US monetary policy – the Fed may yet have more work to do

- ***At 0.6% in annualised terms, US GDP growth in the first quarter was marginally stronger than we anticipated. Nevertheless, the composition of spending growth still leaves a high probability GDP will contract in the second quarter.***

- ***Indeed, while systemic financial risks are receding, and with tax rebates helping to place a floor under GDP growth in the third quarter, in our view the risks to underlying growth remain heavily tilted to the downside. 'Payback' for the tax rebates, lagged effects of the continuing rises in energy and commodity prices, lingering constraints on the availability of new credit, and the prospect of further declines in house prices, all suggest underlying growth will remain weak in the second half of 2008.***

- ***Although we still expect GDP growth of 1.3% in 2008, relative to our earlier forecasts more of this growth is now 'frontloaded' into the first half of the year. Furthermore, we now anticipate growth of just 1.7% in 2009, down from our earlier forecast of 2.2%. We doubt signs of a sustainable upturn will be evident much before late 2008/early 2009.***

- ***While the Fed has signalled a conclusion to the period of aggressive easing, we expect the continuing deterioration in economic data to force the Fed into taking out additional insurance against a deeper and more prolonged downturn. Accordingly, we still expect the Fed to cut the funds rate a further 25 points to 1.75% at the 25 June FOMC meeting.***

Overview of our revised growth forecasts

US output growth in the first quarter was marginally stronger than we expected, GDP expanding by 0.015% in non-annualised terms (we had estimated a decline of similar magnitude). At 0.6% in annualised terms, growth also was unchanged from the final quarter of 2007. While the US is now poised to defy the most common definition of recession (two consecutive quarters of negative growth), nevertheless it is also clear GDP growth has essentially stalled since late 2007 (and following some 18 months of sub-trend growth).

Moreover, the headline number masks a potentially more troublesome pattern of spending growth, still leaving a moderate contraction in GDP the most likely outcome in the second

quarter. Further out, the (temporary) tax rebates should help place floor under growth in the third quarter (the period in which the impact is most likely to be reflected in quarterly data), but with the risk of some ‘payback’ later in the year. Subsequently, our forecast for GDP growth in 2008 remains broadly unchanged at 1.3%. However, with the continuing rise in crude oil and other energy prices, the need to recapitalise bank balance sheets (and the accompanying constraint on new credit growth), and the prospect of further declines in house prices, we have revised down forecast GDP growth in 2009 from 2.2% to 1.7%.

Inventories boost first quarter growth…

Despite the marginal increase in GDP, final domestic demand fell at an annualised rate 0.4% in the quarter (the first decline since the fourth quarter of 1991). The fall comprised declines in residential construction (-26.7%), investment in structures (-6.2%) and equipment (-0.7%), only partly offset by continued growth in personal consumption (although slowing from 2.3% to 1.0%) and unchanged growth in government demand (2.0%).

The contribution from net exports also was the smallest since the first quarter of 2007, reflecting a slowing in export growth (from 6.5% to 5.5%) and a rebound in imports (from -1.4% to 2.5%). Subsequently, final sales of domestic product (final domestic demand and net exports) fell by 0.2%, the first fall since the final quarter of 2005.

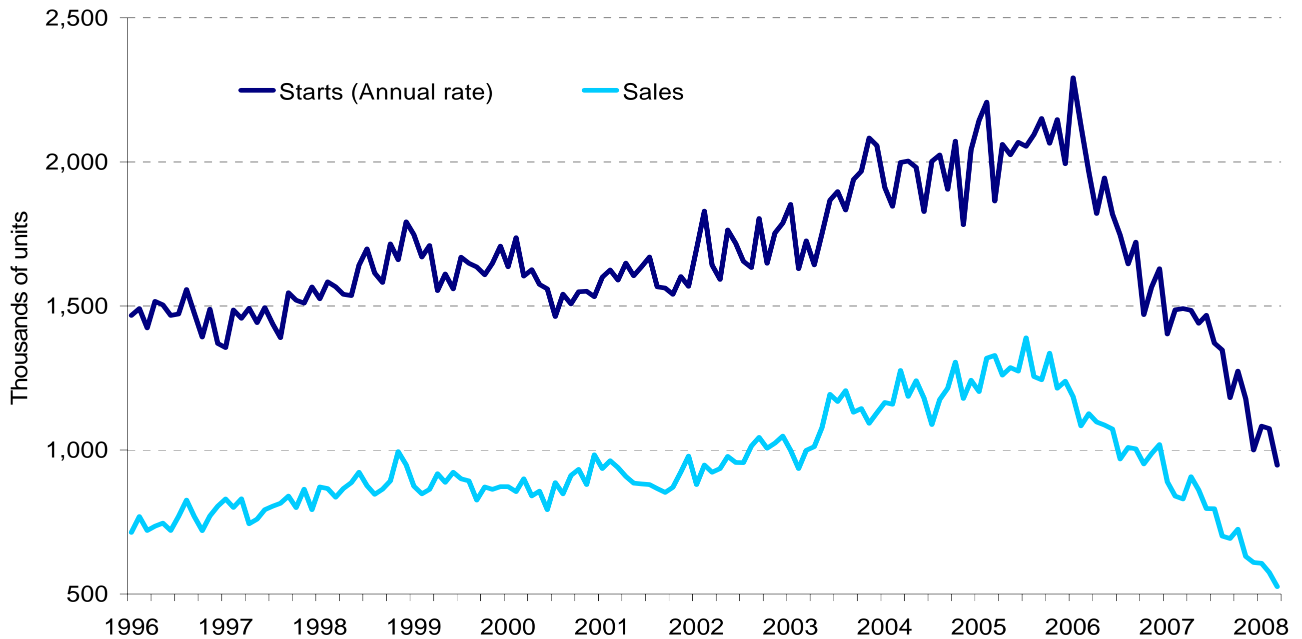
An otherwise weaker increase in GDP was only averted by a small increase in inventories (contributing 0.8 percentage points to growth), following a large1.8 percentage point subtraction in the fourth quarter of 2007. However, with the decline in final sales, the small increase in inventories was most likely unintended. Along with our expectation of a continuing contraction in final demand, the need to cut inventory levels suggests a renewed subtraction from growth in the second quarter.

…but are likely to compound further weakness in domestic demand in the second quarter

To be sure, notwithstanding significant fiscal and monetary easing in the pipeline, the short-term prospect for US domestic spending growth remains grim. While US households are poised to receive income tax rebates over the next two to three months equal to around 3.5% of quarterly disposable income, in terms of GDP data the impact is likely to be spread over the second and third quarters (and most evident in the third).

Moreover, despite the collapse in house prices and stalling in household net worth over the past year, personal consumption expenditure has managed to grow by 1.9% over the past year. In the absence of any significant pent-up demand (and with a current desire among households to deleverage balance sheets), much of the rebates are likely to be saved or used to reduce debt. Abstracting from the impact of the rebates, the likely further falls in employment, together with the recent significant increases in food and energy prices, both suggest a further weakening in underlying consumption growth in the second quarter.

In the housing sector, starts fell a further 12% in March, foreshadowing little abatement in the drag from the residential construction sector. Indeed, although there are some tentative signs the rate of decline in new housing sales may be slowing, or even possibly set to stabilise over the next few months, we estimate starts still need to fall a further 20% to bring inventories of unsold houses back down to longer-term average levels.



Among the other major components of spending, the outlook for business investment also remains challenging. Unlike the housing sector, earlier spending discipline (along with improving international competitiveness) has left the non-financial business sector under less pressure to deleverage balance sheets. Nevertheless, profits and cash-flows have been dragged down by the weakness in household spending, and credit availability has been severely curtailed by the financial market crunch.

Correspondingly, after jumping in late 2007 (possibly reflecting a deferral of capital investment plans at the height of the credit market crisis in August and September), core durable goods orders have since slumped in the first quarter of 2008. A good leading indicator, the fall in orders points to a further contraction in equipment investment in the second quarter.

It is difficult also to anticipate any renewed strengthening in export growth in the second quarter, particularly as slowing domestic demand growth appears to be spreading across a widening range of US trading partners. More positively, however, the expected rundown in inventories is likely to be accompanied by a fall in imports (a positive contribution to growth). Similarly, inventory to sales ratios remain close to record lows, suggesting a relatively mild inventory cycle and a comparatively small subtraction from growth in the quarter.

Confidence in sustained upturn unlikely before late 2008/early 2009

Further out, after the temporary boost to consumption spending growth in the second and third quarters, we expect some ‘payback’ later in the year. Indeed, with likely further falls in housing prices and employment, tougher access to credit, and stubbornly high food and energy costs (partly related to the weakness of the USD), consumer spending growth is expected to remain weak until early-2009.

Similarly, the housing downturn is expected to extend well into 2009, although the rate of decline is expected to begin moderating in the second half of 2008. Although mild by the

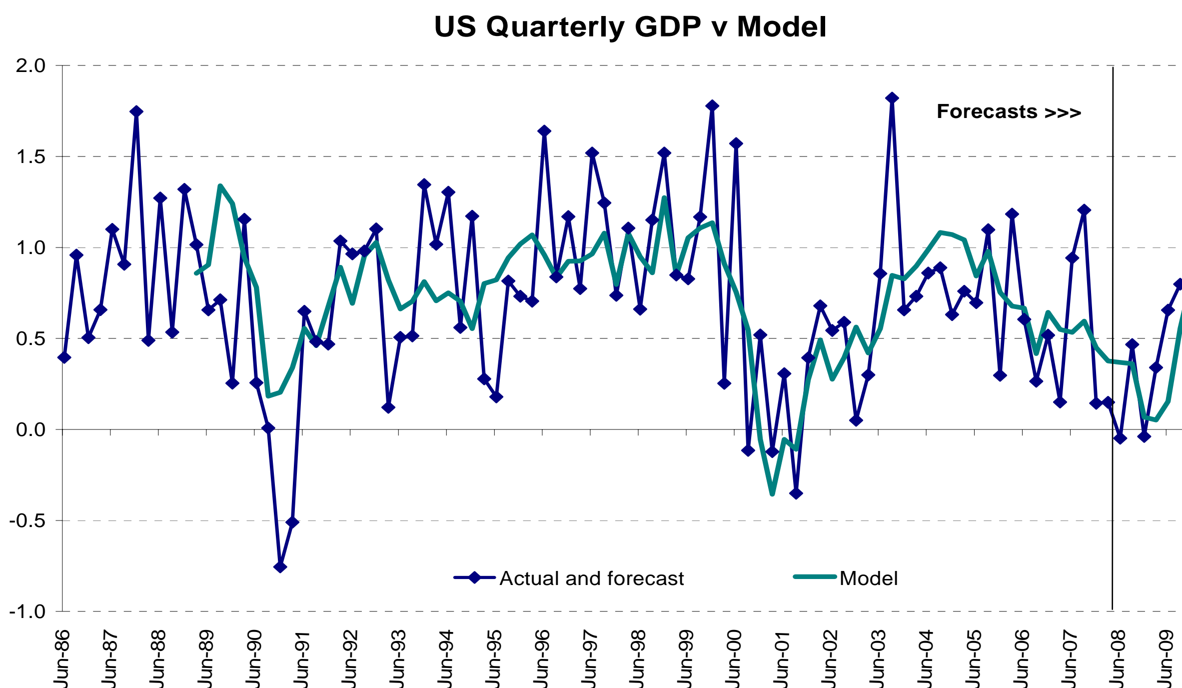
standards of 2001, the downturn in business investment is also likely to bottom until 2009. Furthermore, we estimate the biggest contributions from the trade sector may also have passed. More positively, however, federal fiscal policy is likely to continue providing support for growth in both 2008 and 2009.

These forecasts are consistent with our modelling of US GDP growth, which incorporates real short-term interest rates, the USD exchange rate, house and equity prices, the oil price and the Fed' Survey of Senior Loan Officers. In short, underlying GDP growth troughs in late 2008, and begins to recover steadily over the course of 2009. The key results are illustrated in the accompanying charts.

Interest rate outlook

In addition to cutting the funds rate 25 points to 2.0% (and by 325 points since September 2007), the Fed also signalled it is now prepared to sit back and watch the flow of economic data. With core inflation still stubbornly at the top of the Fed's comfort zone, and some upside risks from the continuing rise in energy and other commodity prices, further easing requires signs of an even sharper slowing in growth from here.

To be sure, markets currently believe the Fed may have now done enough to contain downside momentum and risks to growth. However, our forecasts suggest this view may be rather too optimistic. Growth over the year is expected to slow to just 0.7% in the first quarter of 2009, down from 2.5% in the first quarter of 2008. With forthcoming data re-affirming the prospect of a contraction in growth in Q2, and ensuing risks of a more prolonged downturn, we anticipate the Fed will be forced to take out additional insurance.



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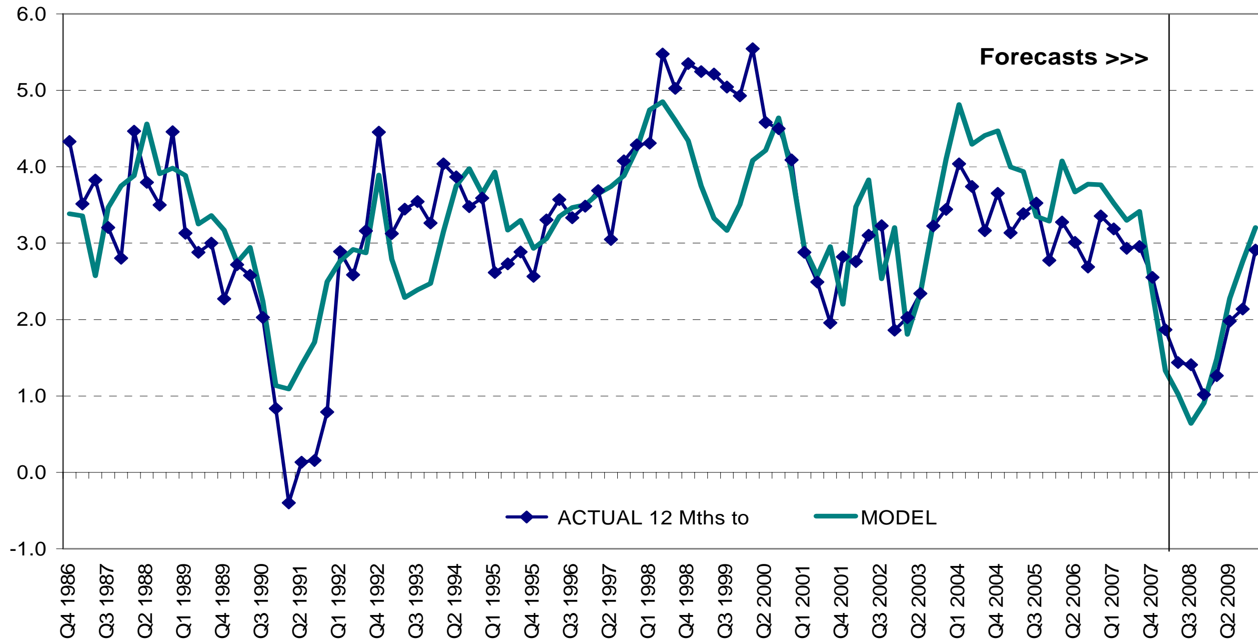

Accordingly, we still believe the Fed will cut the Funds rate a further 25 points at the25 June FOMC meeting. Thereafter, we expect the Fed to again sit back and assess incoming data. At this point, we anticipate the injections of private capital into the banking system, together with the Fed's preparedness to adopt innovative open market operations, will be sufficient to contain further systemic financial risks. Despite the risks from higher commodity and import prices, we also anticipate increasing economic slack will contribute to a further moderation in core inflation.

Indeed, in our view, the balance of risks to monetary policy may still be on the downside until late/2008/early 2009. On one side, is the potential for rising energy and commodity prices to feed through into inflation expectations. However, on the other side is the adverse impact of oil prices on disposable incomes, the difficulties in quantifying the impact of the credit crunch and the extent of further falls in house prices, and the deteriorating outlook ex- the US. Furthermore, based on past relationships, our modelling suggests there are significant risks US growth stays weaker for longer – a scenario that the Fed would still find difficult to accept.

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