Swiss Re

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US Economic Outlook

Growth prospects have diminished.

Growth prospects in the US have diminished somewhat, but as the Purchasing Managers Index (PMI) and the employment report for October indicated, the economy is far from dead in the water. Basically, growth is likely to be between 2.5% and 3.0% next year, which is close to its long-term potential. This week's quantitative easing (QE) was mostly anticipated by the market, so rates have moved only a little upwards. The election will not change the outlook because the result was as expected – a Republican House and a Democratic Senate. The parties will have to work together to accomplish anything, so there are unlikely to be any major new initiatives. Real GDP growth is expected to be 2.7% this year, 2.8% next year and 3.1% in 2012. The modest acceleration over the three years is attributable to employment increases and a small improvement in housing construction. In line with lower growth, inflation and interest rates are expected to be lower, with the QE helping on the latter. All-items inflation is expected to be below 2% for the next two years, while core inflation – which excludes food and energy — will be between 1% and 1.5%. The yield on the 10-year Treasury note will be mostly rising through end-2011, reaching about 3.8% by end-2012. Given weak growth and benign inflation, the Fed is unlikely to raise rates until early 2012.

Forward indicators have turned soft in the past few months.

The growth indicator that guides our GDP forecast is now signaling a slowdown in growth to the 2.5% - 3.0% range for next year. Indicators that are showing above average strength are capital goods orders, consumer durable orders, the aggregate PMI index, manufacturing hours and PMI for deliveries. The indicators that imply below average growth are housing permits, unemployment insurance claims and consumer expectations. After showing quite a bit of strength through May, the growth indicator was between 2 and 3% from June to September.

Private job gains were 159,000 in October.

In October, private sector jobs rose by 159,000, compared to an upward-revised gain of 107,000 in September. Overall, jobs increased by 151,000 due to some slippage in local, not Census, government employment. The unemployment rate remained unchanged at 9.6%, while average hourly earnings were up a modest 1.7% y-o-y, a bit higher than inflation of 1.1%. Manufacturing average weekly hours, a leading indicator, rose 0.1 to 40.3 hours.

Low mortgage rates are not jump-starting housing construction.

Housing starts are still on track to be slightly higher this year than last year, averaging 603,000 through September, compared to 555,000 last year. For the past several months – post housing subsidy – housing permits have been fairly flat. Thus, a major improvement in housing construction is unlikely until 2012. The Fed, with its QE program, is intent holding down the yield on the 10-year Treasury note, which will keep mortgage rates low. Thus far, this has had minimal impact, so the Fed may need to maintain the QE program for longer than currently announced. New home sales were only 307,000, down 21.5% y-o-y, while existing home sales were 4.53 million, down 19% y-o-y. Housing prices are faltering, with Case-Shiller prices falling slightly in August and existing home sales prices down 2.4% y-o-y in September.

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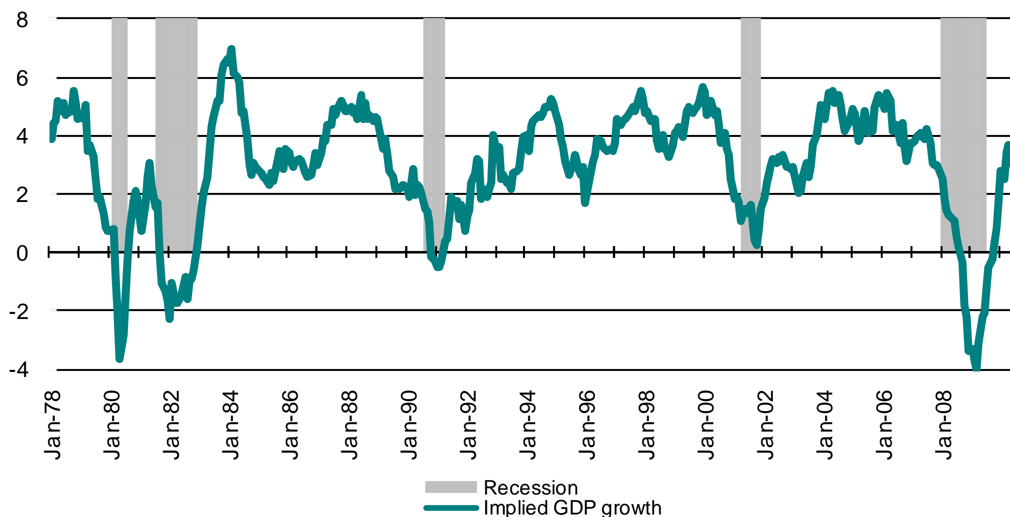
US Forecast Summary

	History		Forecast →					Annual Data			
	10Q1	10Q2	10Q3	10Q4	11Q1	11Q2	11Q3	2009	2010	2011	2012
Real GDP, % Change, SAAR	3.7	1.7	2.0	2.3	2.9	3.3	3.3	-2.6	2.7	2.8	3.1
% Change, Year Ago	2.4	3.0	3.1	2.4	2.2	2.6	3.0				
CPI, % Change, SAAR	1.5	-0.7	1.5	2.2	1.6	1.3	1.7	-0.3	1.6	1.5	1.8
% Change, Year Ago	2.4	1.8	1.2	1.1	1.1	1.6	1.7				
Core CPI, % Change, SAAR	0.0	0.9	1.2	1.0	1.0	1.0	1.0	1.7	1.0	1.1	1.3
% Change, Year Ago	1.3	1.0	0.9	0.8	1.0	1.1	1.0				
			End of period								
Fed Funds Rate (Target)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	3.00
3-Month Treasury Bill	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.2	2.8
5-Year Treasury Note	2.6	1.8	1.3	2.0	2.2	2.5	2.7	2.7	2.0	2.9	4.2
10-Year Treasury Note	3.8	3.0	2.5	2.9	3.1	3.3	3.6	3.9	2.9	3.8	4.7

US Economic Outlook

The growth indicator is signaling a slowdown similar to the 2002-03 recovery.

Growth indicator, implied real GDP growth, %



Source: Economic Research & Consulting

Though confidence is low, consumer spending continues to expand.

Real consumer spending rose 0.1% in September, but was up 2.3% y-o-y, bolstered by real disposable income growth of 1.6% y-o-y. Income growth is expected to increase at a very modest pace as employment rises. New vehicle sales were 12.3 million units (annual rate) in October, up from 11.8 in September and up 18% compared to last October. In contrast, from 1990 to 2009 – a period which includes three recessions – light vehicle sales averaged 15.2 million units a year. Consumers' expectations climbed to 67.8, from 65.5 in September, a level still far below its 1990-09 average of 89.0. Nevertheless, retail sales should rise by about 5 to 7% y-o-y in December. Though consumers are gloomy, they continue to spend.

The ISM surveys continue to predict employment growth.

In October, the Purchasing Managers Index for Manufacturing rose to 56.9 from 54.4 in September, implying accelerating, robust growth. The non-manufacturing sector is also improving – its index was 54.3, up from 53.2 in September, implying a healthy expansion. For both indices, the employment components were also above 50, indicating that private sector employment gains will continue. Manufacturing industrial production fell 0.1% m-o-m in September, but should rise in October if the PMI data is any guide.

The slow pace of growth will keep the deficits elevated.

The election has made major policy adjustments unlikely. Government spending will become more conservative, though that had happened already. It's unclear what exactly will happen with the Bush tax cuts, due to expire and end-2010, but high income households may very well face higher taxes, despite the Republican win. Expect a lot of gridlock.

Inflation is not a concern for the Fed, deflation is.

Though deflation is unlikely, the Fed's decision to have further QE implies some concern on their part about the economy and deflation. All items inflation was 1.1% y-o-y in September and core inflation was 0.8%. Core inflation averaged about 2.7% from 1990-2009, so it is two-thirds of the way to zero inflation from its historical average, but that is still a long ways to go.

The yield on the 10-year T-note will rise to 3.8% by end-2011.

The Fed is clearly trying to do all it can to revive the economy and lower unemployment – the often forgotten half of its mandate. As a consequence, it now appears likely that the Fed will be on hold through all of 2011, with the first rate hike in early 2012. Lower growth and the QE will keep the yield on the 10-year Treasury note lower for longer. It is now expected to rise to only about 3.8% by end-2011.

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