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US: A stronger recovery in the making

The economy grew by 1.8% in the first quarter and incoming data suggest that the second quarter will also be soft. That said, the economy is set to accelerate strongly in the second half of the year, reflecting dissipating fiscal headwinds, positive wealth effects, a stronger labour market recovery and a loosening of credit standards. Against this background, we expect the Fed to start tapering off its QE programmes in December, though there is a risk that the Fed will already move in September. The expectation of the Fed gradually withdrawing its stimulus has sent a shock wave through financial markets. However, the resulting tightening of financial conditions has been modest and will not to derail the recovery. Moreover, in the absence of inflationary pressures, the Fed is likely to manage its exit expectations carefully, suggesting that financial markets will soon enter calmer waters.

Soft first half of the year...

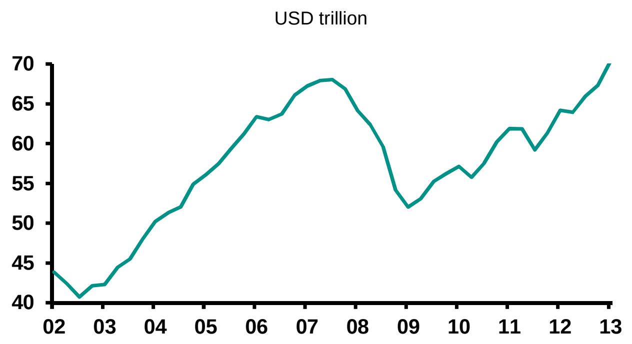
The economy grew by 1.8% in the first quarter of the year, which was somewhat stronger than what we initially had thought. The better performance could mostly be explained by consumer spending, which rose by 2.6%, as households showed quite some resilience to the rise in taxes in the beginning of the year. That said, the government's automatic spending cuts did keep a lid on the recovery, with federal government consumption slicing 0.7pp off growth. The economy looks to have grown only moderately in Q2, with growth forecast to have risen to around 1.5%. There are three reasons why we think that we are likely to see another quarter of soft growth. Firstly, monthly personal spending data suggest that consumption in Q2 grew by just 1.6%. Although the weakness in spending has for a large part been concentrated in utilities services, reflecting payback for strong energy spending due to the cold winter weather in Q1, we think that we are also seeing some residual effects from the rise in tax rates in the beginning of the year. Secondly, we estimate that the automatic spending cuts will remain a drag on government spending. Finally, inventories are likely to contribute significantly less to growth in Q2 than the 0.6pp seen in Q1. Indeed, manufacturers boosted production in the first months of the year to rebuild their inventories after production came partly to a halt due to Hurricane Sandy in the fourth quarter of last year. But this process stopped in March, forcing industrial production to move back into line again with final domestic demand growth.

...but stronger recovery in the making

However, we think that GDP growth in the second quarter will mark the trough, and expect the economy to accelerate from Q3 onwards, with quarterly GDP growth eventually reaching 4% in the fourth quarter of 2014. For a start, fiscal headwinds will slowly start to dissipate in the second half of the year. Indeed, fiscal consolidation amounts to an impressive 1.8% of GDP in 2013, but is likely to drop to around 0.5% of GDP in 2014. Although the effects of the automatic sequester cuts will not noticeably decline until Q4, the drag from the tax increases should soon fade, making the way clear for consumption growth to improve again on the back of a stronger labour market recovery. A second reason why we see the economy accelerating from Q2 onwards is that household and companies´ balance sheets have improved noticeably. In the case of households, strong gains in equity and house prices have significantly bolstered the asset side of their balance sheets. This encouraged households to dip into their savings when disposable income was hit by the $200bn increase in taxes, and helps to explain why consumption continued to grow modestly during the past two quarters. Together with a reduced fiscal drag, positive wealth effects should continue to underpin consumption. Meanwhile, in the case of companies, sound balance sheets should spur hiring and investment. A final reason why we see growth accelerating in the second half of the year is that banks in the US have strengthened their capital position materially in recent years. As a result, they are now loosening their lending conditions, which could be seen in to the latest Senior Loan Officers´ Opinion Survey. This should result in stronger credit growth and underpin overall demand.

Bringing everything together, we see quarterly growth picking up from 1.5% in Q2 to 2.5% in Q3, and moving to above trend growth rates from the fourth quarter of this year onwards. Indeed, we have recently revised our average growth US forecast for 2014 upwards from 3% to 3.2%, reflecting the impressive improvement of the fundamentals of the economy.

Gains in net worth underpinning consumption



Source: Thomson Reuters Datastream

Fed's tapering its QE programmes ´later this year´...
Against this background, Chairman Bernanke during his latest press conference suggested that if the economy continues to improve ´as the outlook suggests´ it will be appropriate to moderate the pace of purchases ´later this year´. Although we continue to think that the Fed will start to reduce its asset purchases in December, Bernanke struck a more hawkish tone during his press conference than we had expected, suggesting that the risks are clearly tilted towards a September move.

...should not derail the recovery,...
The Fed´s intention to start reducing its asset purchase programmes during either its September or December meeting has sent a shock wave through financial markets, raising worries that the subsequent tightening of financial conditions could derail the economic recovery. Although there is a risk that ongoing financial market unrest could eventually dampen the pace of the upswing somewhat, we think that the consequences of the tightening in financial conditions will be very moderate. For a start, even when taking into account the recent rise in mortgage rates, housing affordability has remained above its long-term average. This not only suggests that the housing market recovery will continue, but also that house prices will keep on rising. Indeed, both the FHFA House Price index and the S&P Case Shiller Home price index rose firmly in April and should continue to rise solidly during our forecasting horizon. This should provide a cushion for the recent drop in equity prices. Indeed, based on our calculations, households´ net worth continued to increase in Q2, albeit at a significantly slower pace than in Q1.

...as the Fed will manage expectations carefully...
Apart from the recent tightening in financial conditions having only modest consequences to the economy, another reason why we think that tapering process will happen relatively smoothly is that FOMC officials will manage exit expectations very carefully. Indeed, during his press conference, Chairman Bernanke went to great lengths to explain that the tapering process will be a gradual affair, with the QE programmes not likely to end before mid 2014, and any step in the reduction process being dependent on developments of the economy. Moreover, both Bernanke and other FOMC members have recently highlighted that after the QE programmes are completely wound down, there will still be a considerable time before the Fed will start raising rates. Indeed, according to the projections of Federal Reserve Board Members and Federal Reserve Presidents, the majority of meeting participants see the Fed´s first rate hike in 2015, which is close to our own view of the Fed starting its tightening cycle in 2015Q1.

...and inflationary pressures remain subdued
The reason that the Fed can wait for such a long time before raising interest rates is that inflationary pressures are likely to remain subdued. Indeed, headline inflation was just 1.4% in May. Although this for a large part reflects falling energy prices, core inflation remained 1.7% in that month, keeping it on a modest downward trend. Core inflationary pressures have softened a bit recently on the back of weak developments in core goods prices, though shelter and services inflation have continued to rise. Although we think that shelter inflation will moderate a bit next year as increased building activity will bolster the supply of rental apartments, reducing pressure on rents, services inflation should be underpinned by an ongoing improvement in the labour market. As a result, we continue to see core inflation moving broadly sideways during our forecasting horizon.

US Treasury market to enter calmer waters
US Treasury yields have risen by around a percentage point to 2.5% from their lows at the start of last month as financial markets adjusted to the Fed´s likely exit path. We had anticipated yields to reach these levels towards the end of the year, but the process has obviously gone faster than we had expected. Although the risks to our year-end forecast are tilted to the upside, we see a period of stability in the near term. For a start, expectations of the Fed tapering off its QE programmes are by now fully priced in. Meanwhile, interest rate futures are suggesting an earlier rate hike than the central tendency of the majority of FOMC members. Finally, the recovery is still relatively soft and an overshooting of yields would dampen the strength of the upswing, which in turn would depress yields. This is not to say though that yields will not rise further during our forecasting horizon. Indeed, with growth likely to be significantly stronger in 2014 than in 2013, yields should increase noticeably next year, reaching 3.5% by year-end.

Key forecasts for the US economy

(% yoy unless stated otherwise)

	13Q1	13Q2	13Q3	13Q4	14Q1		2012	2013	2014
GDP (% qoq, annualised)	1.8	1.5	2.5	3.0	3.5	GDP	2.2	1.8	3.2
CPI inflation (% yoy)	1.7	1.3	1.3	1.2	1.3	Private consumption	1.9	2.1	2.9
Unemployment rate (%)	7.7	7.5	7.5	7.3	7.0	Total fixed investment	6.7	4.5	8.9
						Total domestic demand	2.2	1.7	3.3
						Export of goods and services	3.4	2.2	4.9
Official policy rate (eop)	0.25	0.25	0.25	0.25	0.25	Import of goods and services	2.4	1.5	5.4
3M interbank rate (eop)	0.3	0.3	0.3	0.3	0.3				
10Y gov. bond yield (eop)	1.9	2.5	2.5	2.5	2.7	CPI inflation	2.1	1.4	1.8
EUR/USD (eop)	1.28	1.30	1.25	1.20	1.20	Unemployment rate (%)	8.1	7.5	6.6
USD/JPY (eop)	94	99	106	110	112	Budget balance (% GDP)	-7.0	-4.1	-3.2
GBP/USD (eop)	1.48	1.53	1.49	1.45	1.45	Current account (% GDP)	-2.8	-2.6	-2.7

Source: Thomson Reuters Datastream, ABN AMRO Group Economics