



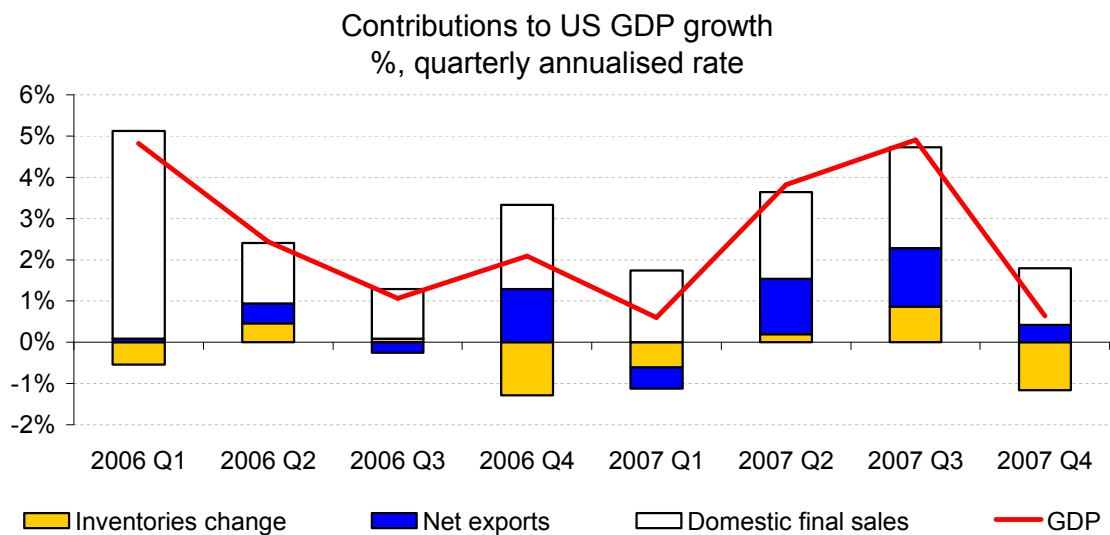
Daily Note: 30 January 2008

No US recession yet – but likely in Q1

WE SUGGEST: Fed will cut interest rates – markets will want more at once

SUMMARY: The US economy was not in recession in Q4 (unless the 0.6% growth figure gets revised down to a negative number). But the momentum into 2008 is distinctly weakening. Corporate investment is unlikely to hold up unless either Americans or foreigners buy its goods – and both household spending and export growth slowed in the quarter. But households are still not saving, which means the fiscal stimulus could increase spending, instead of just being saved.

So the US economy was not in a recession in Q4. Output grew – but only by \$4.6bn (\$18.5bn annualised rate). Since this was only the advance estimate, it wouldn't take much revision to show that the 0.6% headline growth rate (again, annualised, in other words 0.15% in the quarter) actually was a fall. More importantly, however, entering 2008 on a downward trajectory as sharp as this with the economy still losing momentum, almost guarantees contracting GDP in the current quarter.



As usual, there are a large number of points that deserve to be made on the numbers. The drag from inventories was substantial. This is significant in view of yesterday's durable goods orders release, which showed a build-up of inventories in December. But the weakness of equipment and software investment in the quarter implies that this was an involuntary build-up. If so, inventories are likely to continue to be drawn down in the current quarter. Although non-residential structural investment held up reasonably well (slowing to 7.5% growth in the quarter from 9.3% in the previous quarter), there must be a question mark over how long companies will continue to invest in the face of weaker domestic demand. This is even more true in that export growth slowed, admittedly from a surge in Q3, but still to a three-quarter low of 3.9% – in spite of the weaker dollar. The contribution to growth from net exports dropped to 0.4%

Most importantly, personal consumption growth slowed from 2.8% to 2%. While the number has been weaker recently – specifically, in 2007 Q2 and in 2005 Q4 – this is well below the 2.5% average growth over the past year and the 2.9% average growth over the past three years. At that, even this weaker number was only attainable through a sharp slowdown in the household savings rate, from 0.6% to 0.2%. But income growth also slowed in the quarter. The implication is that, unless income growth picks up in the current quarter – which seems unlikely – it will be difficult to maintain even this weaker pace of consumer spending. Of course, the conclusion is also that US households still have not reached the end of their willingness to spend, which in one sense is good news, as it implies that a fiscal stimulus based on tax rebate cheques actually will work. In other words, the cheques are likely to get spent, rather than saved or used to pay down debt.

On the more negative side, residential investment dropped by 23.9%, the biggest fall since 1981. Given that there is so far no end in sight for the housing market's woes, this will remain a drag on growth for further quarters.

The FOMC is currently winding down its two-day meeting. It seems almost certain that it has already decided to cut the Fed Funds rate again. If so, the cut is more likely to be 50bps than 25. First, because this fits in with the stance of the Fed, to implement larger changes and then gauge the effects; and second because a cut of 25bps in the wake of the 75bp cut last week would be perceived as wholly irrelevant. By cutting interest rates today, the Fed could also attempt to dispel the notion that last week's cut was a panic move – although in our view, that is exactly what it was. But watch markets: 50bps are already expected. If there is nothing more, there will be a day or so of positive reaction; then markets will begin to clamour for more. By giving in last week – possibly spooked by market falls initiated as Société Générale started to cover its trades – the Fed has shown that the Greenspan put seemingly has survived Mr Greenspan's retirement. That is a very risky policy.

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