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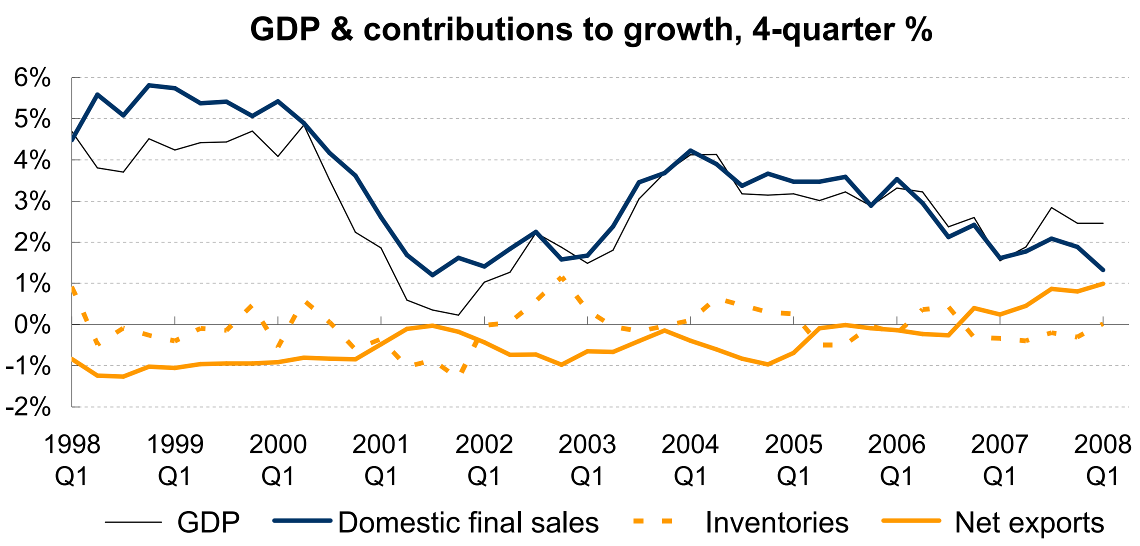
US + China => oil spike partly cyclical

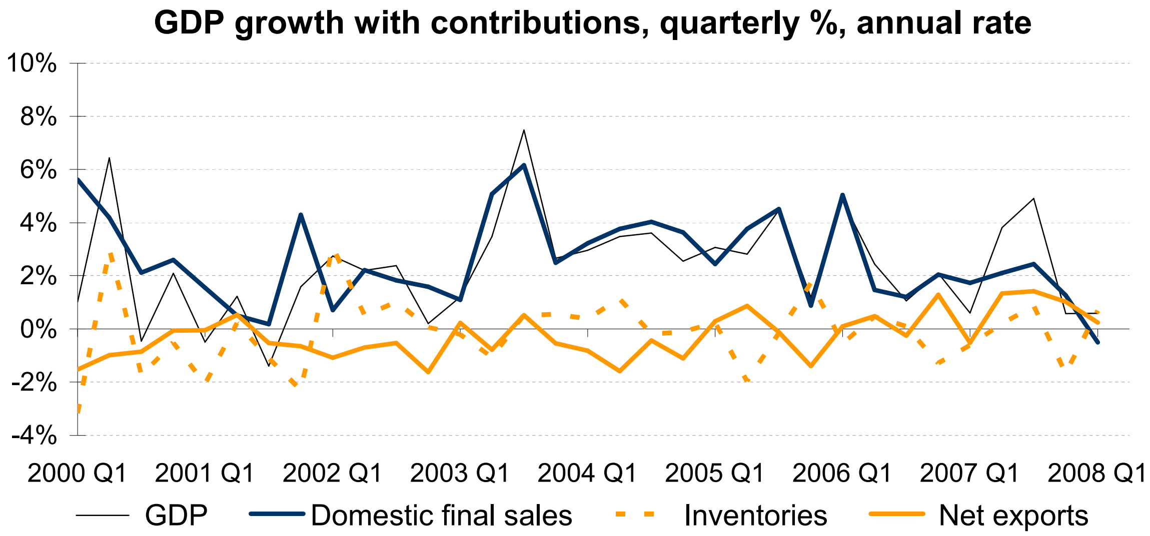
WE SUGGEST: What goes up cyclically, goes down cyclically

SUMMARY: The world economy was growing at above its 4% trend rate up to and probably including Q1. This gives a strong cyclical element in high oil prices. The 0.6% US growth of the past two quarters may well not give way to serious recession, but equally any signs of buoyancy, or sustained consumer spending in the face of fast worsening balance sheets, are likely to be smothered by rising bond yields.

The US, China, the other Asian Tigers and India between them contribute three fifths of the world's trend growth at purchasing power parity, and even more to its cyclical variance. Of this 60% (59% actually) the US is a quarter (15%) and the Asian three quarters (44%) with China alone nearly half at 27%. China's Q1 GDP data may have given 10.6% as its real 4-quarter GDP growth, but as our note showed, with nominal growth of 23% and inflation at the GDP level probably 5%, the true number could have been 16-17% – two thirds higher than the trend rate of just under 10%.



Today's US GDP data show 4-quarter growth of 2.5%, which is scarcely below trend – the two recent quarters at 0.6% followed strong mid-2007 quarters. The world at large then was far above trend in growth, considering India has also been growing at 9%. The much lower US growth rate in the two recent quarters may be partly offset by apparent Chinese growth acceleration. Strong oil prices clearly owe much to long-term demand and (perhaps especially) supply factors, speculative activity in the futures and geopolitical risks. But these GDP data suggest an element of simple cyclical peak.



But is it a cyclical peak? Our forecast says "Yes for the US" and "Eventually Yes for China". A mounting reason for expecting the US downswing to persist is negative feedback from the oil prices, with gasoline now averaging $3.65 a gallon, over 10% clear of the peak in previous upswings. Gasoline alone is 5% of the CPI. Household balance sheets – both excessive debt, and now plunging home values – probably remain a deeper reason. Tax rebates may soften the blow for a short while, but when food, fuel and homes are sources of trouble, consumers are likely to remain subdued. It is fairly amazing that real consumer spending has held up so well (positive in Q1) though that is entirely in service spending that may be "over-measured" at an economic turning-point and revised later. Household borrowing has remained buoyant and the savings rate low. If this manages to persist, against all the head-winds, the bond market will soon get the message, and the acceleration of inflation will translate into yields that could make the recent Treasury bear-patch look very mild. In that case the economic downswing will be long, more than strong.

The Q1 data saw falling domestic final sales, despite consumer spending, as the housing slump was reinforced by a swing downwards of business cap-ex. Exports were only moderately strong, despite rapid Asian growth, and could weaken later this year as Europe slows, followed by Asia. The modestly positive inventory contribution fed back into some import growth so net exports were negligible. A mild inventory overhang could offset a mild propensity to spend the tax rebates (rather than pay down debt) so more of the same looks on the cards for the rest of 2008: teetering on the brink of recession, but with the major problem being the absence of any motor for recovery.

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