

**ECONOMICS:** US PERSPECTIVES—JULY 1, 2011

# Signs of Future Growth After Tough First Half

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US economic growth fell short of our forecast in the first half, owing to unexpected weakness in construction and defense, a spike in energy prices and supply disruptions. We expect faster growth in the second half, driven by gains in auto output and strong liquidity flows—if job markets gain traction.

It's been a disappointing six months for the US economy. Real gross domestic product (GDP) expanded by 1.9% in the first quarter (**Display 1**), and according to consensus estimates, growth is expected to be no better than 2% to 2.5% in the second quarter. In both quarters, economic growth fell short of our forecasts from the beginning of the year by more than one percentage point.

Part of the weakness stems from the unexpected supply disruptions that hit the industrial sector in late March, following the earthquake and tsunami in Japan. High oil prices, triggered by unrest in the Middle East and North Africa, also suppressed demand. However, GDP failed to meet expectations mainly because of sluggish performance in sectors such as construction and defense.

At the same time, policy changes have helped the economy generate substantial liquidity (**Display 2**), which may combine with a strong rebound in the motor vehicle sector to help power improved GDP

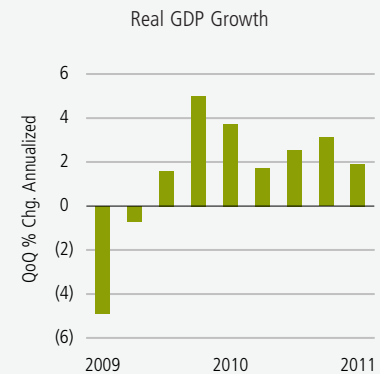
growth performance in the second half. However, we believe that a sustained rebound still depends upon achieving a better balance between business and consumer spending that can only materialize with stronger and broader job creation.

### First-Half Economic Recap

At the beginning of 2011, construction spending was at its lowest level in nearly 20 years. During the first quarter, construction spending weakened further and dampened real GDP growth. Nonresidential construction activity plunged by 14.8% annualized in the first quarter, in part because of bad weather, while housing also declined by 1.9%.

Early data for the second quarter suggest that the sector is still stuck, with activity posting a modest rebound but still falling short of expectations. Nonresidential spending appears to be rising by about 6% to 7%, recapturing only half of the first-quarter decline, while housing has rebounded modestly by about 2% to 3%.

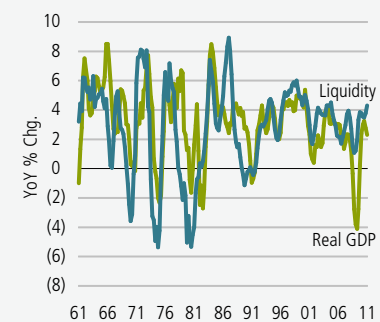
Display 1  
Economic Growth Falls Short of Estimates



As of March 2011  
Source: Bureau of Economic Analysis and Haver Analytics

Display 2  
Liquidity Flows Point to Stronger 2H

Money and Financial Flows vs. Real GDP Growth



As of March 2011  
Liquidity is 12-month moving average on year-over-year % change  
Source: Bureau of Economic Analysis and Haver Analytics

Although weakness in the housing sector wasn't surprising, the defense sector was an unexpected drag on economic growth in the first quarter. Defense spending contracted by 11.8% annualized in the first quarter, far below budget appropriations. Every March, the Bureau of Economic Analysis (BEA) prepares an estimate of government spending (defense and nondefense) based on the US budget.

Actual spending patterns often differ from initial projections because of timing and payment issues. In the first quarter, defense spending fell short of the BEA's estimates by \$20 billion, while in the second quarter, it's still running \$25 billion below estimates despite an annualized gain of over 6%.

It is still unclear whether the first-quarter defense spending shortfall was directly related to the late passage of the 2011 federal budget. In the second quarter, slow spending may have been caused by the delay in extending the Treasury's debt ceiling (i.e., the capacity to borrow). If defense spending has been suppressed because of technical delays, then we would expect a significant boost during the second half as the backlog of defense dollars is spent (**Display 3**).

### Consumer Spending Still Sluggish

In the private sector, business spending on equipment and software and merchandise exports both performed in line with our expectations in the first half. Real capital spending gains in the second quarter are likely to exceed the 8.7% annualized increase posted in the first quarter. Meanwhile, real merchandise exports rose by 10.1% annualized, and we expect a gain of about 8% for the second quarter.

On the other hand, consumer spending has been especially disappointing. At least half of the underperformance reflects the drop in car and truck sales as consumers pulled back on purchases when the supply of many popular models was constrained by production problems for vehicles

produced in the US and abroad, following the disaster in Japan.

### Second-Half Economic Outlook

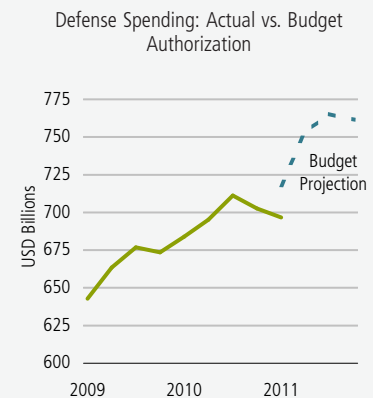
After a challenging first half, we remain bullish on economic growth for the last six months of the year, as we expect a strong rebound in motor vehicle production and continued robust gains in our proprietary liquidity index. Auto and truck production makes a direct impact on GDP, and our estimated gains are based on published industry production schedules through the end of September. The effect of liquidity growth on real GDP is perhaps less understood, but we believe the relationship is very robust.

Our liquidity index, also known as the money and financial flows index, was originally created by statisticians at the BEA. The index aims to capture the powerful cyclical patterns of real money and liquid balances, as their fluctuations tend to presage future spending trends. Throughout the postwar period, the liquidity index has proved to be an accurate predictor of future economic growth and spending, with an average lead time of six to nine months.

One reason that the liquidity index works is its breadth. It includes money balances as well as changes in business and consumer credit and other important financial instruments like commercial paper, which companies use to finance inventory positions. History clearly shows that when this index is rising, business and households are starting to make decisions to substantially increase investment or spending.

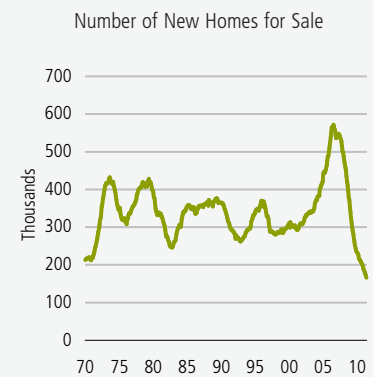
For businesses, that risk-taking process has been underway for some time, with capital spending advancing at a solid pace for the past 18 months. Indeed, real spending on capital equipment and software has increased 14% in the past year. Yet, for a sustained growth cycle to materialize, we need to see a broader pattern of investment and spending.

Display 3  
Defense Spending Poised to Rise Sharply



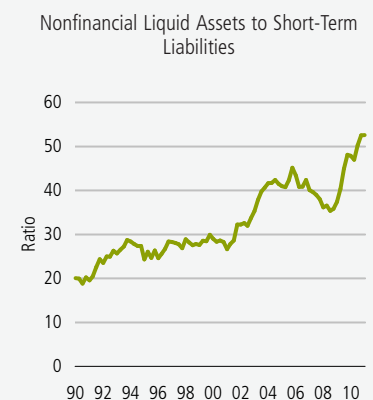
As of March 2011  
Source: Bureau of Economic Analysis and Haver Analytics

Display 4  
Low Level of Homes for Sale Offers Hope for Quick Construction Rebound



As of May 2011  
Source: Census Bureau and Haver Analytics

Display 5  
Cash-Rich Companies Are Poised to Invest and Hire



As of March 2011  
Source: Federal Reserve Board and Haver Analytics

Clearly, stronger growth requires more activity in the construction sector. Some segments of the nonresidential construction sector are rebounding, including oil and mining exploration. Yet other segments such as commercial and institutional buildings remain stagnant, according to the Architecture Billings survey for May.

### Hope for Housing Improvement

Residential construction (housing) also remains stuck in low gear, with the only bright spot an 8% rise in building permits in May. Recent stability in house prices (outside the distressed property segment) may help convince people that many regional US housing markets have bottomed, and offers some optimism for a slightly better residential outlook in the second half. In our view, it wouldn't take much to spark a modest rebound in housing activity, since the inventory of unsold new homes is at the lowest level in 50 years (Display 4, previous page).

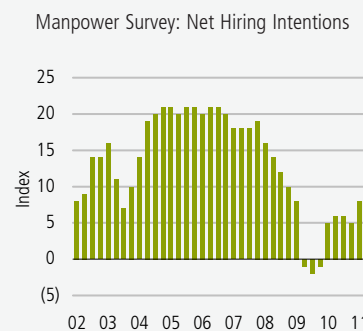
The stagnant housing market highlights that, for the current cycle to gain strength,

more balance is needed between the product and income sides of the GDP equation. In other words, strength in manufacturing, capital spending and exports must spill over to consumer spending and housing. Similarly, the US economy would benefit if resilient corporate operating profits led to stronger gains in jobs and wages. US companies have accumulated a record amount of cash (Display 5, previous page), and it is only a matter of time before they begin deploying their reserves for spending and hiring, in our view.

### Job Markets Are Crucial

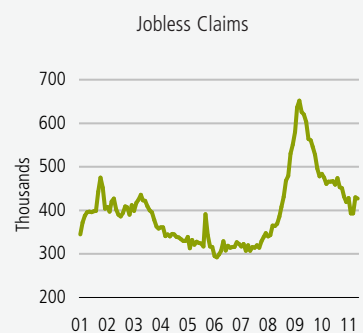
We're encouraged by recent news from labor markets, which indicates that slow and gradual progress is being made. Surveys show that companies continue to plan to hire more workers, while layoffs are slowing (Displays 6 and 7). As output improves and broadens during the third quarter, we're optimistic that more evidence of improvements in labor markets will appear to support our outlook for a pickup in the economic recovery during the rest of 2011. ■

Display 6  
Companies Are Preparing to Hire More



As of June 2011  
Source: Haver Analytics and Manpower

Display 7  
Layoffs Are Declining



As of May 2011  
Source: Department of Labor and Haver Analytics

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