

United States Focus

The Economy's Biggest Problems Are Sentiment And Politics

UOB Economic Projections	2009	2010	2011F	2012F
GDP	-3.5	3.0	1.6	2.0
CPI (average, y/y %)	-0.3	1.6	2.5	1.1
Unemployment rate (%)	9.3	9.6	8.9	8.0
Current account (% of GDP)	-2.7	-3.2	-3.4	-3.1
Fiscal balance (% of GDP)	-10.7	-8.9	-10.0	-9.0

- *The US economic outlook has turned more cautious on the back of a weak 1H and external risk factors. We now expect US GDP to grow by a more sluggish 1.6% in 2011 and a lacklustre 2.0% in 2012 constrained by the slow jobs market recovery, household deleveraging and US policymakers' tug-of-war.*
- *The Fed kept its ultra-low interest rate policy unchanged in its latest September policy meeting but As expected, the US FOMC decided to extend the average maturity of its holdings of securities (popularly known as "Operation Twist").*
- *Fed also maintained its promise to keep rates at "exceptionally low levels ... at least through mid-2013" and its existing policy of rolling over maturing Treasury securities at auction.*
- *Longer dated US Treasury yields could head lower in near term due to Fed's action to extend the duration of its UST holding. We expect 10Y UST yield to head lower to 1.5% by end-2011.*
- *The USD bull run is likely to stay supported near term on safe haven flows as the Euro area debt crisis continues to fester without any clear resolution. We still expect the dollar weakness to resume once the risk aversion emanating from euro-zone sovereign debt crisis recedes, but this is clearly delayed for now.*

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Hobbling Along A Lower Growth Expectations

The US economy looks much more vulnerable now compared to our last review three months ago. Growth has been markedly revised lower in 1H and recently available data suggest that the 2H rebound may not be as rosy as we once believed. The US economy rebounded in 2Q but by a sub-trend growth of 1.3% q/q SAAR (the previous estimate was even worse at 1.0%), from 0.4% in the preceding quarter. While the hard data such as retail sales, manufacturing and trade have been mixed, business and consumer sentiment has plummeted in recent months, leading to fears that this is a prelude that may see the hard data turn significantly lower in the coming months. The US consumer accounted for about 70% of the US economy and with consumer remaining ever cautious, this has been the Achilles' heel of the economy. The weak jobs market and the even weaker housing market have added to the negative sentiment for the US consumer in addition to the continuing deleveraging process of household debt.

The disappointing US August jobs data on 2 September put US concerns back in the forefront again this week. August non-farm payrolls came in at zero, against the Bloomberg poll for 68,000 new jobs. Even as private payrolls was a

positive 17,000 in August (much lower than expectations for 95,000), it was entirely negated by the government job cuts of the same amount. Unemployment rate was unchanged at 9.1% in August. That said, it should be noted that there was a strike at a major US telco (Verizon) which had cut about 45,000 from the job count. Excluding the "Verizon strikers", the outcome would likely have been closer to market expectations.

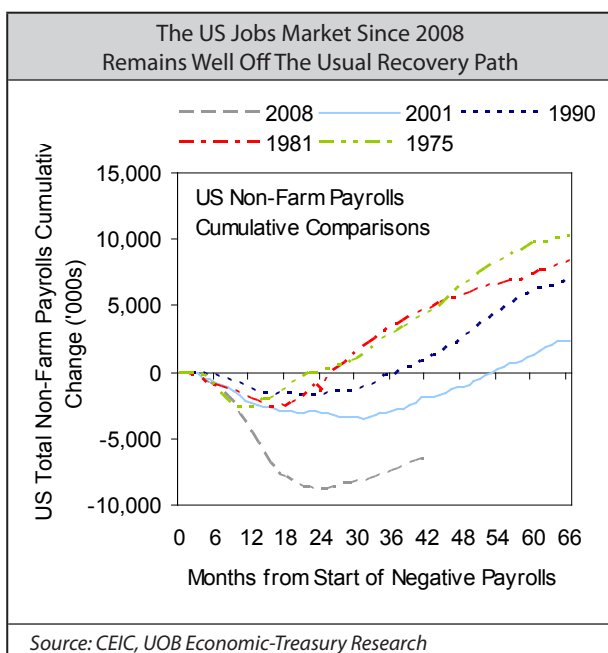
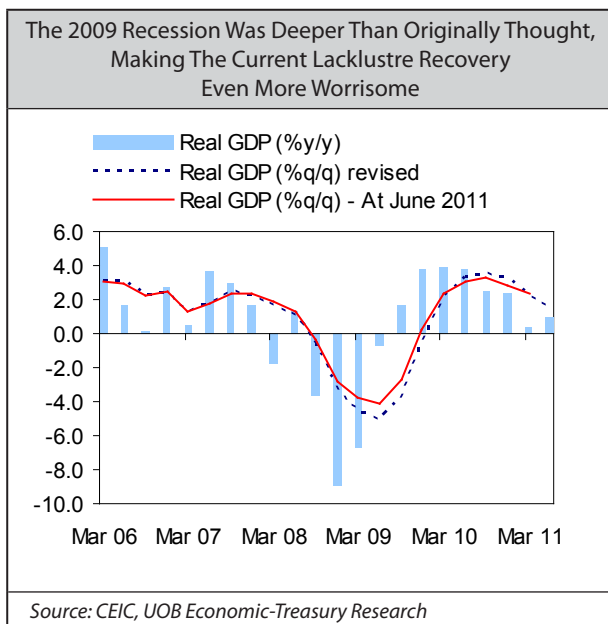
Nonetheless, there were other disturbing parts to the August employment report; July's payrolls number was revised lower to 85,000 (from the previous estimate of 117,000), making it 4 straight months of sub-100,000 job growth months. It is estimated that US needs at least 150,000 new jobs monthly before it can start bringing down the unemployment rate, so US unemployment is likely to remain uncomfortably high for an extended period. Wages in the US are also falling in August and while more people are working in August, more are working part-time signaling the unwillingness of US companies to increase permanent headcount. The September NFP data (consensus forecast at 50,000) out this week on 7 October may disappoint again on the downside.

As for US housing, the outlook remains gloomy even as

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the latest batch of housing starts, existing home sales, prices and permits was rather mixed with the US housing market still sitting on more than half a year of inventory. The steady flow of foreclosures adds to the housing market dilemma as the foreclosures bring about fire-sales which add to downside pressure on housing prices.

While the spate of weaker US economic data does suggest that the pace of recovery in the US is looking less optimistic than what was anticipated at the start of 2011, we are still not expecting a US double-dip recession as the core scenario but we acknowledge that the recession risk is now higher at 35% (from our estimate of 25% previously).



Meanwhile, the White House has downgraded US GDP growth in 2011 to 1.7% (from 2.7% projected in February) and in 2012 to 2.6% (from 3.6% projected in February). It also estimated that unemployment could remain elevated in 2012, averaging 9% for the full year. Our growth forecasts are more or less in line with the official numbers (1.6% in 2011, 2.0% in 2012) but we may see further downgrade in growth should the manufacturing-led recovery fail to materialize in 2H. Overall, the expectation is for lacklustre US growth for the next 2 years.

The FOMC Reintroduces The 1961 Twist Operation, Does Not Rule Out More Easing Measures "as appropriate"

As expected, the US Fed in its 21 September FOMC statement announced the maturity extension program, popularly known as "Operation Twist". The Fed will be purchasing US\$400bn of Treasuries in the 6-30 year maturity range by end-2012 and selling the same amount of the shorter-dated Treasuries with maturities of 3 years and less. According to the Fed, the maturity of its US debt holdings will be extended from the present 75 months to about 100 months by the end of 2012. While the "Operation Twist" announcement was anticipated, the market was surprised that the Fed was purchasing a bigger than expected 29% tranche of the US government debt maturing in 20-30 years.

The other surprise in the September statement was that the FOMC also decided to start reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities (MBS) in agency MBS (instead of longer-term Treasury securities) as a more direct support for the US mortgage market. However, the Fed did not further reduce or eliminate interest paid on the banking sector's excess reserves held at the Fed (the IOER is presently at 0.25%).

The Fed's economic outlook was downbeat, pointing to slowing growth and weak labour market conditions with persistently elevated unemployment. Consumer spending is not picking up as fast as it supposed to be in a recovery cycle while the housing sector remains in doldrums. The Fed judged that "there are significant downside risks to the economic outlook, including strains in global financial markets." The strains that the Fed alluded to are the Euro area sovereign debt crisis and the contagion fears to the banking sector. The Fed remains unworried about inflation in the US noting that "longer-term inflation expectations have remained stable."

The Fed did not announce QE3 but the FOMC statement did repeat the same point that opens the door to further policy action, again commenting that it "discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will

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continue to assess the economic outlook in light of incoming information and is prepared to employ its tools as appropriate.”

A few key things were also kept constant in the latest FOMC statement. The Fed was keeping the Fed Funds Target Rate (FFTR) range unchanged at 0-0.25% and reiterated its promise to keep the FFTR at this exceptionally low level at least through mid-2013. The Fed is also committed to continue rolling over the maturing US Treasury securities at auction. However, the FOMC decision this time was again not unanimous. The same three FOMC voting members (Fisher, Kocherlakota and Plosser) who dissented in the 9 August FOMC meeting, dissented again this time as they “did not support additional policy accommodation at this time.”

The Fed’s poor economic outlook and benign inflation expectation were likely the factors prompting the latest Fed actions. Unfortunately, markets have little (or no) faith that the maturity extension programme will have a material impact on the real economy. And we also agree with that view. It did not work in 1961, and after 50 years, it is also not likely to succeed in 2011 either. Longer-term market interest rates are already very low now and lowering it further will only at best help at the margin. And by that extension, we could also get the same disappointing outcome with QE3. The thing that needs fixing is the lack of confidence which is the key cause of the wavering recovery and monetary policy is not the right medicine.

US monetary policy is likely to have hit its limits to provide any additional grease to oil the stalling economy. And while the Fed needs to show that it is doing something (or anything) to address the anemic growth situation no matter how limited the effectiveness may be, the negative stock market reaction on 21 September despite the FOMC decision should serve as a warning flash signal to the US policy makers that the ball is back on their court. The US policymakers have to start bringing out that the right fiscal bullets if they want to bring the US economy back to life soon. US monetary policy just doesn’t have any bite anymore.

Threats Of More Political Impasse Make Markets Increasingly Fatigue, Eroding Confidence In Policymakers

Markets are probably most weary of the political impasse that is plaguing the present US administration from implementing fiscal measure to reinvigorate the US economy and put more people into jobs. Trouble continues to brew in US politics and the latest threat was a shutdown of US government operations at the end of September due to an impasse over a federal spending Bill amid a partisan dispute on funding for disaster assistance. The Senate

on 24 September rejected with 56 votes to 36, a House-passed stopgap measure to fund the government until 18 November and provide US\$3.65 billion (S\$4.75 billion) in aid to victims of Hurricane Irene and other natural disasters. Without this new money, the US government will have run out of money by end-September but this has been averted.

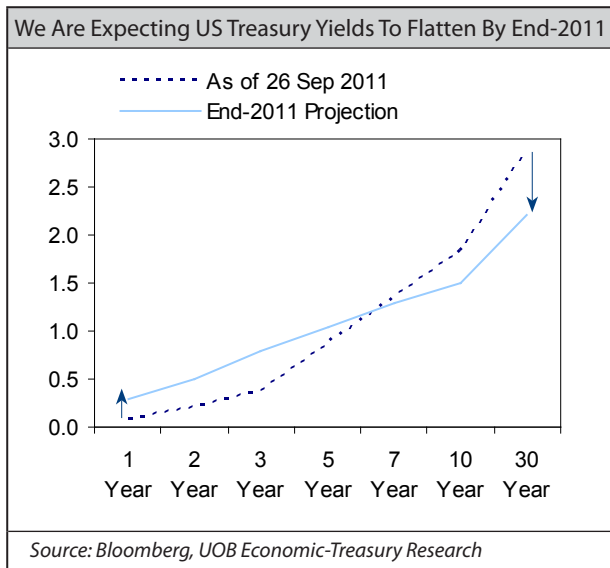
Earlier this year, US Congress also managed to avert a government shutdown and a default on its debt obligations on the eleventh hour although it could not avoid an S&P downgrade of its coveted AAA status. The last time the US government had shut down was between 15 December 1995 and 6 January 1996 for a total of 21 days. Any shutdown this time will add to further disillusionment of investors on the state of US politics.

But even with the emergency government funding issue resolved for now, it will crop up again when the funding shortfall comes up again in end-November. And there will be other political issues waiting to erupt. Recall the 2 August agreement to increase the US government borrowing limit by at least US\$2.1trn in two stages and in exchange, the policymakers pledged to reduce the federal deficit by about US\$ 2.1trn over the next 10 years. USD \$917bn of deficit reduction over 10 years in exchange for increasing the debt limit by \$900bn as the first tranche of the debt limit increase was already agreed upon. Another USD 1.5trn worth of deficit reduction, including from entitlement and tax reform, is next in line to be discussed agreed upon by the Joint Selection Committee on Deficit Reduction created in August. If this committee fails to agree on a deficit reduction plan of between USD 1.2-1.5trn by 23 November and vote on it by 23 December, then an enforcement mechanism will automatically trigger spending cuts of USD 1.2trn split 50-50 between domestic and defence spending. One cannot help but worry that this will be turned into platform for political brinkmanship.

US Treasury Yield Curve Flattened Following The September FOMC Announcement, More Flattening May Be On The Cards

The long end of the US bond markets benefited from the latest FOMC decision while the short end sold off on 21 September. The Fed “Twist Operation” announcement pressured longer term yields lower as the 10Y UST yield fell briefly to an intraday low of 1.854% (weakest since 1940’s) before edging back slightly to end the day at 1.863%, 8.4bps lower than previous close. The 30Y UST price surged on 21 September following the Fed decision as the yield fell 20bps to close at just above 3%. Presently, the 30Y yields is at 2.91% while the 10Y yield is at 1.91% (as at 30 September) We now expect the 10Y UST yield to head lower towards 1.5% by end-2011.

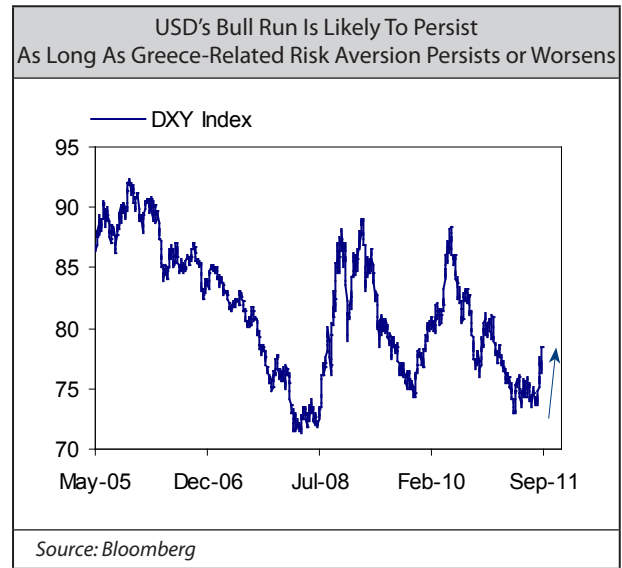
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In comparison, the 5Y yield was up slightly by 0.8bps but still closed below 0.9% at 0.852%. This was because the Fed's purchases only covered 6Y-30Y bond space. The 2Y yields went markedly higher on Wednesday, by 4.1bps and closed above 0.2% at 0.202% as the Fed is now expected to sell a large portion of its short term UST to match its purchase of the longer-term UST. Presently, the 5Y yield is at 0.95% while the 2Y yield is at 0.24% (as at 30 September).

US Dollar's Big Bounce Could Last For The Rest Of 2011, Multi-Year Depreciation Trend View Is Delayed

Just as the US Treasuries benefitted from the increasingly negative developments from the euro-zone, so did the US currency. Since late August, the USD reversed course and broadly appreciated against most of the major currencies so far this year, especially against the Euro and the Asians. Since hitting 75.67 in the last review on 24 June, the US dollar index (DXY) – which indicates the general international value of the USD by averaging the exchange rates between the USD and 6 major currencies – has drifted



lower until last August when the renewed Euro area debt worries with its centre widening from Athens to Rome. The DXY staged a strong rebound, closing at 78.55 on 30 September. More Fed easing announced in late September did not negatively affect the world's reserve currency.

In the previous review, we believed that once the Euro-zone risk subsides and global growth gets back on track, we expect USD to resume its depreciation trend. What has changed now is the increased severity of the European situation and a clearly missing workable short term solution to the European debt problems. That said, the extent of USD strength may be ironically supported (1) weak US economic growth for a prolonged period; and (2) expectations of tighter US fiscal policy to plug the huge fiscal deficit but will slow final demand further, and 3) a worsening of sovereign stress in Europe. In fact, the euro-zone developments will be key factor determining the extent of the dollar bull run and put the USD multi-year depreciation on hold for longer.

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US Selected Forecasts									
%	1Q11	2Q11	3Q11F	4Q11F	1Q12F	2Q12F	2010	2011F	2012F
Real GDP	0.4	1.3	2.0	2.1	2.0	1.8	3.0	1.6	2.0
Real PCE	2.1	0.7	1.9	2.2	2.1	1.9	1.7	1.7	2.1
Unemployment Rate	8.9	9.2	8.9	8.8	8.6	8.5	9.6	8.9	8.0
Total CPI (y/y)	2.2	3.6	2.7	2.1	1.6	1.3	1.6	2.5	1.1
Core PCE Price Index (y/y)	1.1	1.3	1.4	1.5	1.3	1.2	1.0	1.5	1.2
End of Period (%)	1Q11	2Q11	3Q11F	4Q11F	1Q12F	2Q12F	2010	2011F	2012F
Target Fed Funds Rate	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
3-month USD LIBOR	0.30	0.25	0.25	0.25	0.25	0.25	0.30	0.25	0.25
USD DXY	75.86	74.30	79.00	83.00	82.00	80.00	79.03	83.00	78.00
TSY 10-year note	3.47	3.18	1.80	1.50	1.50	1.40	1.40	1.50	1.40
<i>Source: CEIC, UOB Economic-Treasury Research</i>									