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GLOBAL MACRO

Is the U.S. Economy Really Out of the Woods?

The Federal Reserve has finally yielded to a combination of market pressure and the macroeconomic data of the past few months. From January onward, the U.S. central bank will be cutting the pace of its monthly asset purchases by $10 billion—from $85 billion at present to $75 billion. While that still qualifies as significant life support, the overriding message is that monetary policy will soon be on its way back to normal. So a previously dreaded change of course is now being greeted as good news by the markets. The Dow Jones responded positively to the Fed's announcement, as did the dollar.

But the tapering process in the cards will necessarily affect expectations about the target interest rate. And since the Fed has maintained its goal of a more extensive policy shift as soon as the unemployment rate drops below 6.5 percent, long-term yields are even more likely to continue upward. This leads to the big question of whether the U.S. economy can cope with a further increase in those yields.

A Much More Upbeat Mood at the Fed

The Fed's outlook for the U.S. economy has unquestionably changed since September. This week, Ben Bernanke sounded not only much more sanguine about the prospects for growth, but also much less worried about how low inflation is. Overall economic developments are what underlies both his decision and the note of determination in his statement that the Fed intends to scale back its asset purchases in measured steps at future FOMC meetings (unless incoming information suggests it shouldn't). This clearly represents a major change of perception and strategy in relation to the past few months.

Is U.S. Growth Heading Back Up to 3 Percent—Or Not?

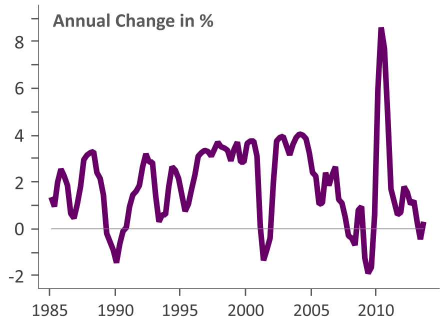
Whether and to what extent the Fed was right to change policy this time around will depend on how that question is answered.

- The consensus among U.S. economists points in any case toward a "yes" answer. This month, they forecast U.S. GDP growth of 2.6 percent and a 1.7 percent inflation rate in 2014, which equates to average nominal growth of 4.3 percent. That estimate suggests that we can reasonably expect long-term yields to reach a similar level. As they see it, there is absolutely no need to fret over the consequences of exiting QE**. In sticking to its quantitative easing program in the last several months, the Fed has continually wrong-footed the consensus forecasts; in reducing its asset purchases, it is now proving them right**. This explains the positive reactions on both the stock market and the forex market, where investors are "buying" the narrative of a return to growth in the U.S. Even better, if this genuinely good news is borne out by events, it could have a positive impact abroad as well. Thanks in particular to a stronger dollar, the improved economic outlook in the U.S. should spill over at least in part to the rest of the world. The risk of tapering for emerging market economies and the euro area may turn out to be extremely limited in such conditions.

- In contrast, economists with greater doubts about the fundamentals of U.S. economic growth obviously tend to taker a dimmer view of this latest change in monetary policy. Their concern is that rising long-term bond yields—an inevitable byproduct of the QE phase-out process—may undermine the economic improvement under way. As before, we share that concern. Here is why:

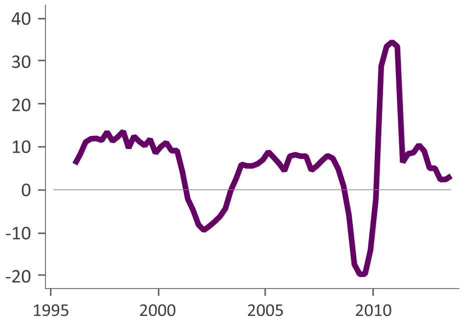
  ➢ Due to weak productivity gains, corporate capital spending is flat—and therefore damaging to the labor market.

Non-Financial Corporate Productivity



Sources: RichesFlores Research, Macrobond

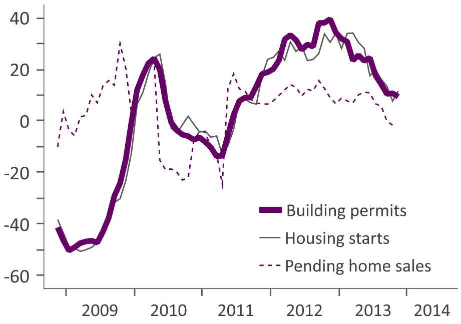
Real Capital Spending, Annual Change in %



Sources: RichesFlores Research, Macrobond

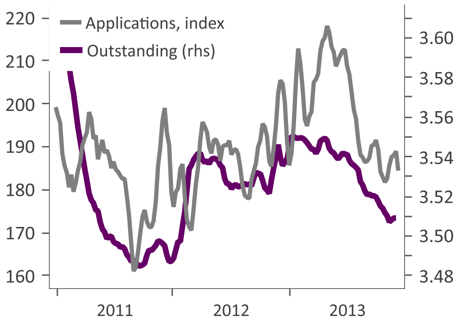
➢ The housing market upturn cannot be taken at face value. For one thing, it is fueled more by rising prices than by higher transaction volume. For another, mortgage lending has yet to recover to a normal level.

Real Estate Market Indicators, YoY (%)



Sources: RichesFlores Research, Macrobond

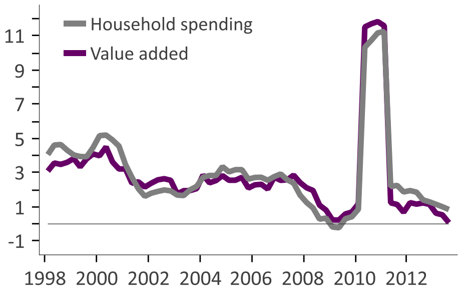
Mortgages Outstanding and Mortgage Applications



Sources: RichesFlores Research, Macrobond

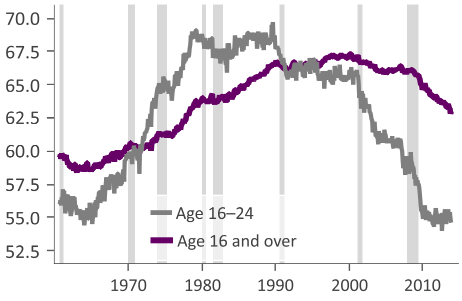
➢ ➢Growth in the service sector is disturbingly anemic. Hard hit by fallout from the financial crisis, it has been stuck for several quarters in the vicinity of zero percent. If service business fails to pick up, not only is the job market recovery in danger of fizzling out—with grim consequences for a large proportion of American workers—but the expectations for higher inflation won't materialize.

Consumer Spending and Value Added (GDP) in Services, Constant Prices, YoY (%)



Sources: RichesFlores Research, Macrobond

Labor Force Participation Rate in the Working-Age Population



Sources: RichesFlores Research, Macrobond

In the coming weeks, we will therefore be focusing on these three key issues as we seek to gauge the impact of the latest FOMC decision and assess its implications for our forecasts.

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