US ECONOMICS WEEKLY

11th Jan. 2016

CAPITAL ECONOMICS

Editor: Paul Ashworth

Is the US economy heading for a recession?

- The latest incoming monthly data suggest that fourth-quarter GDP growth slowed to between 1.0% and 1.5% annualised. Added to the widening in corporate credit spreads, the renewed weakness in stock markets and the news that the ISM manufacturing index fell further below the 50 mark in December, the downward revisions to GDP estimates triggered yet another round of speculation that the US economy is plummeting into recession. As the massive surge in employment in December illustrated, however, it isn't.
- **Rather than dying of old age or at the hands of some external shock, most recoveries are killed by the Fed. But in this case the Fed hasn't even begun to sharpen the axe**. The real fed funds rate is still negative, suggesting that monetary policy is unusually accommodative. In contrast, every post-war recession was preceded by a rise in the real fed funds rate to 2% or higher. (See pages 2-4.)
- Anyone hoping that this week's data releases will trigger a rebound in sentiment in the markets is in for a nasty surprise. December's retail sales and industrial production and January's consumer confidence are all likely to be grim. The already reported drop back in unit sales of motor vehicles points to a sizeable decline in retail sales, although the record high temperatures may have boosted underlying sales. The weather will have been a drag on industrial production, however, with a drop off in heating demand driving a big decline in utilities output. Finally, there is a good chance that the latest bout of stock market weakness will undermine consumer confidence.

Data Previews (pages 5-6)

Retail Sales (Fri. 15th Jan.) – *Hit from lower auto sales and gas prices*

Industrial Production (Fri. 15th Jan.) – *Utilities and mining act as drag again*

UoM Consumer Confidence (Fri. 15th Jan.) – *Stock market slump weighs on confidence*

Economic & Market Data (page 7)

Economic Diary & Forecasts (page 8)

North America
400 Madison Avenue, Suite 6C
New York
Tel: +1 646 934 6162

2 Bloor Street West, Suite 1740
Toronto
Tel: +1 416 413 0428

Europe
150 Buckingham Palace Road
London
Tel: +44 (0)20 7823 5000

Asia
16 Collyer Quay, Suite 26-03
Singapore
Tel: +65 6595 5190

225 George Street, Suite 29-08
Sydney
Tel: +61 2 9083 6800

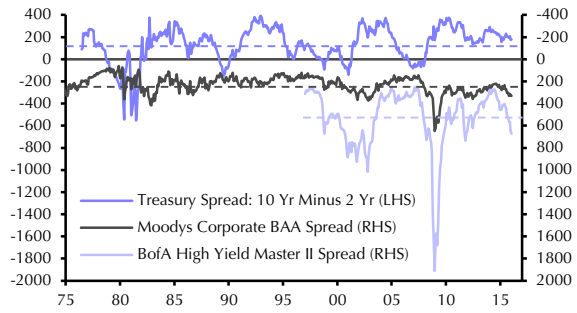
Executive Chairman — Roger Bootle (roger.bootle@capitaleconomics.com)
Chief US Economist — Paul Ashworth (paul.ashworth@capitaleconomics.com)
US Economist — Steve Murphy (Stephen.murphy@capitaleconomics.com)

Is the US economy heading for a recession?

The latest incoming data suggest that fourth-quarter GDP growth slowed to between 1.0% and 1.5% annualised. Added to the widening in corporate credit spreads, the renewed weakness in stock markets and the news that the ISM manufacturing index fell further below the 50 mark in December, that data triggered renewed speculation that the US economy is plummeting into recession. As the massive gains in employment over the final three months of last year illustrate, however, the US economy is doing just fine.

The surge in the spread between yields on junk bonds and Treasury securities is a mild concern. But the spread is only slightly bigger than its historical average and it is well below the levels reached during the past two recessions. (See Chart 1.) The same pattern holds for investment grade corporate bonds: The spread is now slightly bigger than the historical average, but only just.

CHART 1: TREASURY & CORPORATE BOND SPREADS (BASIS PTS)



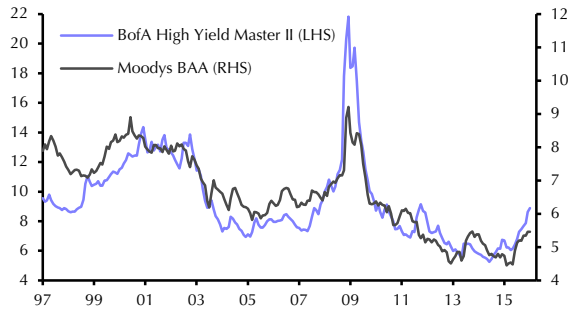
Source – Thomson Datastream

Moreover, while an increase in corporate bond spreads has often coincided with recessions, its track record as a *leading* indicator of the business cycle is patchy at best. The spread has produced plenty of false positives over the past few decades; with an increase not being followed by a recession. The same can be said of the stock market which, as Paul Samuelson famously quipped, has predicted nine of the past five recessions.

As far as financial indicators are concerned, the Treasury yield curve, particularly the 10-2 spread, has historically proven to be a much more reliable leading indicator of turning points in the business cycle. Over the past 60 years, every inversion of that curve has been followed by a recession within the next one to two years. In that time there has been only one false positive (1998). As it stands now, not only is the yield curve positive sloping, but the spread is above its long-term average and, at close to 180 basis points, is a long way from inverting. In other words, the risk of a recession is low.

Furthermore, although corporate bond yields have rebounded, the rise in the spread is also because, partly spurred by three rounds of asset purchases from the Fed, Treasury yields remain unusually low. Investment grade corporate bond yields remain low relative to the long-run average and, while junk bond yields are a little higher relative to historical norms, the recent surge has been focused mainly in the energy sector. This isn't going to have a knock-on impact on the real economy because, regardless of the cost of borrowing, energy firms weren't going to be investing when crude oil is $30 a barrel anyway.

CHART 2: CORPORATE BOND YIELDS (%)

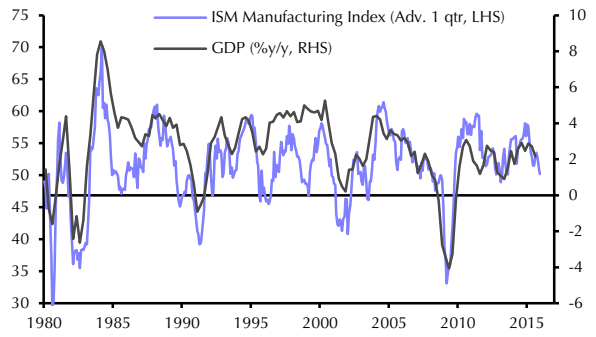


Source – Thomson Datastream

The drop in the ISM manufacturing index to 48.2 in December left it even further below the 50 mark which, in theory, is supposed to separate expansion from contraction. As Chart 3 shows, however, during past recessions in the broader economy the ISM manufacturing index fell to 46 or lower. Furthermore, during times when the dollar was rising rapidly, in particular the mid-1980s and the late 1990s, the ISM

index plummeted well below the 50 mark without any corresponding slowdown in overall GDP growth. This is not surprising since the manufacturing sector is much more export orientated than the domestically focused services sectors. The same divergence is opening up now, with the manufacturing sector getting pummeled by the stronger dollar while the much bigger services sectors appear to be holding up well.

CHART 3: GDP & ISM MANUFACTURING INDEX

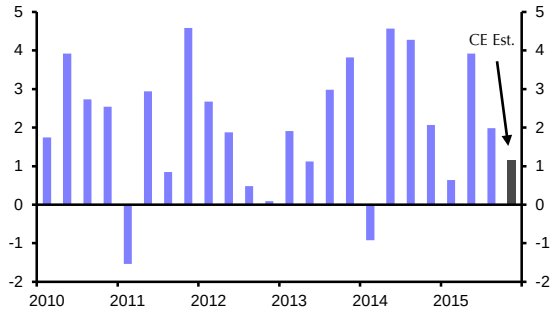


Source – Thomson Datastream

With respect to the slowdown in GDP growth in the fourth quarter, there is no reason to believe that this is the start of a more serious downturn. Quarterly GDP is by nature volatile and even within the past few years we have seen negative or near-negative growth in early 2011, late 2012, early 2014 and early 2015. (See Chart 4.) In each case, those slowdowns were accompanied by claims that the economy was plummeting unavoidably into recession, only for GDP growth to then accelerate again. The ECRI's infamous double-dip recession call in September 2011 is our particular favourite, because it was immediately followed by a near 5% annualised gain in GDP in the final quarter of that year.

In an economy where potential GDP growth is now probably nearer 2%, rather than the 3% post-war average, there will be more times when GDP growth drops below 1%. Bears often make the case that any dip below 1% means the economy has fallen below "stall speed" and a recession becomes inevitable, but the experience of the past few years suggests that view is nonsense.

CHART 4: REAL GDP (%Q/Q ANNUALISED)



Source – Thomson Datastream

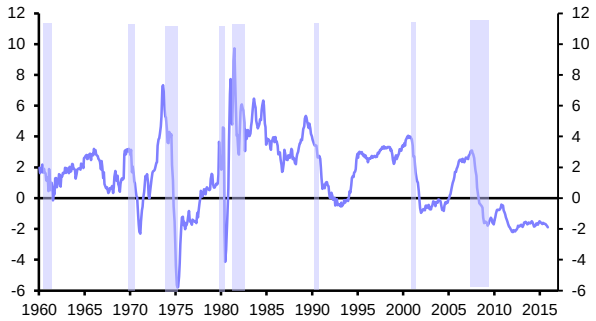
As we argued in our *US Economics Focus* "Did the US recovery just die without warning?", sent to clients in May 2015, recoveries don't just die for no reason, at least not in their early stages when there is still plenty of slack in labour and product markets. Yes, mature recoveries often fall under their own weight. But there are normally obvious signs of bloating in mature economic expansions, with tight labour markets leading to high wage growth and price inflation. Crucially, the latter forces the central bank to push real interest rates up sharply, which hits rate-sensitive spending.

We have reached the point where the US economy is close to full employment. But the important difference is that we have not yet seen any acceleration in price and wage growth and, consequently, monetary policy has remained unusually accommodative. That won't change any time soon. The Fed has stressed repeatedly that it intends to raise interest rates only very gradually and, even when it has met its full employment and price stability goals, it anticipates that the fed funds rate will still be well below its long-run equilibrium level.

In real terms, the fed funds rate is still deep in negative territory. In contrast, every post-war recession has been preceded by a rise in the real interest rate to at least 2% (i.e. monetary policy was tight.) (See Chart 4.) **So it is true that rather than dying of old age, most recoveries are killed by the Fed. But in this case the Fed hasn't even begun to sharpen the axe**.

Even in our more hawkish scenario in which rising inflation forces the Fed to raise interest rates more aggressively this year, the real interest rate remains below zero until early 2017. Admittedly, the real equilibrium interest rate is lower than it used to be, but most estimates put the short-term rate at zero and the long-term rate at above 1%. So, even allowing for that decline in the equilibrium rate, policy will remain accommodative rather than restrictive for the foreseeable future.

CHART 4: REAL FED FUNDS RATE (%)



Source – Thomson Datastream

Relatively youthful economic expansions can still be derailed if there is a sufficiently big external shock. But to torpedo the world's largest economy, which is relatively closed and service-based, it would have to be a very big shock. We don't think China falls into the category of a US recovery killer. For a start, the latest data suggest China's economic growth has stabilised and there is little evidence of any collapse. Even if China did suffer a financial and economic collapse, the trade a financial links with the US are relatively modest. Exports to China account for only 1% of GDP.

Nevertheless, while developments in China won't tip the US economy into recession, they do have the scope to alter the path of US interest rates. The Fed has shown itself to be unusually sensitive to movements in stock markets. Accordingly, if last week's slump in US equities is sustained, it might affect the chances of a March rate hike, even if employment growth remains strong. Similarly, the latest declines in crude oil prices, if sustained, might persuade the Fed that last year's big deflationary pressure from lower commodity prices has longer to run.

Paul Ashworth

Data Preview – Retail Sales (Dec.) 08.30 Fri. 15th Jan.

Forecasts	Previous	Median	Capital Economics
Retail Sales	+0.2%	+0.1%	-1.0%
Core Retail Sales (Less Autos)	+0.4%	+0.4%	0.0%

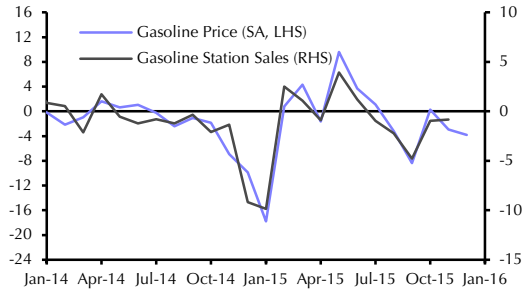
Hit from lower auto sales and fuel prices

Our calculations indicate that retail sales declined by 1.0% m/m in December, as motor vehicle sales fell sharply and a drop in gasoline prices lowered the value of gasoline station sales.

On a seasonally adjusted basis, gasoline prices fell by 3.8% m/m last month, which should translate into a 2.5% m/m decline in gasoline station sales. (See Chart 1.) Unfortunately, despite the lower fuel prices, unit sales data from auto manufacturers point to a 4.5% m/m decline in motor vehicle sales.

Stripping out autos, gasoline and building permits, we anticipate that control group sales advanced by 0.3% m/m in December. The weather could be the wildcard. Thanks to the late onset of winter in the Northeast, last December the warmest on record even at the national level. We wouldn't be surprised if weather-sensitive spending components such as building materials or restaurant sales got a boost.

CHART 1: GASOLINE PRICE & STATION SALES (%M/M)



Source – Thomson Datastream

Data Preview – Industrial Production (Dec.) 09.15 Fri. 15th Jan.

Forecasts	Previous	Median	Capital Economics
Industrial Production	-0.6%	-0.2%	-0.6%
Manufacturing Output	0.0%	-0.1%	0.0%

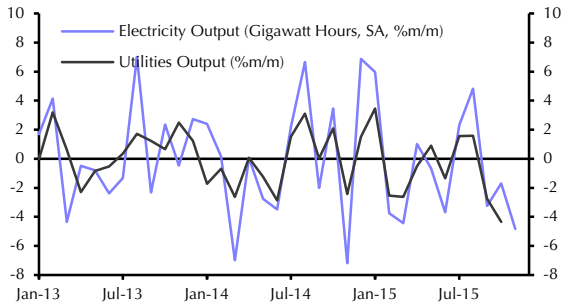
Utilities and mining act as drag again

We expect to learn this week that industrial production fell by 0.6% m/m last month, as a weather-related drop in utilities output and weaker drilling activity weighed on activity.

The weekly electricity generation figures suggest that utilities output fell by as much as 5% last month, as record high temperatures in the Northeast held down the demand for heating. (See Chart 2.) Elsewhere, a big decline in drilling activity points to a 0.6% m/m drop in mining output.

Finally, the latest activity survey measures suggest that manufacturing output was unchanged last month suggesting that the factory sector is flirting with recession. Given the strength of the dollar, we don't expect any meaningful improvement for quite some time.

CHART 2: UTILITIES OUTPUT (%M/M)



Source – Thomson Datastream

Data Preview – Uni. of Mich. Consumer Confidence (Jan.) 10.00 Fri. 15th Jan.

Forecast	Previous	Median	Capital Economics
Headline (provisional estimate)	92.6	93.0	91.5

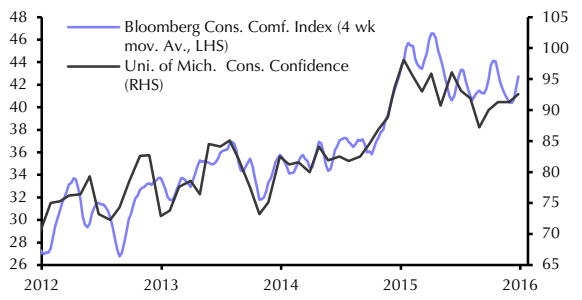
Stock market slump weighs on confidence

We expect to learn this week that the University of Michigan consumer confidence index fell slightly in January, as the latest slump in equity prices weighed on consumer sentiment.

Admittedly, some of the timelier measures of confidence, such as the one published by Bloomberg, have edged up in recent weeks (See Chart 1.) However, these surveys pre-date the most recent sharp drop in equity prices. In contrast, the survey period for the University of Michigan index began on December 30th and would have fully captured those developments.

We also doubt the trivial decline in gasoline prices over the past week provided enough of an offset to the 2.6% decline in the S&P500. Accordingly, we have pencilled in a decline in the headline index to 91.5, from 92.6.

CHART 1: CONSUMER CONFIDENCE INDICES



Sources – Thomson Datastream

Latest Data & Main Forecasts

Latest US Economic Indicators

Monthly Indicators %m/m(%y/y) unless stated	Sep	Oct	Nov	Dec
Consumer Prices	-0.2%(0.0%)	+0.2%(+0.2%)	0.0%(+0.5%)	-
Core Consumer Prices (Excluding Food & Energy)	+0.2%(+1.9%)	+0.2%(+1.9%)	+0.2%(+2.0%)	-
Core PCE Deflator (Excluding Food & Energy)	+0.2%(+1.3%)	0.0%(+1.3%)	-	-
Producer Prices	-0.5%(-1.1%)	-0.4%(-1.6%)	+0.3%(-1.1%)	-
Change in Non-Farm Payrolls	+145,000	+307,000	+252,000	+292,000
Unemployment Rate (%)	5.1%	5.0%	5.0%	5.0%
Average Hourly Earnings	0.0%(+2.3%)	+0.4%(+2.5%)	+0.2%(+2.3%)	0.0%(+2.5%)
ISM Manufacturing Index	50.2	50.1	48.6	48.2
Industrial Production	-0.2%	-0.2%	-0.6%	-
Retail Sales	+0.1%	+0.1%	+0.2%	-
Core Retail Sales (Excluding Autos)	-0.5%	+0.2%	+0.4%	-
Uni. of Michigan Consumer Confidence Index	87.2	90.0	91.3	92.6
International Trade Balance ($bn)	-42.5	-44.6	-42.4	-
House Prices (Case-Shiller, s.a.)	+0.8%(+4.9%)	+0.9%(+5.2%)	-	-
Quarterly Indicators %q/q ann(%y/y) unless stated	**Q4 2014**	**Q1 2015**	**Q2 2015**	**Q3 2015**
GDP	+2.1%	+0.6%	+3.9%	+2.1%
Consumption	+4.3%	+1.8%	+3.6%	+3.0%
Productivity, Non-Farm	-2.2%	-1.1%	+3.3%	+2.2%
Current Account ($bn, as a % of GDP)	-103.1(-2.3%)	-118.3(-2.7%)	-111.1(-2.5%)	-124.1(-2.7%)

Latest Market Data*

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate		1 mth ago	1 week ago	Latest*
Official Rates	US	0-0.25	0.25-0.5	0.25-0.5	Global Yields	Euro 10yr	0.54	0.63	0.52
	ECB	0.05	0.05	0.05		Japan 10yr	0.32	0.27	0.23
	Japan	0-0.10	0-0.10	0-0.10		Canada 10yr	1.41	1.39	1.34
	Canada	0.50	0.50	0.50	Equity Indices	S&P 500	2012	2044	1943
Fed Funds Futures	Dec 2015	0.22	0.24	0.24		NASDAQ	4933	5007	4735
	Dec 2016	0.77	0.89	0.77		DJIA	17265	17425	16589
	Dec 2017	1.28	1.43	1.22	Currencies	$/€	1.10	1.09	1.09
Treasury Yields	2yr	0.88	1.05	0.96		¥/$	120.8	120.4	118.2
	10yr	2.13	2.27	2.17		$ Broad TWI	122.4	123.0	123.0
Inflation-indexed	10yr	0.65	0.70	0.65	Oil Price	Brent ($pb)	37.9	37.3	33.8
Corporate Bond (BAA)		5.37	5.50	5.44	Gold ($/oz)		1075	1061	1101

*Latest as at 08.30 EST 8th January 2015

Main Economic & Market Forecasts

%q/q ann. (%y/y) unless stated	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	2015	2016	2017
GDP	+0.6	+3.9	+2.1	+125	+2.6	+2.6	(+2.4)	(+2.5)	(+2.0)
CPI Inflation	(-0.1)	(0.0)	(+0.1)	(+0.6)	(+1.9)	(+2.1)	(+0.2)	(+2.1)	(+2.6)
Core CPI Inflation	(+1.7)	(+1.8)	(+1.8)	(+2.0)	(+2.1)	(+2.2)	(+1.8)	(+2.3)	(+2.7)
Unemployment Rate (%), Period Ave.	5.6	5.4	5.2	5.0	4.9	4.8	5.3	4.8	4.5
Fed Funds Rate, End Period (%)	0-0.25	0-0.25	0-0.25	0.25-0.5	0.5-0.75	0.75-1.0	0-0.25	1.75-2.0	3.25-3.5
10yr Treasury Yield, End Period (%)	2.00	2.10	2.20	2.50	2.70	2.80	2.50	3.00	3.50
S&P 500, End Period	2090	2063	2000	2100	2125	2150	2100	2200	2300
$/€, End Period	1.05	1.13	1.10	1.05	1.03	1.00	1.05	0.95	1.00
¥/$, End Period	120	122	125	130	132	135	130	140	1.40

Economic Diary & Forecasts

UNITED STATES

Date	Country	Release/Indicator/Event	Time EST	Time (GMT)	Previous*	Median*	CE Forecast*
Mon 11th	US	No Significant Data Released	-	-	-	-	-
Tue 12th	US	NFIB Small Business Optimism Ind. (Dec)	06.00	(11.00)	94.8	95.1	95.0
	US	JOLTS Job Openings Rate (Nov)	10.00	(15.00)	3.6%	-	-
Wed 13th	US	Monthly Budget Statement (Dec)	14.00	(19.00)	-$1.9bn	-$2.7bn	-
	US	Fed's Beige Book (Jan)	14.00	(19.00)	-	-	-
Thu 14th	US	Import Prices (Dec)	08.30	(13.30)	-0.4%(-9.4%)	-1.4%(-8.6%)	-
	US	Initial Jobless Claims (9th Jan.)	08.30	(13.30)	277,000	275,000	-
Fri 15th	US	Retail Sales (Dec)	08.30	(13.30)	+0.2%	+0.1%	-1.0%
	US	Core Retail Sales (Dec)	08.30	(13.30)	+0.4%	+0.2%	0.0%
	US	Retail Sales Control Group (Dec)	08.30	(13.30)	+0.6%	+0.3%	+0.3%
	US	Producer Prices (Dec)	08.30	(13.30)	+0.3%(-1.1%)	-0.1%(-1.0%)	-0.1%(-1.0%)
	US	Core Producer Prices (Dec)	08.30	(13.30)	+0.3%(+0.5%)	+0.1%(+0.3%)	+0.1%(+0.3%)
	US	Empire State Manufacturing Index (Jan)	08.30	(13.30)	-4.6	-4.0	-5.0
	US	Industrial Production (Dec)	09.15	(14.15)	-0.6%	-0.2%	-0.6%
	US	Manufacturing Output (Dec)	09.15	(14.15)	0.0%	-0.1%	0.0%
	US	Capacity Utilisation (Dec)	09.15	(14.15)	77.0%	76.8%	76.6%
	US	Business Inventories (Nov)	10.00	(15.00)	0.0%	0.0%	-0.3%
	US	Uni. of Mich. Consumer Conf. (Jan, Prov.)	10.00	(15.00)	92.6	93.0	91.5

*m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
20th Jan	Housing Starts (Dec)	22nd Jan	Existing Home Sales (Dec)
20th Jan	Consumer Prices (Dec)	27th Jan	Fed Policy Announcement

Selected Recent Publications

Date	Publication	Title
Mon 4th	Capital Daily	-
	Japan Economics Update	Economy should have continued to recover in Q4
	Commodities Update	Bad news from China kicks off an unhappy New Year
	Global Markets Update	Will commodities be top of the flops again in 2016?
	European Economics Update	Euro-zone Fiscal Monitor (Dec.)
	Energy Update	Saudi-Iran tensions unlikely to provide lasting boost to oil prices
	US Data Response	ISM Manufacturing Index (Dec.)
	Commodities Economics Chart Book	A mixed December closes a bleak year for commodities
	US Employment Report Preview	Jump in wage growth not all due to base effects
	Emerging Markets Economics Update	EM Markets tumble but PMIs relatively reassuring
Tue 5th	Capital Daily	Does the latest slide in EM equities set the tone for 2016?
	Emerging Asia Focus	Can Thailand move out of the slow lane?
	US Housing Market Data Response	CoreLogic House Prices (Nov.)
	European Chart Book	A year of zero inflation
	Precious Metals Update	Gold price to rally in 2016 despite US headwinds
	Emerging Markets Market Valuation Monitor	Valuations set stage for outperformance of EM equities
Wed 6th	Capital Daily	Should we be alarmed by the rise in US corporate credit spreads?
	Australia Economics Update	LNG to the rescue?
	Africa Economics Update	Nigeria: Devaluation inevitable, delays only lengthen the pain
	Industrial Metals Chart Book	A bit of a breather in December
	Global Markets Update	What to make of renewed intervention in China
	China Watch	When might things improve?
	US Housing Market Data Response	Mortgage Applications (Dec.)
	US Data Response	Internat'l Trade (Nov.) & ISM Non-Manu. (Dec.)
	Energy Data Response	US Weekly Petroleum Status Report
	UK Economics Chart Book	Recovery loses its vigour in 2015
Thu 7th	Capital Daily	Authorities in China back on the defensive
	European Economics Update	Will the Riksbank put its money where its mouth is?
	Global Markets Update	On the link between US economic, equity and credit cycles
	Global Economics Chart Book	Renewed worries about China look overdone
	Global Markets Update	Is the sell-off in EM equities really justified?
	UK MPC Watch	Will 2016 be the year when interest rates finally rise?
Fri 8th	Capital Daily	Oil prices to recover, but $100 shouldn't be seen again this decade
	Australia & NZ Weekly	China concerns wash away New Year cheer
	Emerging Asia Economics Weekly	Elections in 2016 – what they mean for Asia
	Japan Economics Weekly	How will the Bank of Japan react to cheaper oil?
	UK Economics Weekly	
	European Economics Weekly	
	Canada Economics Weekly	
	US Economics Weekly	

For copies of any of these reports, please call +44 (0)20 7823 5000 or e-mail publications@capitaleconomics.com