October 15, 2012

GLOBAL MACRO

The U.S. Economy: Still Far From the Mark

In an environment dominated for months by mounting fears of the worst, pleasant surprises understandably create a fair amount of enthusiasm. That leaves economists with the thankless task of urging the enthusiasts not to get their hopes up too fast. The U.S. economy has shown encouraging signs in the past few months, including revival of the housing market, higher consumer sentiment, and, in the past few days, good news from the job market. But the country is not out of the woods yet.

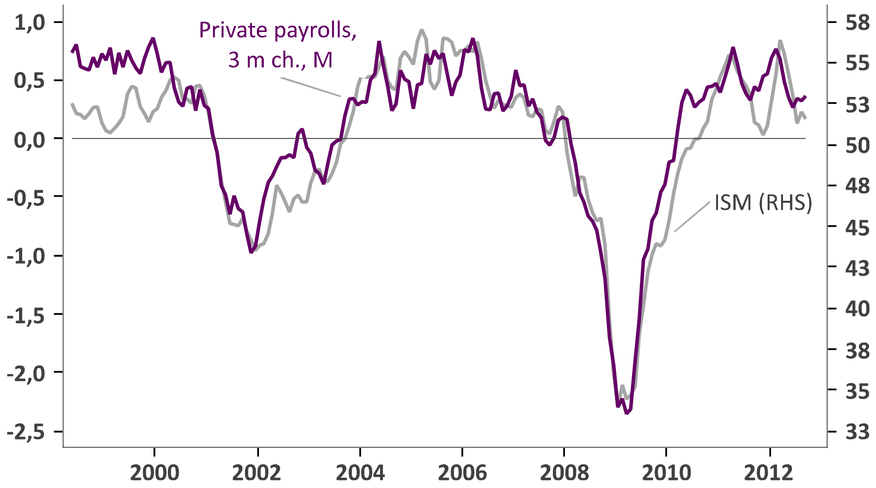
- **The jobless rate has fallen to its lowest level since 2008.** A less heartening statistic, however, is that private-sector employment has yet to recover to where it stood in 2001. In this area, the U.S. economy has not performed any better than the French economy over the past eleven years!
- **The housing market is unquestionably picking up, and all the evidence points to further improvement down the road.** But the key drivers of demand have taken quite a bruising from the weaker economic environment of the past few years, and real estate has lost a good deal of its power to tow the rest of the economy in its wake.
- **Corporate profits in the U.S. are at a historic high.** However, decelerating productivity growth has led to a significant slowdown in the rise of earnings over the last several quarters. The upshot is that by any standard, developments on the investment front have been extremely disappointing.
- **Lastly, while American pragmatism can be expected to bring about a postponement of the deadline for balancing the budget, thereby limiting the "fiscal cliff" risk to the economy,** the fact remains that the country's public finances are in alarming shape. The upcoming negotiations will necessarily turn the spotlight on one of the most disturbing issues facing the United States.

The whole picture offers very little grounds for blind faith of the kind that seems once again to be gaining followers. The crisis has seriously undermined the structural drivers of growth in the U.S. It will clearly take the world's number one economy a good deal of time to achieve growth that is sufficiently robust to eliminate the risk of further slumps and, even more to the point, to be able to function as the powerhouse of the global economy. Although our 1.3 percent outlook for growth in 2013 is well below the consensus forecast (2 percent as of October), we see no reason to change it.

U.S. Employment Still Lower Than in 2001

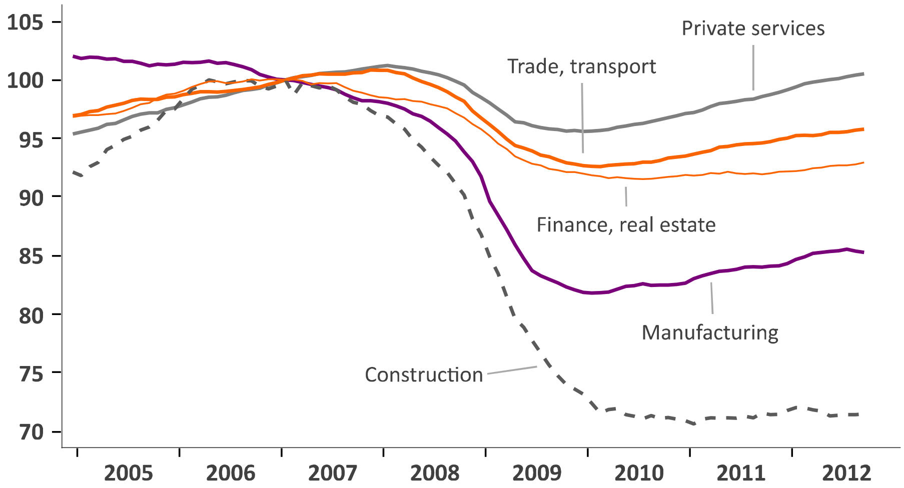
The recent good news from the labor market is none too convincing. For one thing, the surprise dip in the unemployment rate in September doesn't match up with the results of business surveys; for another, the country's employment figures provide no hard evidence for such a trend. Over the past few months, those figures have been anemic, showing more signs of softening than of tangibly improving. The sectors of the economy hardest hit by the crisis—construction, manufacturing, information technology, finance—have continued to drag the overall trend down.

Private Sector Payrolls and ISM Employment Composite Index



Sources : RichesFlores Research, Macrobond

US Private Payrolls by Sector, Jan. 07=100

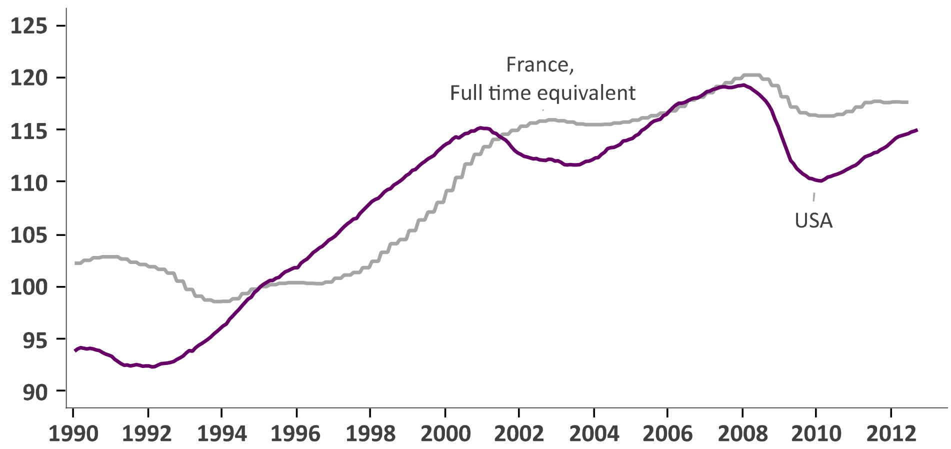


Sources : RichesFlores Research, Macrobond

Moreover, the developments of the past few quarters should be drawing less attention than the disruption affecting the labor market since the early 2000's. After a 30-year period in which the number of wage and salary earners doubled due to an expanding service sector, private-sector employment has plainly stopped growing. In September, the number of private-sector jobs still lagged behind the level recorded in January 2001. Few observers seem to be cognizant of this reality and of what it means. To mention just one example**, the U.S. economy has not been any better than the French economy at creating jobs in the last eleven years—or even since 1995, as shown in the graph below.**

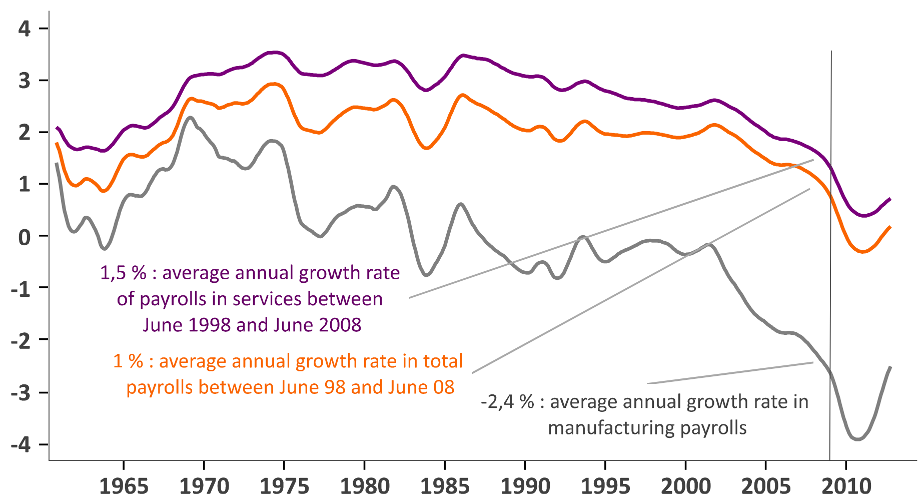
Private sector jobs: US vs France

1995=100



Sources : RichesFlores Research, Macrobond

10 yr average annual growth in US payrolls by sector, %

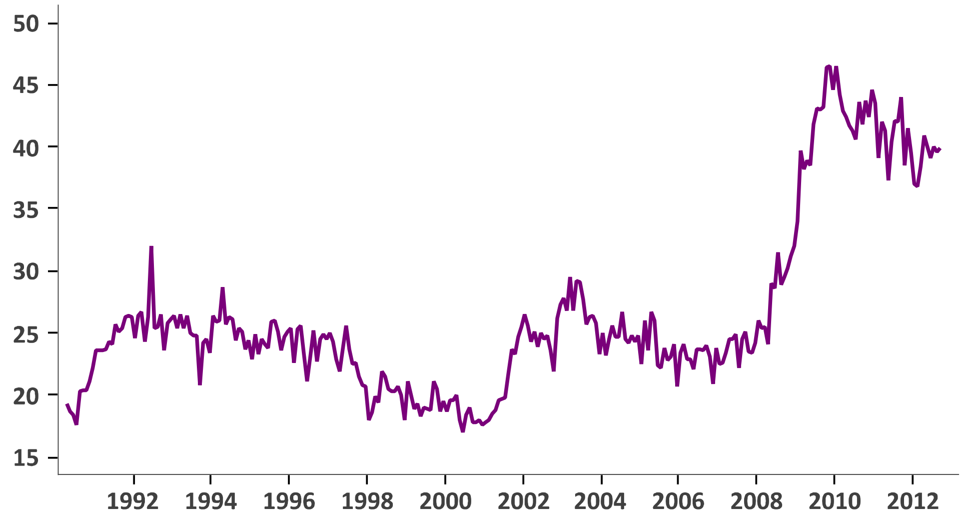


Sources : RichesFlores Research, Macrobond

Although the current situation results to a large extent from the crisis of 2008, it needs to be analyzed against the background of these long-range developments, i.e., against the background of an economy that lost its ability to add huge numbers of jobs long ago. During the ten years leading up to the crisis of 2008, the average annual rate of private-sector job creation did not exceed 1 percent, with service employment gaining 1.4 percent and manufacturing shedding 2.4 percent. It's hard to believe that the rate will be higher from here on in.

In addition, accompanying this trend has been an unprecedented increase in underemployment. **At 40 percent, the September jobless rate for young Americans aged 16 to 19 puts the U.S. in the same league as Europe's worst performers.**

Full-Time unemployment rate, 16 to 19 years, %

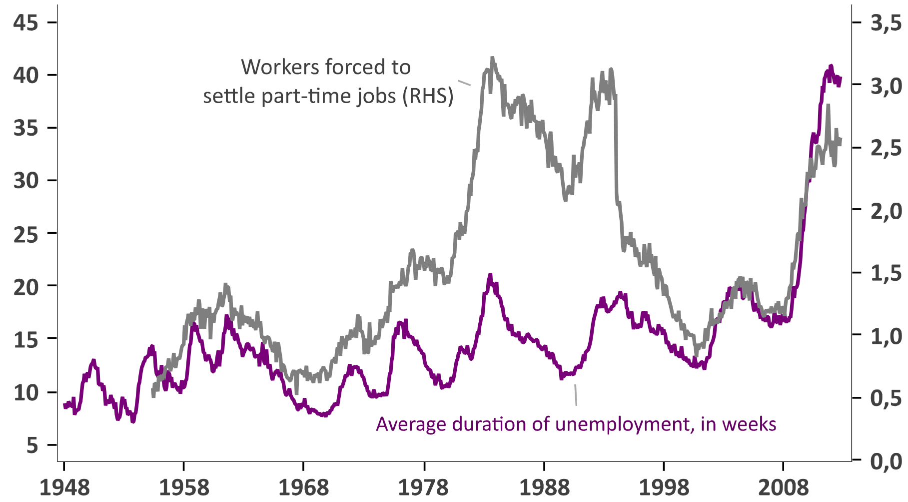


Sources : RichesFlores Research, Macrobond

Two further indicators of this worsening situation are that the average duration of unemployment, currently 40 weeks, is twice as high as the peaks reached in the deepest recessions the U.S. has experienced since World War II, and that the number of workers seeking full-time work but forced to settle for part-time jobs is without precedent since the end of the 1980's.

So even with the encouraging signs of these past few weeks, the labor market is still very much in the doldrums.

Average duration of unemployment and forced part-time jobs



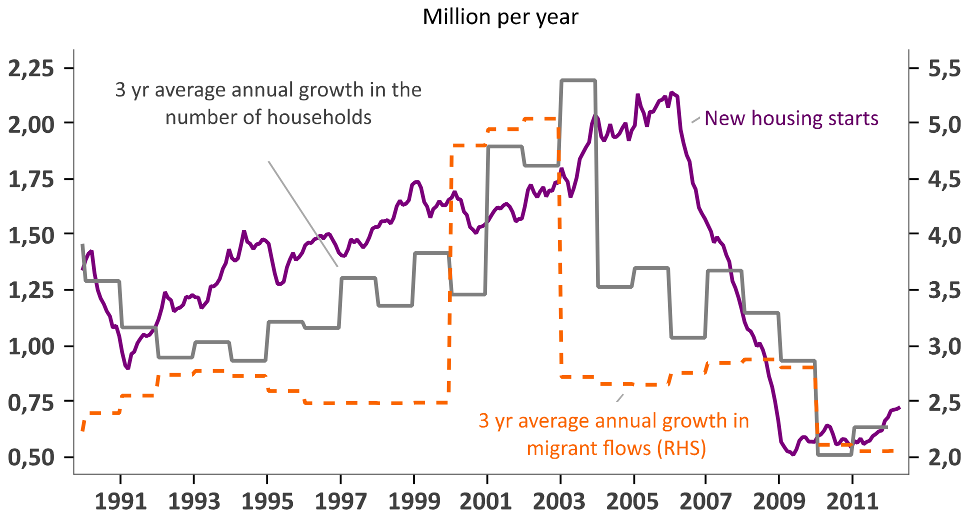
Sources : RichesFlores Research, Macrobond

Real Estate Market Recovery Under Way, but Housing Demand Drivers Are Damaged

After a slump of more than four years, the real estate market is clearly staging a comeback. The recovery has been vigorous, and with today's extremely low mortgage rates and house prices, it should continue. There is no need to dwell here on this unquestionable trend. Of greater interest at this point is how much the recovery will affect the rest of the economy, and whether it can drive overall growth. While the uptrend in transaction volume and house prices is a prerequisite to economic consolidation, it is unlikely to be adequate to the task of restoring the U.S. to its pre-crisis boom conditions. Underpinning this assertion are two insights. First of all, **the growth potential of housing demand has eroded;** and second of all, **a good many of the wealth effect multipliers operating before the crisis are gone.**

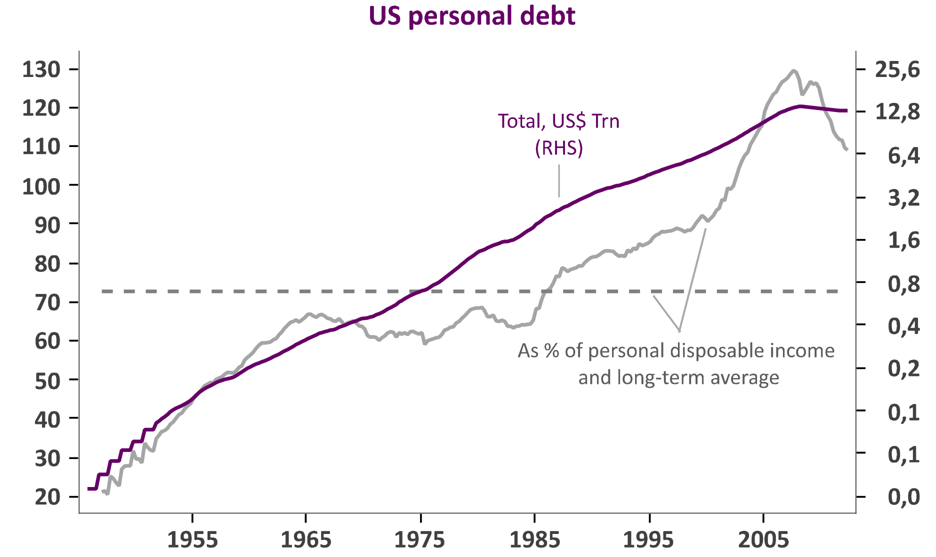
The drivers of real estate demand just aren't what they used to be. Annual growth in the number of households, which exceeded two million in the mid-2000's, began to plummet in 2008, with the result that the average for the three years up through 2011 was a mere 633,000. The key factors at work here are the rising number of young adults "doubling up" with their parents at a time of high unemployment and the damage done by the student loan crisis. In addition, immigration flows to the U.S. have been declining in the past three years. **All told, the mainsprings of growth in demand for dwellings have weakened considerably. This suggests that contrary to a widespread assumption, the current annualized pace of new housing starts-750,000-may not be so out of line with the growth of actual needs after all.**

Households, immigration and housing starts



Sources : RichesFlores Research, Macrobond

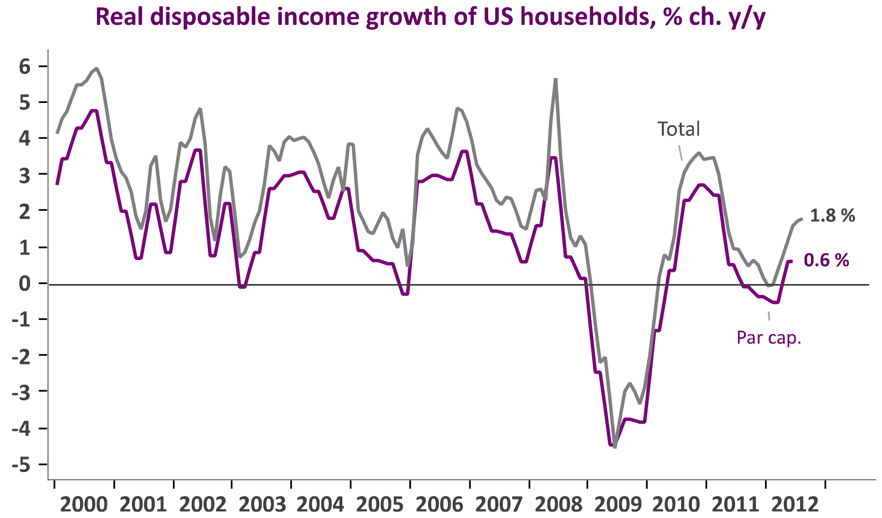
Quite clearly, no spectacular upswing in real estate can be expected, especially in light of the persistently high level of household debt. Even though foreclosures and the renegotiation of home loans have brought monthly mortgage payments down to roughly where they stood in the early 1980's, the *stock* of household debt shows only a slight decrease. Equal to 110 percent of disposable income today, household debt is barely 20 points below the high recorded in 2007. **And while this problem will not stall the upturn under way, it does place an obvious limit on the future growth of mortgage lending, and therefore on the scope of recovery in the real estate sector.**



Sources : RichesFlores Research, Macrobond

Furthermore, the powerful multiplier effects of rising property values on the broader economy have partially disappeared. Not only has the increase in house prices been extremely modest so far; the level of prices in absolute terms rules out recourse to home equity loans, which in the 2000's ensured positive spillover from the real estate boom to the rest of the economy, first and foremost to personal consumption.

Thus, while lower monthly mortgage payments have undoubtedly helped by mitigating the detrimental effect of over-leveraging on consumer spending, this improvement does not eliminate the issue of over-leveraging or of disposable income, which the general state of the economy is unquestionably slashing into today.

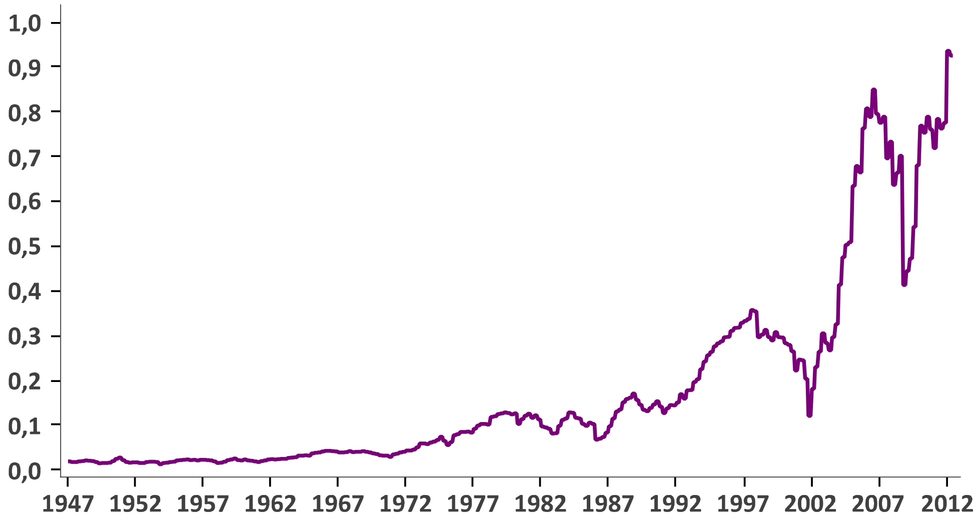


Sources : RichesFlores Research, Macrobond

High Corporate Profits, Low Corporate Investment

Any number of economists have anticipated a recovery fueled by productive investment whose multiplier effects would presumably be strong enough to put the U.S. economy back on the path to sustainable, job-rich growth. The stunning surge in profitability shortly after the shock of 2008–2009, which left American corporations awash with cash, has played a large part in creating these expectations, and the record profits reported by non-financial firms in early 2012 has lent further credence to them. Unfortunately, things haven't turned out as expected.

After-tax profits of domestic non-financial corporate business, USD Trn

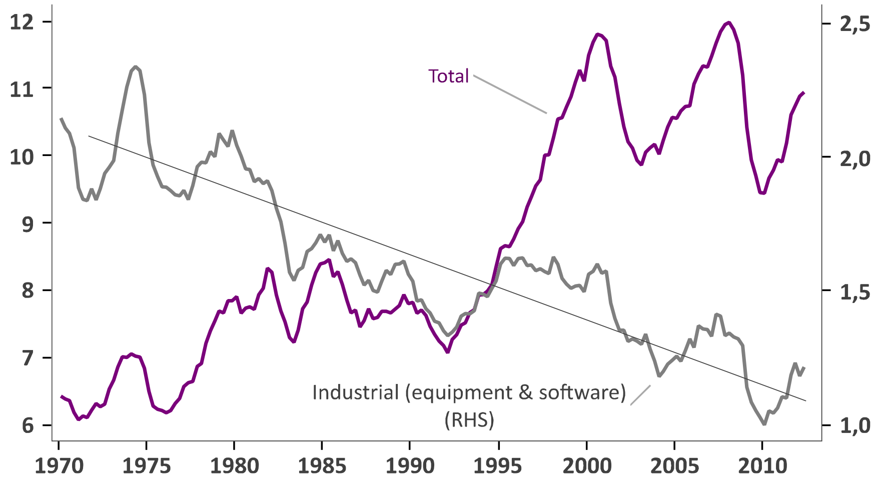


Sources : RichesFlores Research, Macrobond

Not only was the investment revival initiated in 2010 too weak to make up for the shrinkage recorded during the recession; it also started seriously to mark time as soon as the stimulus program expired at the end of last year. The rate of investment has remained well below its pre-crisis level, and the secular decline in industrial investment shows no sign of abating (see next page).

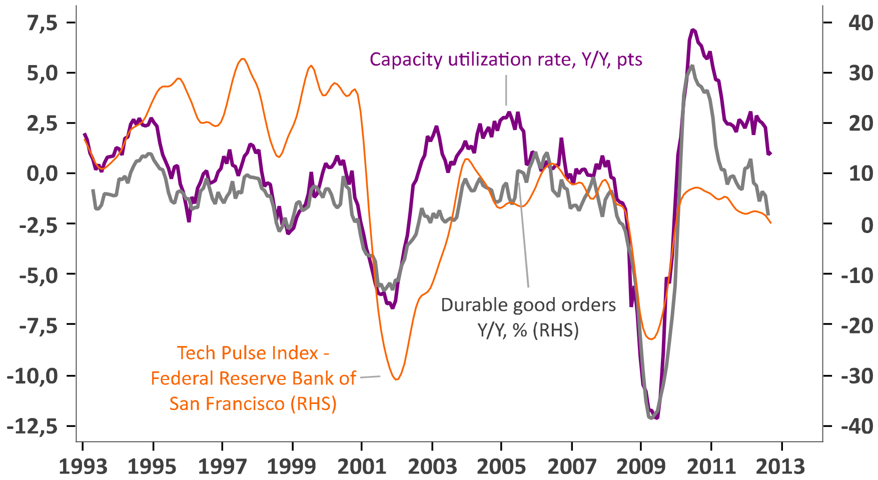
So it should come as no surprise that the investment outlook has worsened steadily since the start of the year, initially because of dwindling productivity gains and reduced profit expectations, and more recently due to the general economic slowdown. All this makes it hard to take solace in current trends. To be sure, high corporate profits have allowed companies to go back to paying out fairly generous dividends, which at 6 percent of value added stand well above the long-term average. But the healthy condition of America's non-financial companies has not contributed so far to restoring the U.S. economy's growth potential.

Non-residentiel fixed investment to GDP ratio, %



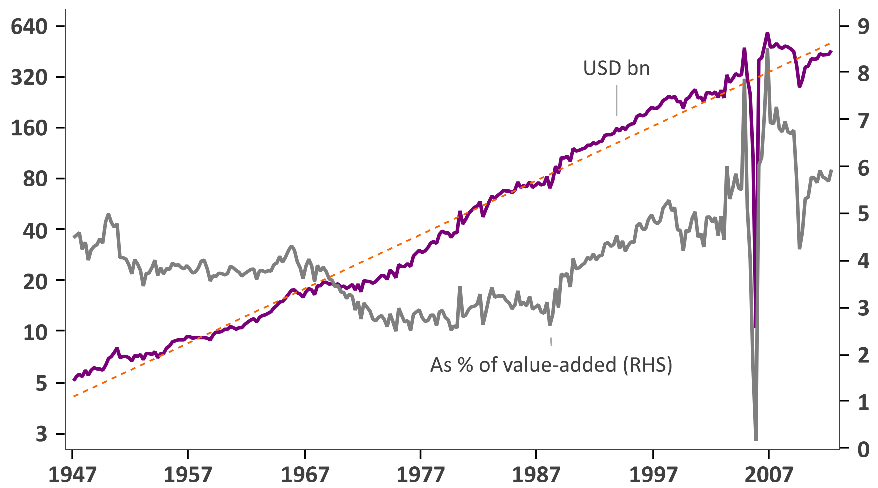
Sources : RichesFlores Research, Macrobond

Leading indicators of non-residential investment



Sources : RichesFlores Research, Macrobond

Net dividends paid by US domestic non-financial corporations

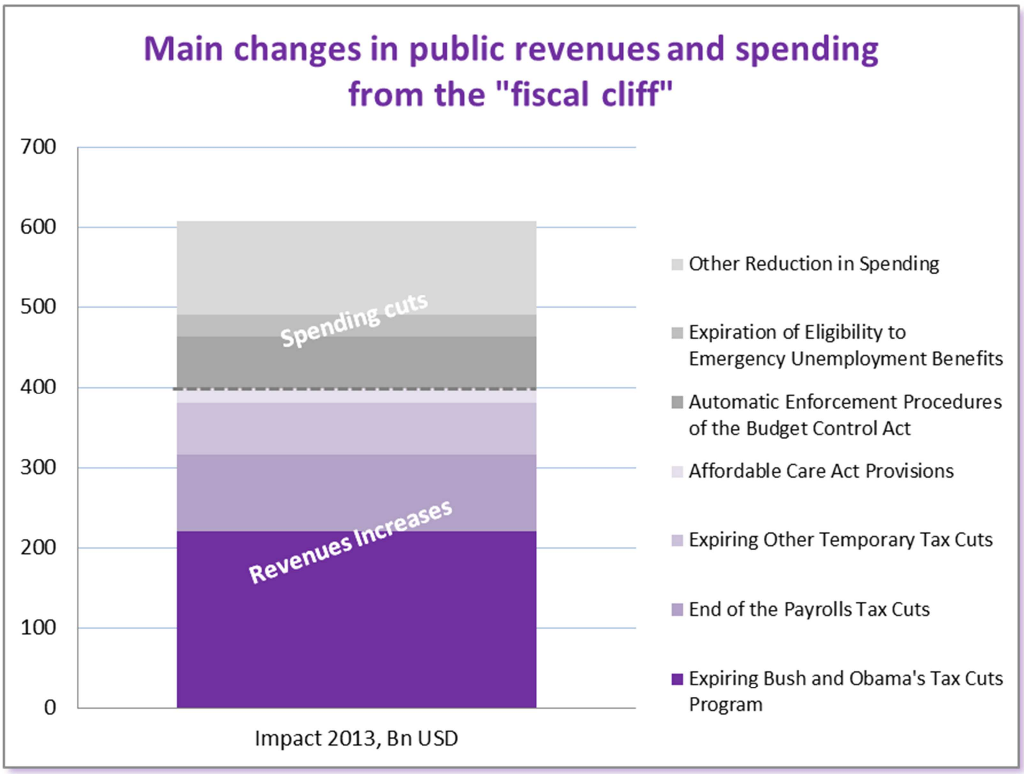


Sources : RichesFlores Research, Macrobond

The Fiscal Outlook: From Confidence in the Ability of U.S. Politicians to Downsize the Fiscal Cliff to the Alarming Surge in National Debt

The foregoing analysis leaves little room for doubt. The U.S. economy is still nursing its wounds, and it can't get by without the life support provided by the current policy mix that the Fed and the government have put in place. Openly acknowledging the patient's fragile condition, the Fed announced another extension of its program to purchase mortgage-backed securities (MBS) in September. How far what looks increasingly like a headlong flight will go or what longer-range consequences it will have is anyone's guess, but this latest move highlights just how deeply concerned the Fed still is about the state of the U.S. economy. The other available tool is the ability to maintain the fiscal stimulus policies in place. That ability, however, is far from guaranteed today:

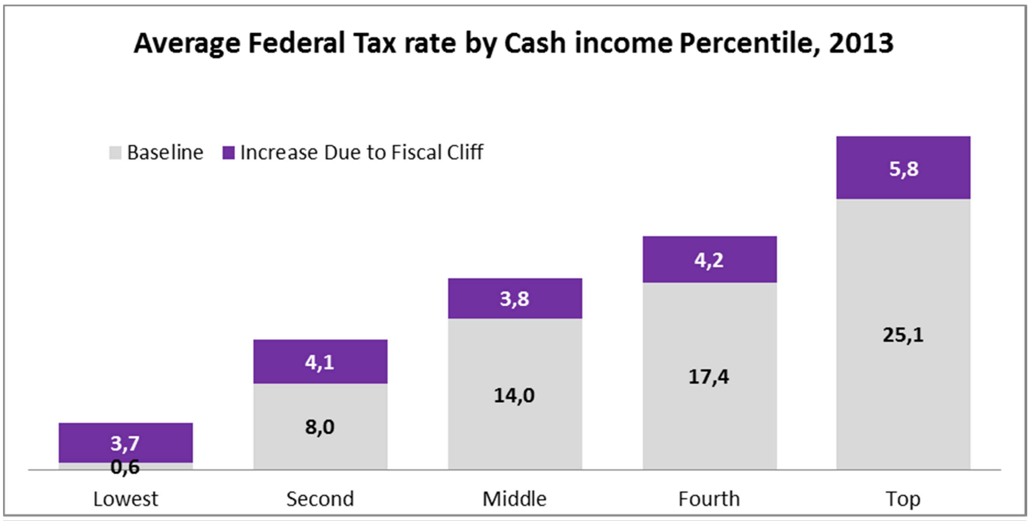
- It is threatened by the expiration at the end of this year of most of the tax cuts introduced since 2001, at the same time that health care reform goes into effect. Referred to as the "fiscal cliff," this eventuality, were it to materialize, would take out the equivalent of 4 percent of U.S. GDP in fiscal year 2012–2013, not to mention the ex post economic cost, which could potentially be much higher.
- It is also threatened by the alarming state of the country's public finances. Aside from requiring what will probably be complicated negotiations once again to get Congress to vote to lift the debt ceiling by the end of the first quarter of 2013, this situation raises serious doubts as to whether the current trend is sustainable and as to how the U.S. economy will be financed in the long term.

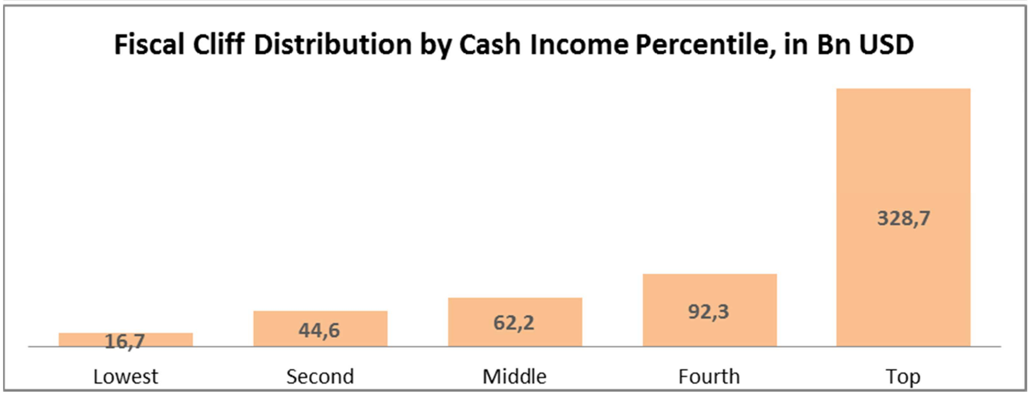


Sources: CBO and US Tax Policy Center « Toppling the fiscal cliff », October, 2012

As matters now stand, all American taxpayers, from the worst-off to the best-off, will have to say goodbye to several percentage points of their income in net terms. The marginal rate of federal income tax will go up by 3.7 points for the lowest-income households, and by 5.8 points for the wealthiest. Introducing changes of this magnitude would represent a huge shock to a still ailing economy, so huge in fact that no observer believes the U.S. will actually go over the fiscal cliff.

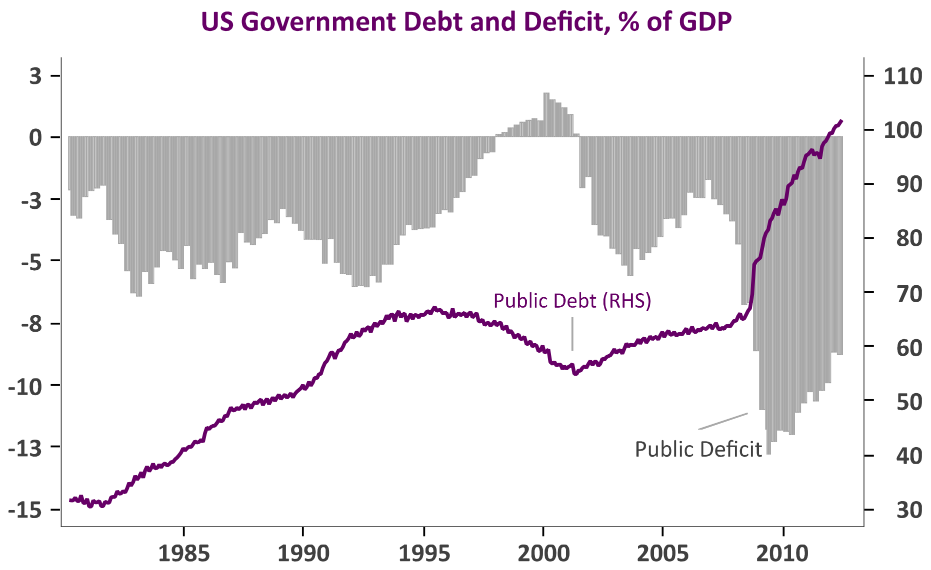
Negotiations between the new Administration and Congress should lead to slight changes in the law and a substantial downsizing of the tax cut package. By how much, in what political climate, and with what economic policy outcome? These questions cannot be answered at present, particularly because it is by no means clear who will emerge from the presidential election with exactly what influence. But in any event, the choices made by the incoming Administration will have a major impact on future developments in the U.S. economy.





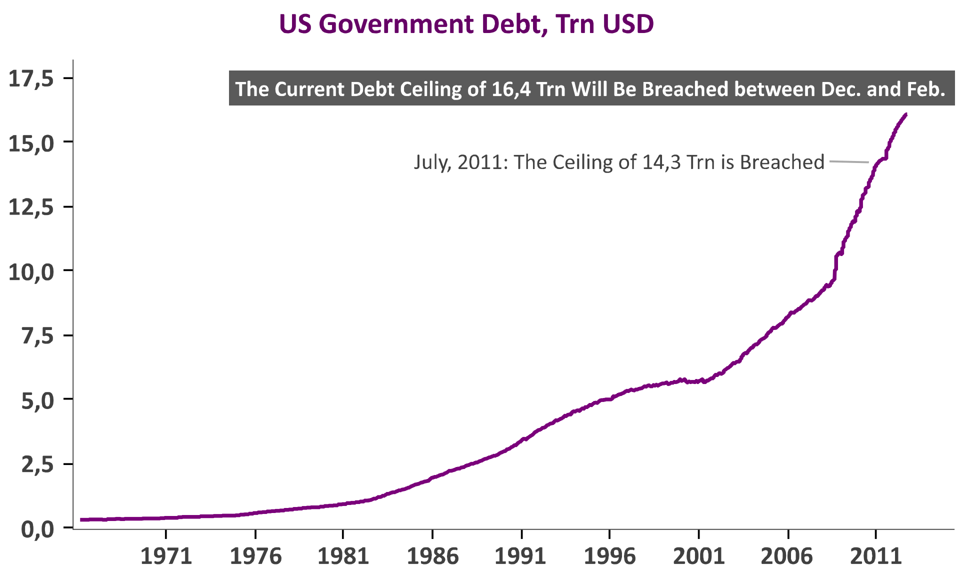
Sources: CBO and US Tax Policy Center « Toppling the fiscal cliff », October, 2012

Fortunately, America's tradition of pragmatism should guarantee that neither the Republicans not the Democrats will be willing to take the risk of driving the economy into another recession by imposing a "European-style" austerity program. Yet this doesn't settle the underlying question of how the United States will address its fiscal predicament. With a budget deficit of more than 8.5 percent of GDP in 2012, the Federal government is still in no position to halt the upward trend in the national debt, which already exceeds 100 percent of GDP.



Sources : RichesFlores Research, Macrobond

The current $16.4 billion debt ceiling will, in all likelihood, be breached before year-end. At the same time, the upcoming negotiations on raising the ceiling will take place under such tense conditions that the chances of another U.S. sovereign credit downgrade, upward pressure on borrowing rates and, ultimately, downward pressure on the dollar look increasingly high.



Sources : RichesFlores Research, Macrobond

Maintaining Our 1.3 Percent Growth Forecast for 2013

The dearth of encouraging indicators in the past few weeks obviously makes it impossible at this stage to claim that the U.S. economy is on its way back to growth rates decent enough to eliminate the risk of another trend reversal.

In an environment marked by major uncertainty about the future direction of fiscal policy and by uninspiring economic indicators, a cautious stance has more to recommend it than an upward revision in forecasts. Our growth scenario for 2013 accordingly remains unchanged at 1.3 percent, after 2.0 percent in 2012. This puts us squarely at the low end of the October consensus, which yielded an average estimate of 2.0 percent, with forecasts ranging from 1.4 percent to 2.7 percent.

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