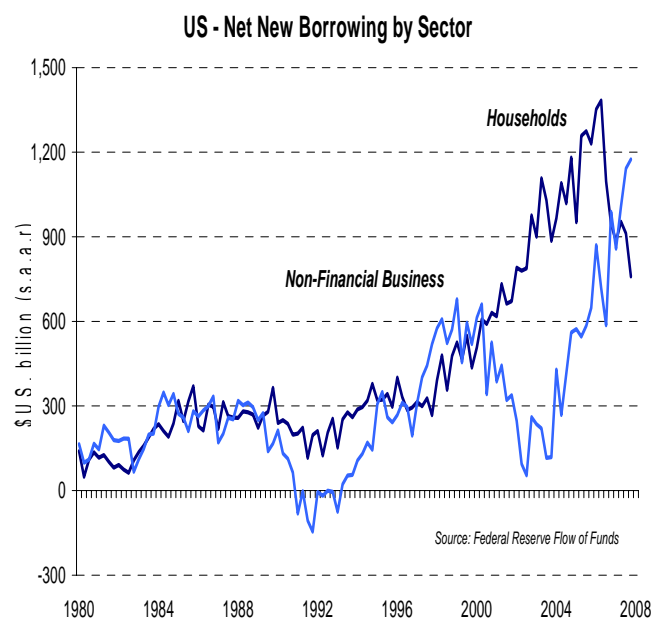


Fear receding in the US – but growth remains hobbled by deleveraging

Key trends

- US GDP growth has stalled (probably even contracting) in the first quarter of 2008, as weakness in household spending continues to intensify and begins also to drag down business investment. Indeed, hours-worked fell in the quarter, which since 1990 has only ever occurred once in the absence of recession or outside the early stages of recovery.
- Following the combination of aggressive open market operations and monetary easing, progressive disclosure of sub-prime and related losses, and significant capital injections into the banking system, there have been signs of returning investor risk appetite. However, while the likely extent of sub-prime and related losses appears to have been fully discounted, uncertainty over the distribution of losses continues to weigh on inter-bank and other short-term funding markets.
- From a policy perspective, moreover, these lingering funding problems are leaning against the effectiveness of earlier policy easing, and underscore the continued high risk of a more prolonged downturn in activity. Accordingly, we believe the Fed has little choice but to lower the funds rate a further 25 basis points at the 30 April FOMC meeting.
- Cutting rates further will do little to promote demand while households and the financial sector remain focussed on repairing balance sheets. Nevertheless, this process of deleveraging also suggests the US is facing constraints on credit availability and domestic demand growth over at least the balance of 2008. The accompanying probability of an eventual moderation in (domestically-sourced) inflation provides the Fed with additional justification to ease further.



- Even as the household and financial sectors eventually work through the current housing-related excesses, however, a range of economic, regulatory and demographic factors all foreshadow much slower growth in private non-financial sector debt accumulation (relative to the past two decades). While this medium-term outlook promises fewer private sector imbalances, it is likely to be at the cost of financial re-regulation, higher underlying inflationary pressures and slower economic growth.

- In the meantime, as inter-bank funding strains eventually abate, we expect the Fed to begin to taking back what has been partly a series of 'emergency' rate cuts. In our view, this is still most likely in 2009, although an earlier move is possible in the event inflation proves more stubborn than currently expected. Importantly, however, the Fed is likely to be 'normalising' policy against the backdrop of a relatively subdued cyclical upturn.

The economy probably contracted in the first quarter

US GDP growth has stalled (probably even contracting slightly) in the first quarter of 2008, as weakness in household spending continues to intensify and starts also to drag down business investment.

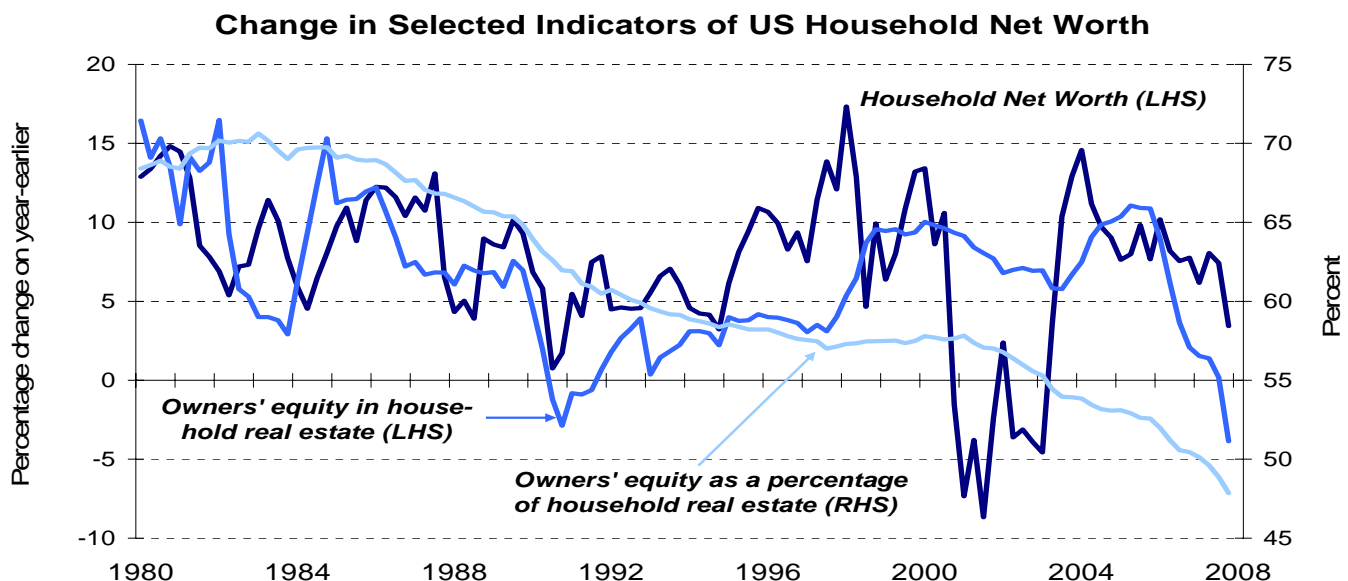
Consumer spending growth appears to have ground almost to standstill, as rises in disposable income and net worth have moderated sharply, while credit standards have tightened even for prime household borrowers. Excluding autos and gasoline, nominal retail sales increased at an annualised rate of just 1.2% in the first quarter (most likely contracting after a 2.4% annualised increase in core consumer prices in the same period). Total consumer spending in the quarter is likely to be further undermined by a collapse in auto sales in March to the lowest level since October 2005.

There have been some tentative signs the rate of decline in new house sales may be moderating, while a further 12% plunge in housing starts in March suggests the inventory of

unsold new houses probably peaked at 9.8 months' supply at the turn of the year. However, some slowing in the rate of decline in sales was always likely after such a precipitous and unprecedented fall, and there has been little corroborating evidence of returning demand in new house prices (which continue to fall steeply).

Moreover, in the event new housing demand steadies at current levels, we estimate starts still need to fall a further 20% - 25% to bring inventory levels down to longer-term levels. In the meantime, the continuing steady fall in the total value of private new residential construction spending in January and February (and the ensuing further fall in starts in March) suggests the drag from construction unlikely to abate in the first quarter (following a 25.2% annualised fall in the fourth quarter of 2007).

The continuing deterioration in household demand (and possibly the tightening in credit availability) appears also to have contributed to a renewed downturn in equipment investment in early 2008, partly reversing the moderate recovery over the course of 2007. Durable goods shipments (ex defense and aircraft) fell in March to the lowest level



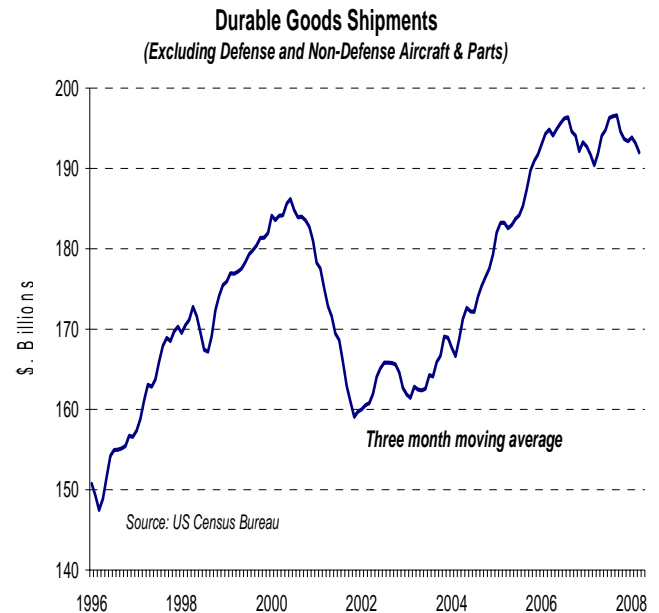
since February 2007, and declined by 0.7% in the three month period to March.

A rebound in orders in late 2007 has also dissipated in early 2008, foreshadowing a further fall in equipment investment in the second quarter (although downside in the current cycle remains limited by the earlier prudence in capital spending and the improving competitiveness of the traded goods sectors). Furthermore, investment in non-residential structures has fallen in each of the three months to February, suggesting one earlier pocket of strength in the US economy is now also beginning to turn down.

Similarly, export growth (the other clear area of strength) appears to have peaked, with slowing demand in major trading partners offsetting the benefits of the weak US dollar. In value terms, exports of goods and services surged at an annualised rate of 17% in the three months to February. However, the volume of goods exports increased at an annualised rate of just 4% in the same period (and in contrast to the 6.5% increase in real goods and services exports in the fourth quarter and the 8.1% increase in calendar 2007).

More positively, imports continue to decline in the wake of the fall in domestic demand and the dollar. Real goods imports fell at an annualised rate of over 1.0% in the three months to February, broadly similar to the fall in real imports of goods and services in the fourth quarter (and compared with the 1.9% increase in 2007). Moreover, inventory levels remain relatively lean, following the substantial -1.8 percentage point subtraction from growth in the fourth quarter, and could even provide a small positive contribution to growth in the first quarter.

Nevertheless, despite the likely positive contributions from net exports and inventories, the spreading weakness in domestic demand has been mirrored in a softening in a wide range of production indicators. Most notably, private sector

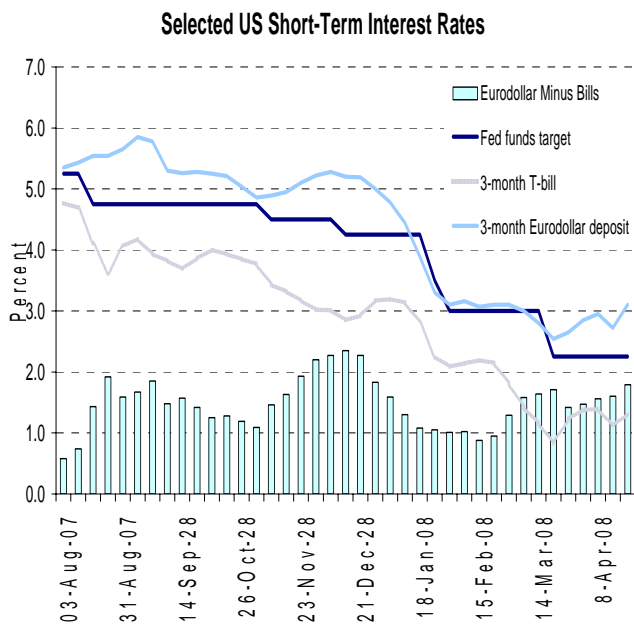


payrolls have fallen in each of the four months to March. Hours-worked also fell in the March quarter, which since 1990 has only ever occurred once (in 1996) in the absence of recession or outside the early stages of recovery.

The decline in payrolls corroborates the ISM services index, which suggests the contraction in activity has spread beyond the construction and manufacturing sectors. More positively, like the most recent industrial production data, the ISM manufacturing index suggests the contraction in manufacturing is comparatively mild, with exports cushioning the impact of slumping housing, consumer and business demand.

Fragile lending markets to prompt further policy response

Rather more disconcertingly, however, despite the combination of aggressive open market operations and monetary easing, progressive disclosure of sub-prime and related losses, significant capital injections into the banking



system, and a recent sharp rise in short-term yields, inter-bank and other short-term funding markets remain fragile. The clearest manifestation is the continuing wide spread between the fed funds rate and LIBOR, and dormant ABS and commercial paper markets.

If anything, however, the Fed’s prompt policy response should help contain the wave of potentially troublesome ARM resets in 2008 and 2009. The decline in LIBOR (on which ARMs are generally fixed) will cushion the impact of the large increases in spreads as teaser rates are reset, while the steep falls in house prices (and accompanying incidence of negative equity) remain confined to a relatively small number of regions. Furthermore, implied default rates in corporate bond valuations appear rather high, with corporate borrowers in generally better shape than households (for reasons discussed below).

However, as long as the distribution of these potential (leveraged) losses is uncertain, inter-bank markets will remain characterised by high levels of distrust and liquidity hoarding. From a policy perspective, moreover, these

lingering funding problems are leaning against the effectiveness of earlier policy easing, and ensure a high risk of a more prolonged downturn in economic growth. Accordingly, we believe the Fed has little choice but to ease a further 25 basis points on 30 April.

To be sure, cutting rates further will do little to promote demand while households and the financial sector remain focussed on repairing balance sheets. Nevertheless, this process of deleveraging also suggests the US is facing constraints on credit availability and domestic demand growth at least over the balance of 2008. The accompanying probability of some eventual moderation in domestically-sourced inflation provides the Fed with additional justification to ease further.

The medium term outlook - hemmed in by the limits of private sector leverage?

Even as the household and financial sectors work through the current housing-related excesses, however, it is difficult to envisage a return to the earlier strong growth in non-financial sector debt accumulation, and which has played a crucial role in shaping the pattern of US GDP growth over the past two decades (as well as contributing to the various US asset price bubbles and global imbalances).

The 2001 recession was largely the result of balance sheet deleveraging in the non-financial business sector (following the investment excesses accompanying the ICT and dot.com bubbles), but the depth of the downturn was cushioned by continued strong credit growth to the household sector (which barely skipped a beat). In 2008, by contrast, it is the non-financial sector cushioning deleveraging in the household and financial sectors (and the basis of our expectation that labour and investment retrenchment will be relatively mild in the current downturn).



Nevertheless, relative to the past 20 years or so, a range of prospective changes in the economic, regulatory and demographic environment all point to growing constraints on the capacity or willingness of the private non-financial sector to assume ever higher levels of gross indebtedness.

Firstly, following the deleveraging process earlier in the decade, the chart above shows the non-financial business sector was significantly more prudent in rebuilding gearing ratios over the ensuing economic expansion, despite the strength of profit growth and liquidity, and ready access to credit. The impact of leveraged buy-outs appears to have been largely offset by much greater resort to internal funding of capital investment. Indeed, this prudence largely explains the relative resilience of the corporate sector in the current downturn.

Secondly, the earlier large rise in household indebtedness corresponds with rapid growth in the prime working-age cohort, the cohort that has the strongest capacity to assume new debt. However, as the US population continues

to age, growth in this cohort is slowing. According to US Census data, the population aged 25-54 grew by 15.6% between 1990 and 2000. Using the so-called 'middle' assumptions (on fertility, morbidity and migration), this cohort is expected to grow by just 4.0% over the 10 years to 2010 and by 0.9% over the decade to 2020. While more recent Census Bureau estimates of the US population suggest the projections are now rather conservative (with the total population estimated to have increased by 3.1% between 2000 and 2005), nevertheless the broad ageing scenario still holds true.

Thirdly, similar to the process of corporate leveraging in the late 1990s, but largely in response to slowing market growth (refer to point two above), the rise in household indebtedness was partly underpinned by the steady extension of credit to ever less creditworthy borrowers. In addition to less supportive demographics, the unfolding regulatory responses to these practices are likely to emerge as another constraint on more rapid growth in debt accumulation.

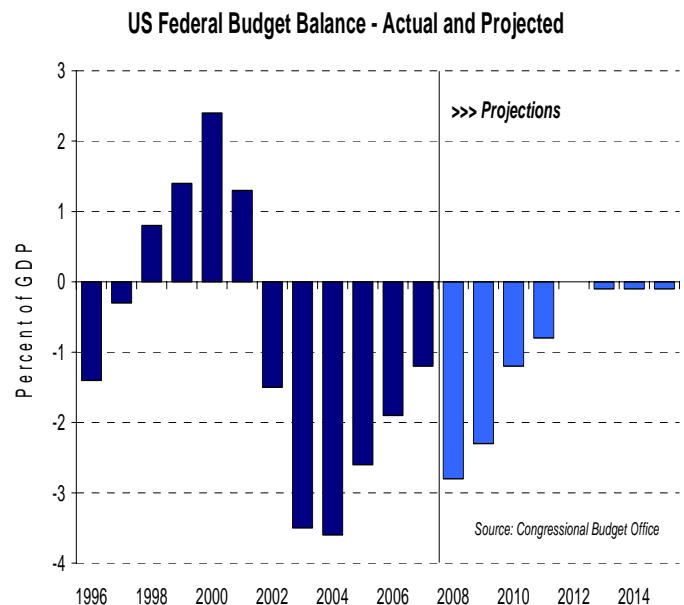
Fourthly, it is more than a co-incidence that the leveraging of the private non-financial sector accompanied a prolonged period of global disinflationary pressures. Steadily declining inflation allowed an otherwise more accommodative monetary policy, which in turn contributed to declining risk premia, asset price inflation, and a positive feedback loop into credit growth. As secular global inflationary pressures have turned in the other direction over the course of the current decade, however, monetary policy is unlikely to be as supportive. Indeed, it appears housing sectors in developing economies are largely bearing the brunt of central bank responses to rising commodity prices and inflationary risks.

But there are other sources of demand growth...

Despite these possible secular constraints on private sector credit growth, the relatively brighter prospects for developing economies and the weak dollar (the major sources of current US inflation pressures) suggest the trade sector will continue to support US GDP growth.

Furthermore, and in contrast to the private sector, the federal government budget deficit is poised to widen considerably in 2008 (and a major reason we expect the downturn to bottom around the middle of the year).

Along with the fiscal stimulus package already enacted, approval of the Administration's proposed budget would result in the deficit widening from 1.2% of GDP in 2007, to 2.8% in 2008, and remaining at 2.3% in 2009. Furthermore, in the event Congress approved the extension of the (temporary) tax provisions that are due to expire at the end of 2010, the budget will remain in deficit for much of the



forecast horizon. While the forthcoming change of administration foreshadows a differing fiscal strategy, a more aggressive approach to fiscal consolidation appears unlikely in the current environment.

More broadly, this medium-term outlook promises fewer private sector imbalances, but at the cost of re-regulation in the financial sector, higher underlying inflationary pressures and slower economic growth. As inter-bank funding strains eventually abate, we expect the Fed to begin to taking back what have been partly 'emergency' rate cuts. In our view, this is still most likely sometime in 2009, although an earlier move is possible in the event inflation proves more stubborn than currently expected. More importantly, however, the Fed will be 'normalising' US monetary policy against the backdrop of a relatively subdued cyclical upturn.

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