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Global Investment Scenarios Service

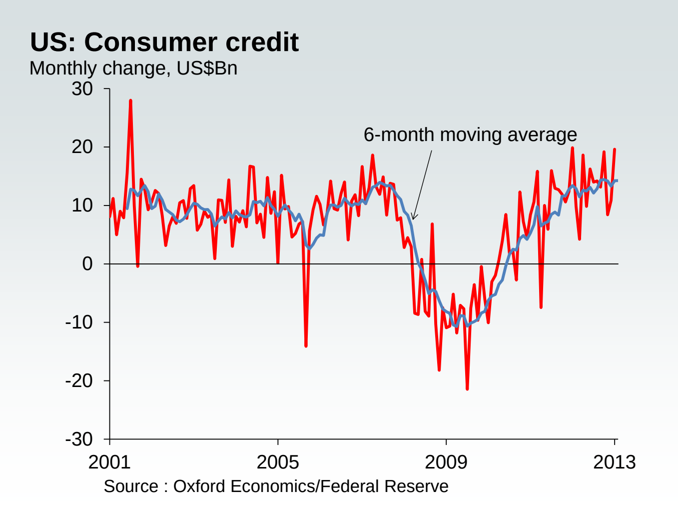
Economic alert

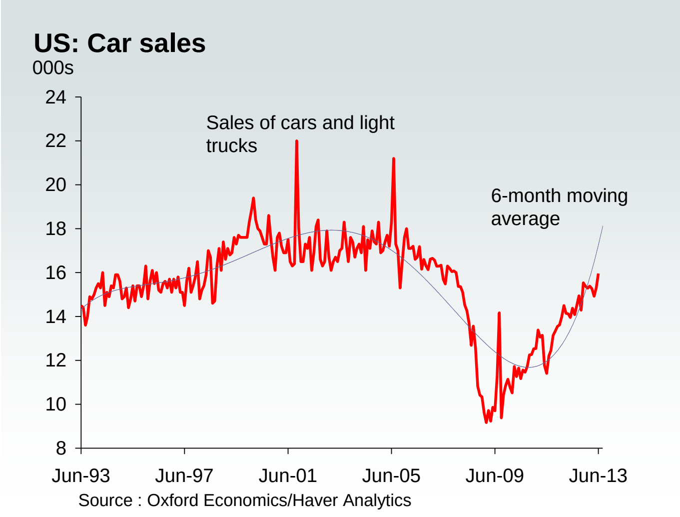
US recovery on track

Recent US data have been uneven. An improving manufacturing ISM survey was offset by non-manufacturing data being worse than expected. Last week a strong consumer credit number was balanced by weaker small business confidence. The US economy almost certainly went through a soft patch in Q2. However, on balance the recovery – unexciting as it has been – remains on track, with some possible further mileage to be had from equities. This is consistent with the recent dovish statement by Fed Chairman Bernanke, suggesting that the tapering of quantitative easing is still some way off.

Uneven data; strong consumer credit

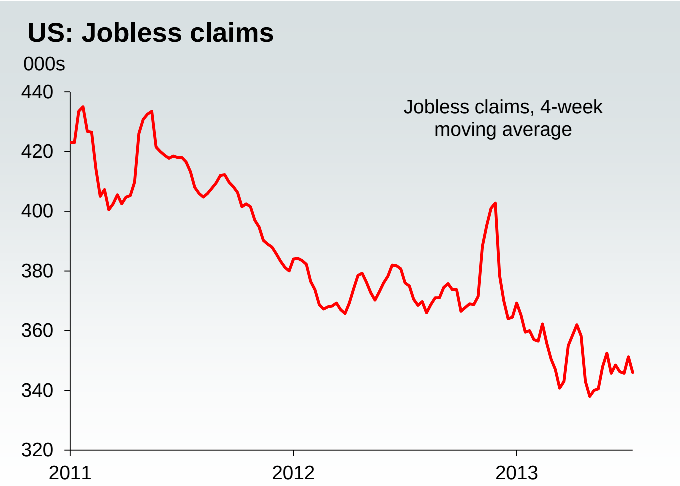
Recent US data releases have been erratic. The manufacturing ISM survey was somewhat stronger than expected, notably in new orders. But the non-manufacturing ISM index fell, where expectations were for a rise. Construction spending rose in May, but by less than expected; while car sales were the highest for over five years. Looking at some recent data, on 8 July the Federal Reserve published consumer credit numbers for May. The growth of consumer credit slowed for a third month, from 6.1% in the year to February to 5.8% in May. However, that is still higher than the 5.6% average over the last 12 months. Moreover, the actual rise in consumer credit – $19.5 billion – was the highest since May 2012 and the second highest since November 2001 (which was boosted by the 9/11 attack two months prior). The latest data may be somewhat distorted by changes to student loans; but, even so, they show that US households' appetite for some borrowing – and therefore also spending – remains intact. Rising car sales indicate where at least some of this borrowed money is going.



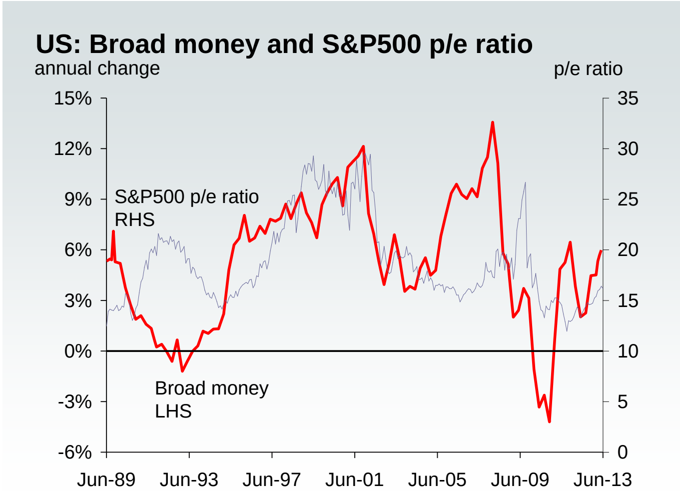


Small business confidence weaker

The healthy consumer credit number was balanced a day later by a weaker small business confidence report than expected from the National Federation of Independent Business (NFIB). NFIB confidence fell in June, having risen in both April and May. The latest number, 93.5, is up from 87.5 in November 2012; but the upward trend is feeble at best, and the number is lower than the fluctuations around 100 that used to be standard in the decades prior to 2007. Even here, however, there were some brighter spots; plans to increase employment and to expand are edging up and inventories are perceived as slightly below normal, which should boost output in coming months. And both nonfarm payrolls and jobless claims have been healthy.



Source: Oxford Economics/Haver Analytics



Source : Stein Brothers (UK), Oxford Economics/Haver Analytics

Fed confirms that it will be very careful about tapering

This mixed data set supports the relatively more dovish statements by Fed Chairman Bernanke recently. In essence, what the Mr Bernanke said – and has said all along – is that when and how the Fed tapers and ends quantitative easing will be determined by events and data; that there is no pre-set path; and that unemployment is still unacceptably high and inflation disconcertingly low.

Our baseline scenario forecasts that American unemployment will reach the Fed's 6.5% threshold by Q3 2015. If the 6.5% target is reached earlier, the Fed is likely to move faster towards not only ending QE but also beginning to normalise interest rates. But this would happen, by definition, in the context of a stronger recovery than we currently envisage. As a result, we do not think that earlier Fed action would hinder the recovery.

Equities still attractive

Although the Fed is still unhappy with US unemployment – and although it is clear that Q2 growth will have been weak – the overall outlook for the US economy remains benign. While uneven, recent data confirm that the recovery – unexciting as it is, particularly in comparison with previous cycles – remains in place. This strengthens our view that US Treasuries are no longer an attractive asset, nor will be for some years to come. But what about equities? They have had a good run since November 2012, even allowing for set-backs. However, monetary developments imply that this is set to continue. There is (unsurprisingly) a reasonable relationship between developments in broad money and asset prices.[1] Although subject to variable lags, 12-month broad money growth tends to lead the S&P500 p/e ratio trend by about a year. At the moment, the p/e ratio is at the lower range of the 15-20% band it has moved in for the past few decades. The broad money numbers imply that it still has some way to rise.

Watch out for…

- Weekly Federal Reserve money and credit numbers
- Labour market data, notably weekly jobless claims

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[1] 'Broad money' refers to the recreation by Stein Brothers (UK) of the M3 measure that the Federal Reserve ceased to publish in March 2006.