Flying on one engine

ANDREW McLAUGHLIN PONDERS THE US AND GLOBAL OUTLOOK AND WONDERS WHETHER THE WORLD IS HEADING FOR A SOFT, HARD OR PERFECT LANDING.

Former US Treasury Secretary Lawrence Summers said "the world is flying on one engine". He was referring to the US economy and the US consumer in particular as the main propellant of global growth in recent years. As that one engine has audibly spluttered in the last few months, the media has been increasingly dominated by fears that a crash or hard landing is in prospect for the US economic aeroplane. The most likely outcome, though, remains a soft landing for the US and therefore the global economy. Let me explain why.

In the three years to 2006 the world economy will have delivered its fastest growth in a generation fuelled by the voracious spending appetite of US citizens. They have feasted on a table stacked with goods from China and the Asian production platform. This dynamic of US spending and Asian exporting is the global growth engine of the decade so far.

BOOM CAUSES The impetus for spending in the US has come not from higher consumer incomes but a house price boom that has allowed Americans to spend more than they have earned in the last couple of years (see *Chart 1*). Savings have not been this low since the great depression of 1929.

Equity withdrawal on this scale cannot last forever and the spectre of falling house prices has started to loom large in the US political debate. Housing affordability has been stretched beyond most measures of what can be sustained in the recent boom. Median house prices are at a record 4.7 times income (the long-run average is 3.3). As a result mortgage payments as a share of income are well above their long-run average.

Executive summary

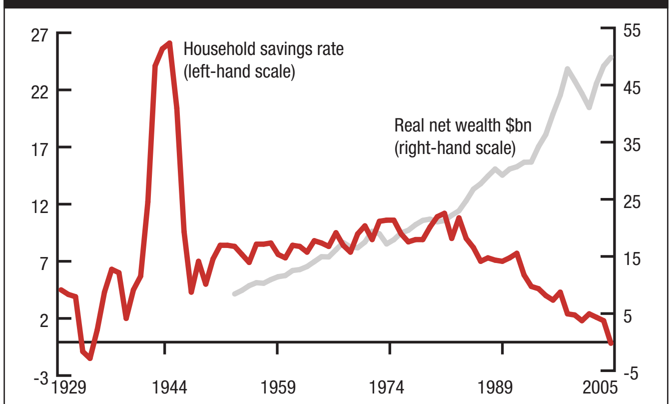
- A US house price boom has delivered the fastest growth in a generation as US citizens have devoured goods produced in the factories of China and Asia.
- The process of equity withdrawal can't go on for ever and a faltering housing market along with sluggish wage growth and a tightening labour market is denting US consumer confidence.
- The good times may be coming to an end but there is no reason to fear the end of the party and a great hangover – just yet.

There is no doubt that the market needs a correction but that doesn't need to mean a market crash. Rather, the self-correcting adjustments can kick in – and so far they appear to be.

Housing market activity in the US is abating and prices slowing. In some metropolitan hot spots, where planning constraints restrict the supply of new housing, prices have risen so high that a negative correction is now likely. But at a national level there is no precedent in US history for an actual fall in house prices overall. Much more likely is for house prices to rise more slowly than inflation. Slower price growth helps one side of the affordability equation and on the other we look for rising incomes.

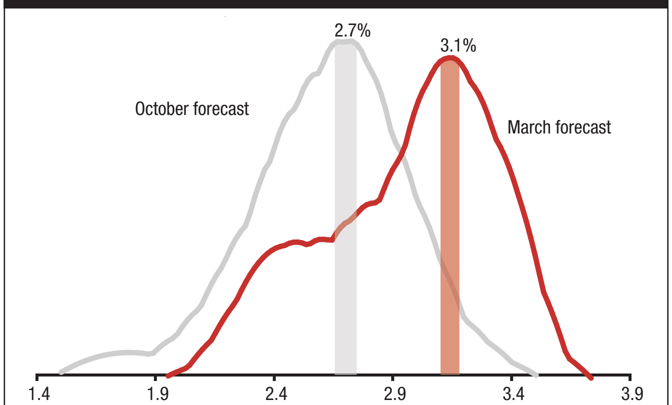
LABOUR FACTORS Wages and salaries have fallen to their lowest ever share of national income on the back of subdued incomes

Chart 1. Personal saving as a % of disposable personal income



Source: US Federal Reserve

Chart 2. US GDP growth in 2007



Source: Consensus

growth in the period after 2001 (hence the recourse to equity withdrawal to sustain spending). Yet the US labour market has tightened significantly in the last 12 months with unemployment reaching 4.4% in October, its lowest rate in five years. With every economist's estimate of 'full employment' in the US involving a higher rate of unemployment than this, the pressure on incomes is upwards. In 2006 Q3 labour reimbursements hit 6.6% year-on-year – a more than healthy pace of increase.

So just as house prices are slowing, incomes are rising. This is one of several transitions that hold the key to an orderly slowdown in the US economy. That said, bringing the housing market back to sustainable affordability metrics won't happen overnight – we could be in for a reasonably long haul of subdued activity.

At a macro-economic level, as the impetus to the consumer from asset growth abates we might expect their contribution to follow suit. But the growth in incomes from a tighter labour market means that consumers will not disappear from the malls altogether. And riding over the hill in the fourth quarter like the Seventh Cavalry are lower oil prices to add more spending fuel to the consumer fire.

NOTORIOUSLY FICKLE US consumer confidence is notoriously fickle and very much driven by what happens to petrol prices. As oil prices dip 25% from their August peaks, so US householders will have a greater spring in their step.

If this story plays out, then one of the trickiest of a series of self-correcting transitions will have taken place that underline the resilience of the world's main growth engine.

Just as we look for less asset-fuelled consumption from households, so we also look for a greater contribution from businesses in the next stage of the cycle. Business profitability reached record highs in the US this year with corporate returns reaching their highest share of the economy since 1966. High profits, rising equity markets and tight credit spreads add up to an invitation to companies to invest in the capital stock.

After a period of slow investment growth following the hyperdrive of activity around the dotcom boom and bust, US industry is spending again. Capacity utilisation rates are well above their long-run average and as high as they have been in the last five years. That is yet another reason to expect business to step up to the plate with higher spending if consumers take a well-earned breather in 2007. Capital outlays so far in 2006 are up 7% on the same period in 2005.

The result of these tricky transitions is moderating growth of the soft-landing variety rather than the dreaded hard landing. *Chart 2* looks at the combined views of the army of Wall Street economists who pore over the data and make forecasts for a living. It shows a distribution curve of forecasts for GDP growth next year as published in March and then again in October. The peak of the curve is the 'consensus view' and it shows moderation from growth beginning with a 3 to growth beginning with a 2.

As a snapshot of the collective sentiment of Wall Street's economy watchers, *Chart 2* gives a crystal-clear perspective on where views are headed. Wall Street has clearly lost some confidence during 2006 but the data is consistent with a slowdown not a meltdown.

If anything, I would be towards the more optimistic view of the curve as the soft-landing thesis appears, at least to date, to be playing out. The labour market in particular is a lot more resilient than many have anticipated. So much so in fact that one autumn revision to the statistics added the best part of a million workers that the statisticians had never spotted previously (although you can bet the US taxman did).

AFTER A PERIOD OF SLOW INVESTMENT GROWTH FOLLOWING THE HYPERDRIVE OF ACTIVITY AROUND THE DOTCOM BOOM AND BUST, US INDUSTRY IS SPENDING AGAIN. CAPACITY UTILISATION RATES ARE WELL ABOVE THEIR LONG-RUN AVERAGE AND AS HIGH AS THEY HAVE BEEN IN THE LAST FIVE YEARS. THAT IS YET ANOTHER REASON TO EXPECT BUSINESS TO STEP UP TO THE PLATE WITH HIGHER SPENDING IF CONSUMERS TAKE A WELL-EARNED BREATHER IN 2007.

As these transitions develop in the US, we also look for a more substantial transition of growth impetus between the US, which is moderating, and the euro zone and Asia, which we look to for a greater contribution, especially from the consumer sector.

We don't expect the three years of blistering global growth to continue apace but neither do we expect the party to end with a hangover just yet. If the current cycle stops now, it will have been the shortest in a generation (six years). If anything, one of the dividends of globalisation appears to be a lengthening of the global business cycle: the last two have averaged more than 10 years!

The closest thing the world economy has to a pilot to steer it through these transitions is the US Federal Reserve. The hoped-for soft landing is the prize it exists to deliver.

An unbroken succession of 17 interest rate hikes to August have been followed by what looks like a determined pause at 5.25%, which is a moderately restrictive position after five years of policy accommodation. The Fed calculates that this will be enough for the slower growth in the economy to pull inflation back towards its comfort zone of around 2%. The good news is that the Fed has plenty left in its arsenal to hike again if inflation proves too frisky and also to cut, as many expect, if growth slows too fast. I for one retain a hold/hike bias for 2007 and think that any talk of imminent rate cuts is premature.

If you are looking for reasons to worry, economy-watchers will always be able to find evidence to raise your blood pressure. But the picture emerging from the US and elsewhere at the time of writing suggests to this author at least that the one-engine plane is on a trajectory to land safely. If the pilot is able to steady collective nerves, it might just manage it on two wheels – not so much a soft landing as a perfect landing.

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