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RODNEY'S RAVINGS

Could the US economy be starting to heal itself?

EXECUTIVE SUMMARY

In the last Raving on the US economy I focused on the risk of a significant slowdown in US economic growth led by the housing market (see http://sra.co.nz/pdf/USEconomy.pdf). The housing menace remains in play and reflects some of the rot still at the core of the Big Apple.

I am dubious of whether the second round of quantitative easing announced by the Fed on 4 November will work as intended. But there is much more to US economic growth prospects, especially from a medium-term to longer-term perspective than the housing market, the financial crisis or quantitative easing.

There are already signs that the US economy is starting to heal itself, helped significantly at the moment by the low or competitive USD. The low USD may be partly a by-product of quantitative easing but more generally reflects the normal market response to an economy in trouble. The implications of the low USD are far larger and will ultimately be more positive than most commentators have contemplated. Adam Smith's "invisible hand" of capitalism will also already be at work in the US and will ultimately play a major part in restoring economic growth. Even from the ranks of the unemployed will come some new innovators and entrepreneurs who will play a part in driving the eventual return to sustained economic growth in the US.

My proof reader is away today so a higher than normal typo quota is inevitable in this Raving, but this hopefully won't detract from the insights it offers.

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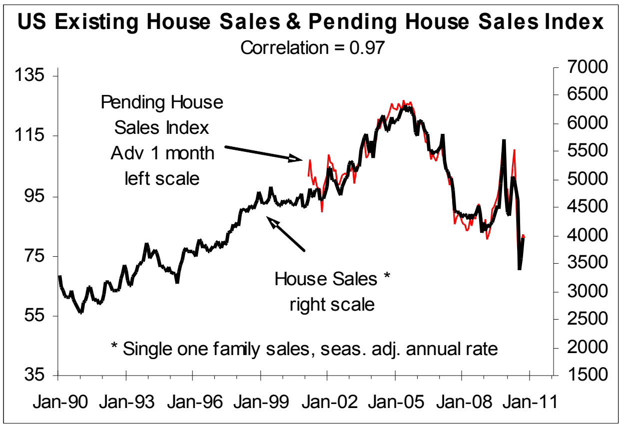
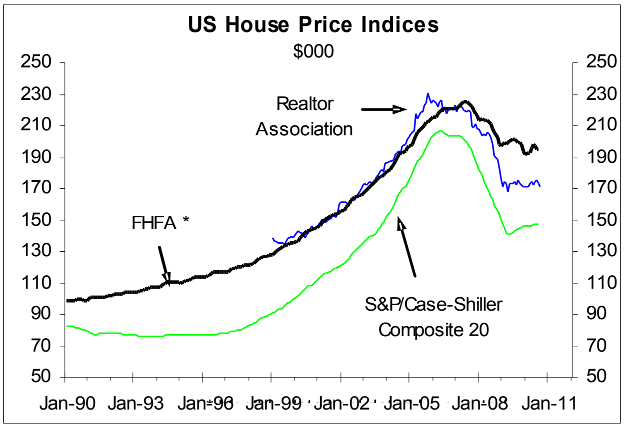
Revisiting the US housing market

In the months since the tax incentives for home buyers ended, the number of existing house sales has fallen to the lowest level since the financial crisis began (left chart). The tax incentives significantly boosted the number of sales between late-2009 and mid-2010 and this stimulus to demand halted the fall in US house prices (right chart). The right chart shows three measures of US house prices, all of which have largely stabilised in response to the tax-incentive-driven boost in demand. But where the number of house sales goes, house prices generally follow a few months later.

The fall in the number of sales in the left chart only started in earnest in July, while two of the three house price measures are only updated to August at the moment, the other to September. Given the time it takes for changes in demand to impact on prices it is too early for the fall in the number of sales to be reflected in these price measures, but there is clear and present danger of falling US house prices ahead.

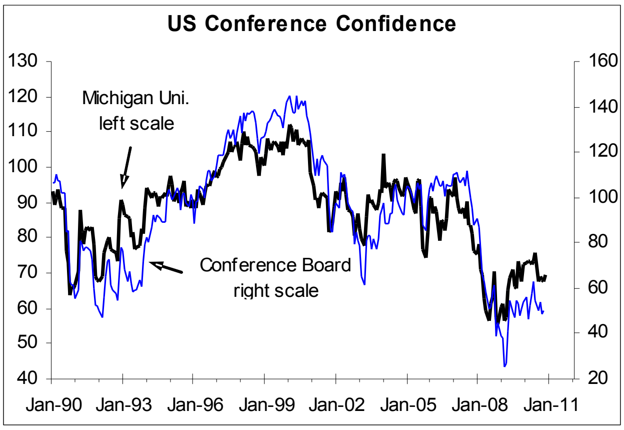


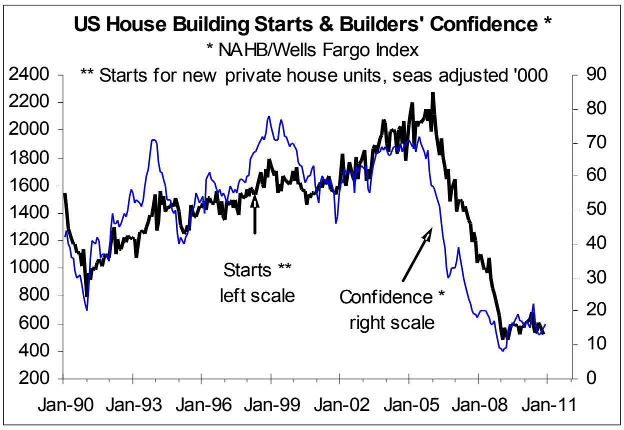


This outlook for house prices casts several shadows. Falling house prices risks more foreclosures. I noted with interest the latest comments by the RBA about the US housing-banking situation: "One sector that had underperformed the global market was the US banking sector, whose share prices had been weighed down by recent earnings reports that showed a slowing in income growth, and by the concerns about the foreclosure process that had recently surfaced. Members noted that around 5 per cent of all US mortgages were in the process of foreclosure at the end of June." Source: http://www.rba.gov.au/monetary-policy/rba-board-minutes/2010/02112010.html.

That is "5 per cent of all US mortgages"!!! In NZ we get excited when 5% of the number of house sales in a month are mortgagee sales, but even at the peak of 343 mortgagee sales in September 2009 this only represented something vaguely like 0.03% of all people with housing mortgages.

Falling house prices also impact on consumer spending and will be part of the reason why US consumer confidence surveys have struggled to recover (left chart). The fall in demand for housing is also likely to result in lower demand for new houses, so there could be some downside ahead for housing starts in the US (right chart). As discussed in the last US Raving, the "steroids" are wearing off.





But could the modern day home of capitalism be starting to heal itself?

In Chapter Two of the **How the Economy Works** booklet I showed the critical role housing market activity plays in driving cycles in economic growth (see http://www.sra.co.nz/pdf/PivotalHousing.pdf). In normal circumstances recent developments in the US housing market would be ringing warning bells about US and global growth prospects in 2011.

In this context, the following is what the Economist Intelligent Unit (EIU) chief economist, Robin Bew, wrote overnight: "The global economy is entering an uncertain phase, although conditions have improved in some respects since the summer, when fears of a double–dip recession were acute. … Our latest forecast for the world economy envisages a slowdown in 2011, as stimulus fades and as measures such as the US's new round of quantitative easing fail to take up all the slack." The EIU is part of The Economist magazine family and you can sign up for Robin's weekly free commentary using the following link - http://www.eiu.com/form_submit.asp?form_name=enquiry_form&enquiryType=BMP&rf=0.

In our pay-to-view economic reports (see http://sra.co.nz/interesting.html for info on these) we are, like Robin, focused on the risk of a US and global economic slowdown and we doubt the second round of quantitative easing (QE2), involving the Fed injecting USD600b into the financial system, will cure the rot at the core of the Big Apple. However, we are also acutely aware that the normal tools of economic forecasters are of limited use, especially in a situation such as this and at some stage behaviour by individuals and firms not visible to the economic forecasters will generate an economic recovery in the US.

The leading indicator approach we use for predicting the near-term outlook for economic growth in our pay-to-view reports provides our clients with early warnings about economic upturns and downturns, which is more than can be said for the traditional approaches used by most economic forecasters, as discussed in the last Raving on the US and in Chapter Two of the booklet. However, when we try and look 2-4 years ahead the leading indicator approach and the traditional forecasting approach are of no help. As discussed in Chapter One of the **How the Economy Works** booklet, the economic forecasters keep predicting that economic growth will gravitate back towards the historical average rate irrespective of whether it will or will not (see http://www.sra.co.nz/pdf/TradeSecrets.pdf). Equally, the leading indicators are only helpful for predicting near-term growth. This means we will pick up turning points in economic growth ahead of the economic forecasters almost irrespective of what is driving them, but this is no help in trying to assess medium-term growth prospects for the US.

The medium-term outlook for economic growth (i.e. the outlook for the next 2-4 years) is as much about whether any new industries or major new technologies will come along as it is about the sorts of things economic forecasters focus on. The US is still the home of modern capitalism and every day that passes is a day closer to the next generation of Bill Gates and Steve Jobs's driving the next technological leap forward, creating new firms, even new industries and loads of new jobs along the way.

Multiple New York Times best selling author and financial expert, John Maudlin is a US-sceptic in terms of near-term economic growth prospects, but in the context of where the light at the end of the tunnel will eventually come from he observed that, "Whole new industries will come into existence. Pay attention to the advancements in robotics. Biotech will be HUGE this decade, but we need to change the rules so we don't lose the intellectual property and the jobs. Electric cars will boom as we replace our fleet all over the world. Nanotech later in the '20s. Green energy and nuclear. Artificial intelligence (finally!). Really cheap (I mean *really* cheap!) wireless high-speed broadband all over the world will open the door to all kinds of possibilities. I met last night with very credible scientists who have developed a way to filter water very cheaply. A desalinization module that fits in a cargo container. Yes, they need a lot of money to finish, but they will figure it out. And on and on."

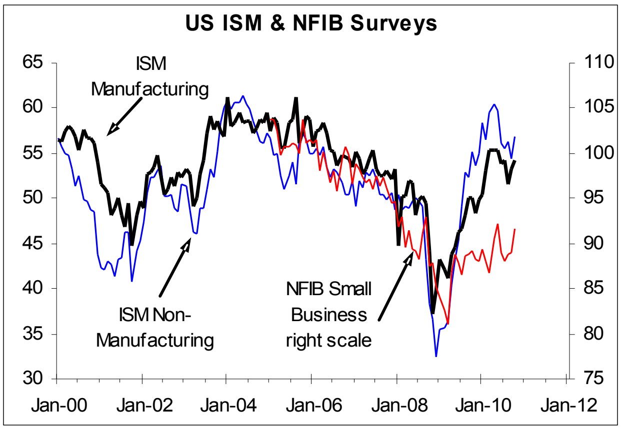
This quote comes from John's 20 August 2010 ***Thoughts from the Frontline Weekly Newsletter***. You can sign up to John's free weekly newsletter via http://www.frontlinethoughts.com/gateway.asp. He also provides a weekly ***Outside the Box*** commentary, which supplies "best of" commentaries from other commentators on topical US and global economic and market issues.

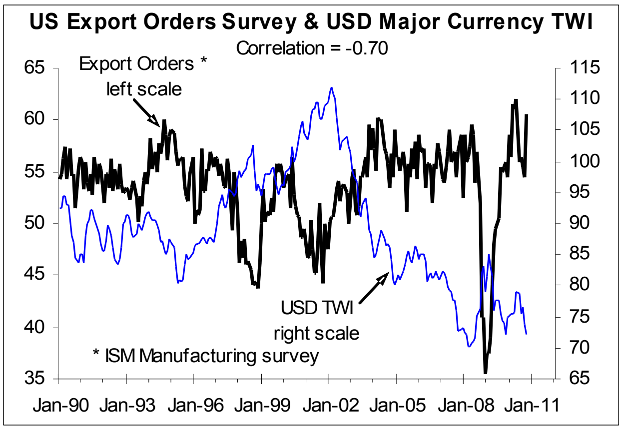
Again, the leading indicator approach to assessing near-term economic growth prospects we employ will pick up when the good news on US economic growth prospects driven by either QE2 (unlikely) or favourable industry/technology is about to hit town. But we can't say when this will be. We doubt it will be tomorrow, but it can't be ruled out that at the same time as dark shadows are being cast by the US housing market the US economy is already starting to heal itself as individuals and firms adjust to the challenges arising from the financial crisis, as well as there being trickles of good news from the next generation of innovators and entrepreneurs. This behaviour reflects Adam Smith's "invisible hand" of economic behaviour at work, with the cumulative result of the behaviour of innovators and entrepreneurs being what drives medium-term and longer-term growth in real personal incomes.

Layoffs have been massive in the US in recent years, but NZ's experience with this in the early 1990s taught us that some of the people who get laid off respond by setting up their own businesses, some of which go on to great things and quite a few go on to achieve sufficient success that they create quite a few jobs. This sort of behaviour should be starting to unfold in the US.

There may be a hint of Adam Smith's invisible hand being are work in the improvement in some of the key US leading indicators we monitor in October, like the ISM manufacturing and non-manufacturing surveys and the NFIB small business survey (left chart). However, the improvements in October may also reflect an element of wishful thinking or even misguided optimism about QE2. QE2 was imminent and widely anticipated at the time the October surveys were undertaken.

We see developments in the NFIB small business survey, which has significantly underperformed the ISM surveys since mid-2009, as being particularly important. Most successful businesses start as small businesses, while more generally small businesses are the heart of job creation. I have lost the link, but there was an interesting report a couple of months ago on job creation in the US – I think in one of John Maudlin's ***Outside the Box*** articles – that showed that large companies were in general rather than just recently net destroyers of jobs while all of net job creation came from the SME sector.





However, the low USD is probably the major mechanism driving the leading indicators in the left chart. The right chart above shows the distinct inverse relationship between the USD TWI (the measure of the USD against the currencies of its major trading partners) and the ISM survey of manufacturing export orders. The latest weakness in the USD has fuelled export orders back to around peak levels.

Some commentators focus on the printing of money in the US as the reason for the lower USD and there is something to this, but a lower exchange rate simply reflects a normal market reaction to a country in economic trouble. Rather than get too focused on what caused the lower USD, I believe what is most important is that the USD is playing a significant part in boosting the US economy, which is part of the self-healing process. To put this mechanism in perspective, the US exports around 12% of GDP versus 32% for NZ and imports 15% of GDP versus 33% for NZ (i.e. US economic growth is significantly less geared to the exchange rate than NZ growth, but this will still be an important mechanism). But over 2-4 year periods the share of exports in GDP in the US will increase significantly if the exchange rate remains low.

Professor William C Bailey, Chair, Department of Agriculture, Western Illinois University, is the regular guest commentator in the ASB Commodities Weekly report and stated in the 17 November report that "US dairy exports continue strong with milk powder exports increasing more than 50% from last September's level, cheese exports up almost 50% with butterfat shipments almost 100% greater than a year ago with cumulative 2010 butter and milk fat exports triple the volume during the same period in 2009." If you want to follow international dairy industry developments I recommend that you sign up to these weekly reports via https://reports.asb.co.nz/register/index.html.

I don't understand fully what is driving the boost in US dairy exports, but a competitive USD will be part of the story. There will be a wide range of not just US exporters but also US firms competing against imports that are currently experiencing the best level of international competitiveness ever. In time this will not only result in better performances by existing exporters and by firms competing against imports, but some new export firms/industries will arise (including some that got closed down by the earlier high USD) while some local manufacturing that got closed down by a high USD will reopen. But these developments can take a few years to play out, so most of the real benefit of the low USD lies ahead.

These positive developments are important enough to drive US manufacturing export orders back to peak levels and play a significant part in boosting a number of US leading indicators. I can't say when these positive developments will get a sufficient head of steam up that they overpower the unfolding negative impact from the US housing market. It could be some time yet because there is still quite a bit of rot at the core of the Big Apple. But I believe that these are the issues that should be focused on most in terms of assessing medium-term or at least longer-term US growth prospects.

Add to these positive factors the fact that the US has lots of spare capacity (e.g. a 9.6% unemployed rate). To many commentators the high US unemployment rate is bad because it has negative connotations for consumer spending, but in terms of medium-term growth prospects it is positive. If you doubt this just look at the strong economic growth NZ achieved in the mid-1990s – 4.8% average between 1993 and 1996 – after the unemployment rate peaked at 12% in 1991. The high unemployment rate means the Fed will remain growth-friendly for a protracted period because a high unemployment rate means the most important component of inflation – labour costs – will remain well behaved for a protracted period.

It is not time to crack the bubbly, but even in the face of negative prospects for US house prices we should not lose sight of the fact that the US economy still has the heart of an entrepreneur.