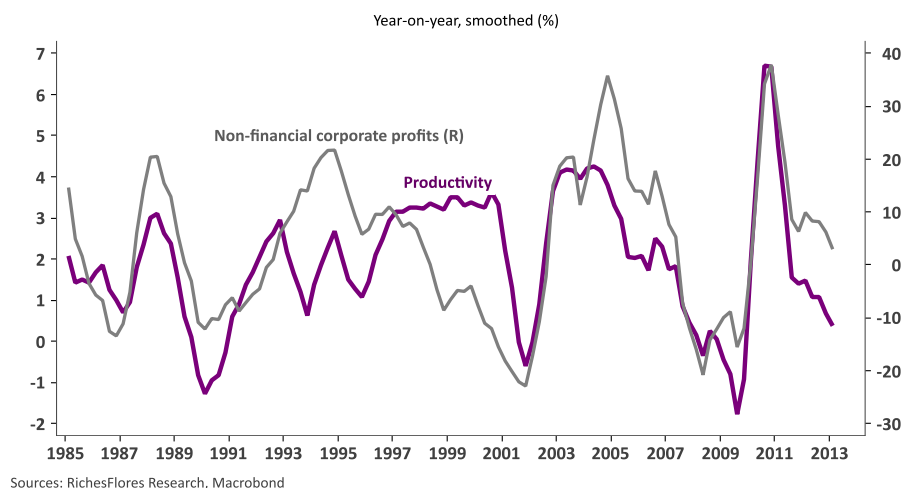


The U.S. Economy: Don't Count Your Chickens Before They Hatch

Sentiment on the U.S. economic outlook has gone from a flurry of uncertainty at the start of the year to renewed optimism. Admittedly, there are grounds for being bullish. Growth has held up despite tougher fiscal and tax policies; the housing market recovery has continued; and the Fed has stuck to its easy money policy. But let's not get carried away! The latest numbers are no more encouraging than those available at the end of last year. In particular, decelerating productivity growth, with all that it implies in terms of profit, investment, and job trends in the next few quarters, may well drag the U.S. economy back down in the second half of the year. And with a policy mix that is less accommodative than before, the key ingredients for a genuine recovery are still nowhere to be seen. All this has conditioned our analysis on several points:

- We wonder whether a change in monetary policy is on the short-term agenda—and worry that the Fed may withdraw its support too soon.
- While we aren't overly concerned about trends in the U.S. bond market and the euro's exchange rate, we do suspect that the stock market will be more vulnerable to disappointing macroeconomic data.
- We have very little faith in the American economy's chances of regaining its status as powerhouse of the global economy before the year is out.

Productivity and Real Profits in the U.S.

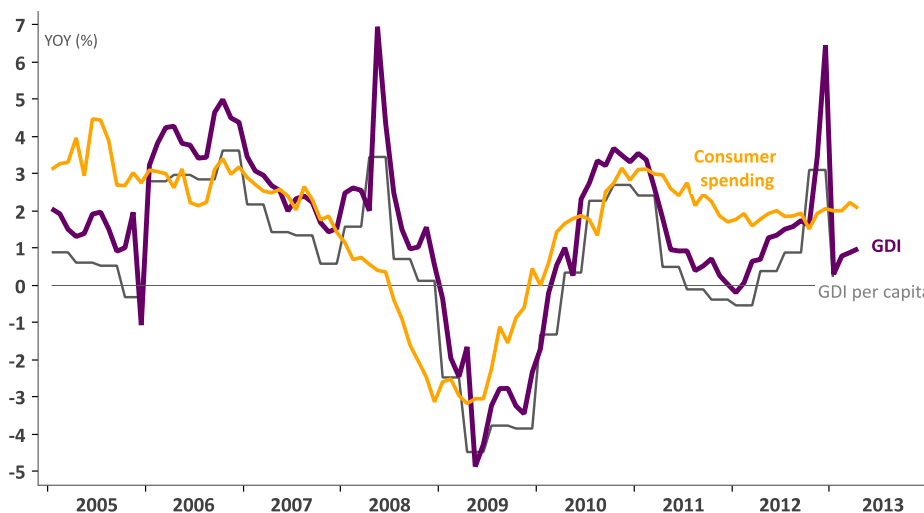


Improved Sentiment Among Economists Due Solely to Financial Market Performance?

The latest U.S. economic indicators hardly justify the upbeat mood recently expressed by a good many economists, so it would be worth reviewing them one by one.

- It was no big surprise that growth on an annualized basis recovered from 0.4 percent at the end of 2012 to 2.4 percent in the first quarter: strong household consumption in February alone accounted for most of the improvement. The latest consumption figures, along with weak growth in disposable income and low savings levels—currently under 2.0 percent—together suggest that consumers are likely to spend less in the second quarter. The other components of GDP growth are fairly disappointing: non-residential investment is virtually flat, investment in real estate has declined, and net exports had a slightly negative impact on GDP. At the close of the first quarter, the U.S. economy's annual growth rate was still a measly 1.8 percent—showing almost no increase compared with the end of 2012.

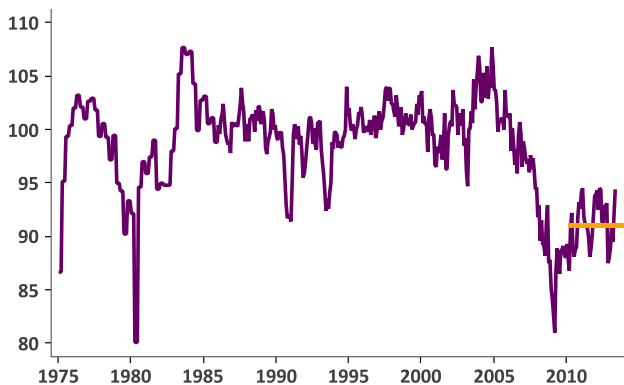
Real Gross Disposable Income and Spending of U.S. Households (%)



Sources: RichesFlores Research, Macrobond

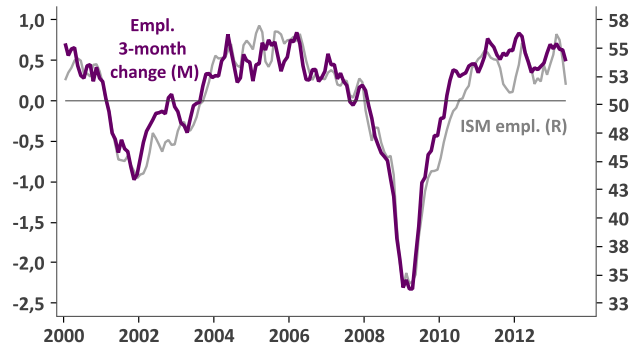
- The drop in weekly initial unemployment claims should be taken with a grain of salt. Since declining labor force participation has been “disappearing” increasing numbers of Americans from the unemployment rosters, this metric has lost much of its value as a barometer for employment trends. A further reason for not counting our chickens before they hatch is that ISM surveys and the persistently low level of small-business confidence bear witness to a deteriorating employment outlook. All in all, there is no clear evidence to date that the pace of job creation will pick up. In fact, it is more likely to continue downward over the next few months.

U.S. Small Business Outlook



Sources: RichesFlores Research, Macrobond

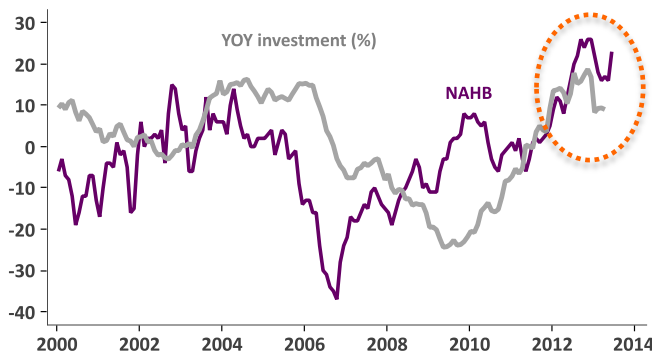
Private-Sector Employment and Composite Employment Component of ISM



Sources: RichesFlores Research, Macrobond

- Lastly, real estate market data confirm what we have argued for almost a year: the recovery is well under way. On the other hand, the readings from the sector are less positive on the whole than they were in the second half of 2012 (not so surprising after a year of catch-up). Growth in housing starts and building permits has tapered off, and sentiment in the industry is likewise on the wane even if rising house prices testify to a deepening recovery. **Given the low household savings rate, it's hard to imagine a wealth effect capable of fueling a rebound in consumer spending unless the U.S. sees a surge in disposable income—which would require a lot more jobs and higher pay.** Not exactly the case today.

Private-Sector Construction Investment and Builder Confidence (NAHB)



Sources: RichesFlores Research, Macrobond

Ratio of U.S. Household Savings to Disposable Income

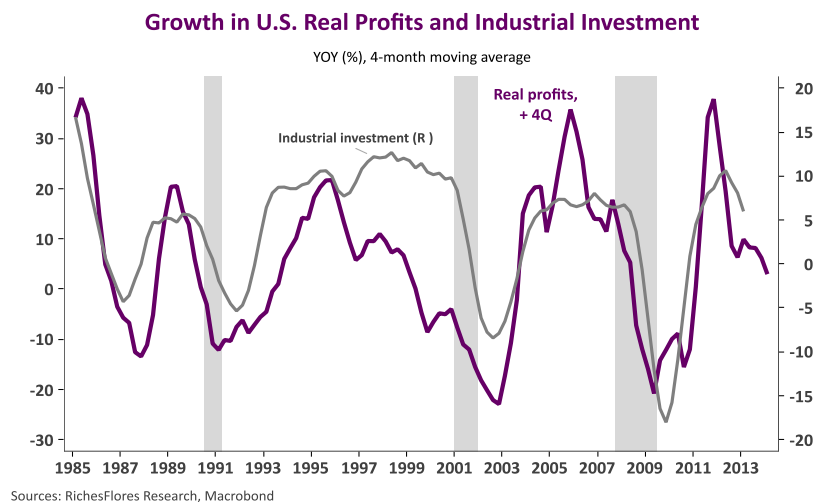
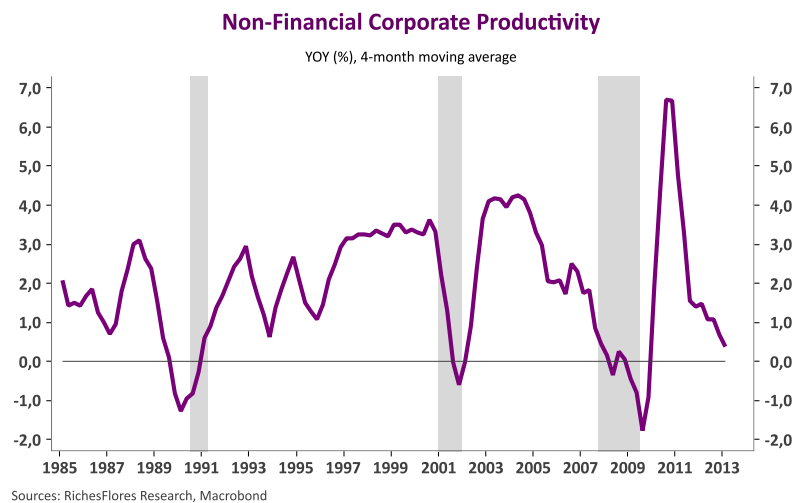


Sources: RichesFlores Research, Macrobond

In short, U.S. economic data provide precious little in the way of justification for the new-found optimism among economists, so there has to be another explanation. Two developments may be shaping their thinking. The first one is the recent shift toward less stringent austerity policies in the euro area, which should reduce the threat to global financial stability and therefore offer the U.S. economy a window of opportunity. The second development perhaps influencing economists is better overall financial market performance. Their reaction is in part understandable, considering the atypical disconnect between financial markets and the real economy over the last few quarters. **But in this case as with the changes in Europe, the high hopes entertained by economists are soon likely to be dashed.**

Expectations Belied by Declining Productivity Gains

Productivity trends are none too reassuring. They have been going steeply downhill in the last few quarters, and the outlook for the next few isn't particularly rosy either. With real GDP growing at an annual rate of 1.7 percent and job creations at 1.6 percent, productivity has posted diminishing gains over the last several quarters. In the non-financial corporate sector, it even declined slightly at the beginning of the year. This is clearly bad news, both for corporate profits, which are now increasing at a much slower pace, and for the investment and employment outlook, as can be seen from the charts below.



The Fed May Change Course Too Soon

As these charts show, recent U.S. economic indicators give the Fed very little reason to change policies in the immediate future. Not only is the economic outlook still highly uncertain, as we have seen, but lending to the private sector has yet to get back on track, while wage and price trends point, if anything, toward a risk of deflation.

The only legitimate argument for undertaking such a policy shift would be the current state of the financial sector, and specifically the extent to which quantitative easing has distorted asset prices. Although the Fed's Governors are divided on this issue, there is a very real danger that the central bank will end its accommodative policies too soon. If it does, the ensuing increase in long-term interest rates could turn out to be much more modest than is commonly assumed—and much more short-lived due to the economic fallout it is likely to produce. In contrast, such a reversal of course would affect the stock market much more seriously—just when the outlook for corporate profits is getting dimmer.

A virtual outcome involving an improved growth outlook and gradual removal of policy accommodation is not yet a realistic scenario. And since the Fed clearly knows as much, it is likely to hold off on changing directions. This means that the environment should work more to the euro's advantage than the consensus currently suggests.

Véronique Riches-Flores
contact@richesflores.com

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Véronique Riches-Flores, contact@richesflores.com