IS THE US BACK ON TRACK?

A third round of quantitative easing by the Federal Reserve is remarkable given the abundant signs of economic recovery across the pond, writes David Bowers

FACTS AND FIGURES

+10%
THE INCREASE IN US MEDIAN HOUSE PRICES (EXISTING HOMES) IN THE YEAR TO AUGUST 2012

+17%
THE INCREASE IN US MEDIAN HOUSE PRICES (NEW HOMES) IN THE YEAR TO AUGUST 2012

8.6%
THE US RENTAL VACANCY RATE IN THE SECOND QUARTER OF 2012 (THE LOWEST LEVEL IN A DECADE)

57%
THE PERCENTAGE INCREASE IN US HOUSING STARTS IN AUGUST 2012 COMPARED WITH THEIR 2009 TROUGH

SOURCE: THOMSON REUTERS DATASTREAM

The bold decision by the US Federal Reserve in September to launch another round of quantitative easing (QE3) has once again put the economic forecasting profession on the spot. As we head into the final months of 2012 and start to peer into 2013, the jury is still out on whether this will make any difference whatsoever to next year's growth prospects.

The immediate reaction by investors has been positive. QE3 does seem to have reduced some immediate tail risks in financial markets, even if it has not materially changed the medium-term growth prospects for the US. But heightened political risk – not only in America, but also in China and the Middle East – is still sufficient to cast the third-quarter rally in equities as 'a trade' rather than as the start of a fundamental bull run.

We think it would be wrong to be too dismissive. The move by the Fed is interesting from three perspectives. Firstly, the timing is unusual given where we are in the economic cycle. Secondly, it has occurred at a time when sentiment in the US housing market has begun to turn. And thirdly, the longer-term consequences of QE3 may yet be boosted by Asia's response.

We can all rationalise why the Fed has launched QE3, but the timing is in many ways remarkable, three years into this economic recovery. The move took place with US equities up some 25% in the preceding 12 months (just 7% short of their 10-year high); with housing starts (the number of new houses under construction) about to augment a robust V-shaped recovery in new auto sales; and with both nominal and real GDP growth over the past two years in line with the trends of the past decade.

The conventional wisdom is that there has been no US economic recovery, and therefore the Fed's action was essential. Indeed, across a range of economic variables – but particularly employment – the bears highlight that we are still not yet back to the levels observed at the official start of the recession in January 2008.

But if we adopt the official start of the recovery – July 2009 – as the benchmark, the past three years have actually seen a most extraordinary, if unbalanced, recovery. If we examine all economic recoveries starting with April 1975, we find that this cycle's rebound in non-residential capex, in durable goods orders, in truck sales, in auto sales, in capacity utilisation and in exports, to be the strongest on record. This recovery has also seen the best rally in equities of any economic upswing. Of course, there have been disappointments: this is the worst recovery in real consumption and in construction. But to say that there has not been an economic recovery is just plain wrong. This reframing of the US statistics makes the Fed's decision all the more remarkable.

The Fed's move has also taken place against the backdrop of a turnaround in the US housing market. House prices are showing year-on-year increases, rental vacancy rates are falling sharply, the cost of 'buying' versus that of 'renting' remains compelling thanks to 30-year mortgage rates below 4%, and the inventory of new homes relative to demand has fallen to levels that should boost housing starts. A 10% rise in house prices next year on top of a rising stock market could be a game-changer for US consumer behaviour, and so help America to regain its domestic 'mojo' by putting a break on household deleveraging.

But we should not think about QE3 in isolation. A lot depends on how Asia responds and China, in particular. If China does not ease monetary policy and QE3 turns out to be solely an American initiative, there remains the risk that the benefits of QE3 leak out in the form of a weaker dollar and higher commodity prices, which will eventually prove self-defeating. If the global economy is to reach 'escape velocity', we must look to China, faced with slowing growth and sub 2% inflation, to respond. If China eases aggressively, corporate treasurers should not hunker down for the economic equivalent of the 'end of the world'; they should also prepare for the unexpected, namely that policymakers – against all odds – succeed in delivering stronger growth next year.

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