Country Report

United States

More fuel for growth bulls

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Highlights

- Growth indicators confirm growth pickup. The ISM Non-Manufacturing index and the trade balance surprised on the upside, underscoring the upside risk to our 1.9% q/q annualized real GDP growth forecast for 2Q07.
- The big stress test for the consumer. After several quarters of house price deflation, we expect the negative housing wealth effect to be more pronounced in retail sales.
- Is the surge in oil prices stoking core inflation? We expect core CPI growth to remain tame in May.
- Industrial activity revival continued? Likely not.
- Greenback rally presents EURUSD long opportunities. Renewed weakness in US growth numbers should undermine recent USD strength.

Economics

Growth indicators confirm growth pickup

The ISM Non-Manufacturing Business Activity Index rose sharply to 59.7 in May from 56.0 in April, pointing to strong growth in the non-manufacturing sectors. Housing-related sectors painted a mixed picture. Construction, retail, and finance/insurance grew, while wholesale and accommodation/food services contracted. We are still not convinced that the double-dip recession in housing will not leave its marks on the rest of the economy, even though the current data does not offer much support for that view. Consumer and labor market data remain key. Chain store sales were reported higher by 2.5% y/y in May, suggesting an improvement in consumer spending versus a dismal April. However, in real terms, we doubt that overall consumption growth will climb much from a meager 0.2% m/m in April. The trade deficit narrowed unexpectedly to USD 58.5bn in April, as imports sagged by 1.9% m/m. This is a net positive for growth and highlights the upside risk to our current 2Q07 growth forecast of 1.9% q/q ann.

The big stress test for the consumer

One of key indicators of the impact of the housing recession on the consumer will be the May release of **retail sales** (Wednesday, June 13, 8:30 EDT). House price deflation has been in evidence since 3Q06 on a quarterly growth basis, according to the S&P/Case-Shiller index. That's long enough to fully exert the negative housing wealth effect on consumption. If, as we believe, the negative housing wealth effect is large, then real retail sales growth should remain sluggish. April sales were down by 0.2% m/m and a payback to +0.5% m/m seems likely (consensus: 0.7% m/m). Even so, given high gas and goods price inflation in May, that would still be lackluster in real terms.

Is the surge in oil prices stoking core inflation?

Since early 2007 the WTI crude oil price is up by 11.5%. In tandem, the prices paid components in the business climate surveys have edged higher. While the link between the oil price and core inflation is much looser than in previous cycles (higher efficiency in energy usage, high profit margins), the risk exists that core inflation might drift higher. We are not too concerned, as we continue to expect sub-trend growth on average in 2007, which will help to dampen price pressure. We expect the **CPI** release (Friday, June 15, 8:30 EDT) to show an increase of 0.6% m/m in the headline and of 0.2% m/m in the core rate. Such increases are in line with consensus and would leave the respective yearly rates at 2.6% and 2.3%, respectively.

Industrial activity revival continued? Not likely

One of the recent developments that has not been playing into our protracted growth slowdown scenario is the revival of industrial activity. We interpret the rebound in industrial growth as a reflection of the preceding inventory correction in late 2006-early 2007. As inventories have been pared down to be more aligned with sales, the need for fresh production has increased. We think this reaction will be over soon, as consumption growth is ebbing. The **Empire State General Business Conditions Index** (Friday, June 15, 8:30 EDT) will likely drop to 5.0 in June (consensus: 11.0) after rising to 8.0 in May from a recent low of 1.9 in March. Moreover, we expect **industrial production** (Friday, June 15, 9:15 EDT) to stall in May (consensus: 0.2% m/m) after a surge of 0.7% m/m in April.

Foreign Exchange

Greenback rally presents EURUSD long opportunities

After steadily trading above 1.34, EURUSD dramatically dipped below this level. Strong data out of the US, especially ISM and employment, had previously failed to move EURUSD back to April lows. However, sharp moves in global equity and fixed income markets benefited USD. The dollar has profited from investors exiting emerging market positions and returning to USD and higher USD yields.

In addition, ECB offered little support for the EUR; while the central bank hiked as expected and left the possibility of further interest rate increases open, inflation forecasts for 2008 were left unchanged. We see current EURUSD rates below 1.335 as interesting opportunities to go long EUR, although significant weakening is a risk to our US call. In the long run, we think a rebound of the USD is only possible if inflation around the world remains contained. If high inflation becomes a worrisome issue, the US may have difficulties marketing its Treasuries abroad.

Appendix

Terms and Abbreviations			
Abbreviation	Description	Abbreviation	Description
GDP	Gross Domestic Product	yoy	year-on-year
qoq	quarter-on-quarter	mom	month-on-month
ann.	annualised	wow	week-on-week
nsa	non-seasonally adjusted	sa	seasonally adjusted
CPI	Consumer Price Index	PMI	Purchasing Managers' Index
Core CPI	Consumer Price Index less Food and Energy		

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