Non-Farm	+2.2%	-0.6%	-0.1%	+2.3%
Current Account (\$bn, as a % of GDP)	-112.2(-3.0%)	-119.6(-3.2%)	-124.7(-3.1%)	-110.3(-2.9%)
House Prices (Case-Shiller, s.a.)	-1.6%(-3.7%)	-1.3%(-4.8%)	+0.2%(-5.9%)	-1.2%(-3.9%)

LATEST MARKET DATA*

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*	
Official Rates	US	0-0.25	0-0.25	0-0.25	Global Yields	Euro 10yr	1.92	1.85	1.98
	ECB	1.50	1.00	1.00		Japan 10yr	0.97	0.99	0.98
	Japan	0-0.10	0-0.10	0-0.10		Canada 10yr	2.08	1.87	1.96
	Canada	1.00	1.00	1.00	Equity Indices	S&P 500	1188	1220	1244
3mth Euro\$	Jun 2012	0.13	0.13	0.13		NASDAQ	2521	2555	2578
	Dec 2012	0.13	0.14	0.15	DJIA	11494	11866	12108	
	Dec 2013	0.35	0.32	0.30	Currencies	\$/€	1.35	1.30	1.31
Treasury Yields	2yr	0.26	0.22	0.27		¥/\$	77.0	77.8	78.1
	10yr	1.92	1.85	1.97	\$ Broad TWI	100.3	101.2	101.1	
Inflation-indexed	10yr	0.03	-0.11	0.14	Oil Price (\$pb) Brent	108.5	104.1	109.1	
Corporate Bonds (BAA)	10yr	5.11	5.12	5.21	Gold (\$/oz)	1700	1599	1612	





















Latest as at 06.00 EST 21 Dec. 2011.

MAIN ECONOMIC & MARKET FORECASTS

%q/q ann. (%y/y) unless stated	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2011	2012	2013
GDP	+2.0	+2.5	+1.0	+1.0	+1.5	+1.5	+1.7	+1.5	+2.0
CPI Inflation	(+3.8)	(+3.3)	(+2.2)	(+1.5)	(+1.0)	(+0.8)	(+3.0)	(+1.5)	(+0.6)
Core CPI Inflation	(+1.9)	(+2.1)	(+2.0)	(+1.7)	(+1.5)	(+1.3)	(+1.6)	(+1.6)	(+1.0)
Unemployment Rate (%), Period Ave.	9.1	8.8	8.9	9.0	9.0	9.0	9.1	9.0	9.0
Fed Funds Rate, End Period (%)	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
10 Year Treasury Yield, End Period (%)	1.92	2.00	1.50	1.50	1.50	1.50	1.75	1.50	1.50
S&P 500, End Period	1131	1250	1180	1170	1160	1150	1200	1150	1200
\$/€ End Period	1.34	1.30	1.25	1.20	1.15	1.10	1.35	1.10	1.10
¥/\$, End Period	77	78	70	70	65	65	72	65	60

Economic Diary & Forecasts

UNITED STATES

Date	Country	Release/Indicator/Event	Time		Previous*	Median*	CE Forecast*
			EST	(GMT)			
Mon 26 th		US Christmas Holiday – Markets Closed	-	-	-	-	-
Tue 27 th		US Case-Shiller 20-City House Prices (Oct)	09.00	(14.00)	-0.6%(-3.6%)	-0.2%(-3.2%)	-0.5%(-3.2%)
		US Conference Board Consumer Confidence (Dec)	10.00	(15.00)	56.0	58.0	60.0
Wed 28 th		US No Significant Data Released	-	-	-	-	-
Thu 29 th		US Initial Jobless Claims (24 th Dec)	08.30	(13.30)	-	-	-
		US Chicago PMI (Dec)	09.45	(14.45)	62.6	60.0	-
		US Pending Home Sales (Nov)	10.00	(15.00)	+10.4%(+7.3%)	+1.5%(0.2%)	+2.5%(+1.2%)
Fri 30 th		US No Significant Data Released	-	-	-	-	-
Mon 2 nd		US New Years Day Holiday – Markets Closed	-	-	-	-	-
Tue 3 rd		US ISM Manufacturing Index (Dec)	10.00	(15.00)	52.7	53.0	54.0
		US Construction Spending (Nov)	10.00	(15.00)	+0.8%	+0.1%	+0.5%
		US Fed FOMC Minutes (13 th Dec Meeting)	14.00	(19.00)	-	-	-
Wed 4 th		US Factory Orders (Nov)	10.00	(15.00)	-0.4%	+1.5%	+1.5%
Thu 5 th		US Change in ADP Employment (Dec)	08.15	(13.15)	+206,000	+190,000	-
		US Initial Jobless Claims (31 st Dec)	08.30	(13.30)	-	-	-
		US ISM Non-Manufacturing Index (Dec)	10.00	(15.00)	52.0	53.0	52.5
Fri 6 th		US Change in Non-Farm Payrolls (Dec)	08.30	(13.30)	+120,000	+140,000	+150,000
		US Unemployment Rate (Dec)	08.30	(13.30)	8.6%	8.7%	8.7%
		US Average Hourly Earnings (Dec)	08.30	(13.30)	-0.1%(+1.8%)	+0.2%(+2.0%)	+0.2%(+2.0%)
		US Average Weekly Hours Worked (Dec)	08.30	(13.30)	34.3	34.3	34.3

*m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
12 th Jan	Retail Sales (Dec)	25 th Jan	Fed Policy Announcement
13 th Jan	International Trade (Nov)		

Selected Recent Publications

Date	Publication	Title
Mon 19 th	Capital Daily	Momentum in the US economy unlikely to last
	Emerging Europe Chart Book	Sliding back into recession
	European Economics Update	The implications of a French downgrade
	UK Housing Market Update	First thoughts on the revised Mortgage Market Review
	US Economics Update	2012 will be another year of sluggish growth
Tue 20 th	Emerging Asia Economics Update	Kim Jong-il's death adds to Korean uncertainty
	Capital Daily	Surveys should highlight weakness in European economies
	German Ifo Survey (Dec.)	Ifo points to positive, but very weak, growth
	European Economics Update	Swedish Riksbank cuts rates and more likely to come
	Emerging Europe Economics Focus	The economic consequences of Russia's unrest
	Latin America Economics Update	Q3 probably as good as it gets for Colombia
	Japan Chart Book	Fading momentum points to slower growth
	Commodities Update	Two painful lessons for commodity investors from 2011
	Canada Consumer Price Index (Nov.)	Underlying inflation likely to drift lower in 2012
	US Housing Starts (Nov.)	Moving in the right direction
	US Economics Update	Monetary Indicators (Nov)
	Latin America Central Bank Watch	Policy set to ease across the region in 2012
	Emerging Europe Economics Update	Hungary: further tightening on the cards
	Global Markets Update	2012 should be another disappointing year for US equities
	Middle East Chart Book	Clouds gather over North Africa
Wed 21 st	Capital Daily	Outlook for US equities still gloomy
	Italian GDP (Q3)	Heading into another recession
	Latin America Economics Update	Uruguay better placed to weather slowdown than Argentina
	UK Housing Market Update	What are empty homes really telling us about the housing market?
	China Chart Book	Weak start to 2012
	Middle East Economics Update	GCC summit reveals lack of unity on economic policy
	Japan Economics Update	Falling exports point to GDP contraction in Q4
	US Chart Book	Inflation set to fall sharply in 2012
	Canada Retail Sales (Oct.)	Consumer spending showing strength
	European Economics Update	Have we underestimated Germany?
	Emerging Asia Economics Update	Strong growth to continue in Sri Lanka
	US Existing Home Sales (Nov.)	Downward revisions are not a disaster
	US Housing Market Analyst (Q4)	Finding a floor
	Canada Economic Outlook (Q4)	Confidence important during global slowdown
Thu 22 nd	Capital Daily	Markets - 2012 could be much like 2011
	UK Economics Weekly	What does 2012 hold in store?
	US Economics Weekly	What to watch in 2012
	European Economics Weekly	Crunch year for the euro-zone
	Japan Economics Weekly	A look back at 2011
	Emerging Asia Economics Weekly	How bad is the outlook for Indian growth?
	Canada Economics Weekly	-