

Disappointing 2011 US growth will keep Fed ultra-loose

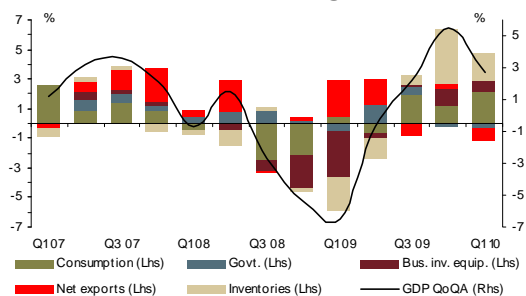
Consensus tends to lag economic reality. Forecasters were late to see the upcoming recovery during the trough of the crisis, remaining too pessimistic as the economy started recovering. We believe the opposite is now the case: economists fail to see the coming slowdown in the US economy. We forecast growth will be in a 1.8-2.3% range next year, significantly weaker than the current 3.1% consensus. This will slow earnings growth and create volatility for risk assets, though equities still remain attractively valued. A weak growth environment, combined with substantial slack in the economy also increases the risk of the economy falling into deflation. As we argued in our 2010 Investment Outlook, the Federal Reserve (Fed) will respond to weaker growth and falling inflation by not only keeping interest rates lower for longer than many expect. If necessary, it will also engage in further aggressive quantitative easing.

quarters. However, if the current recovery had followed the average historic path, GDP growth would have been 5-7% year-on-year (y/y) this year, instead of the 2.7% y/y pace recorded so far this year. We expect growth to be even weaker next year.

Consumer spending is key for 2011 growth

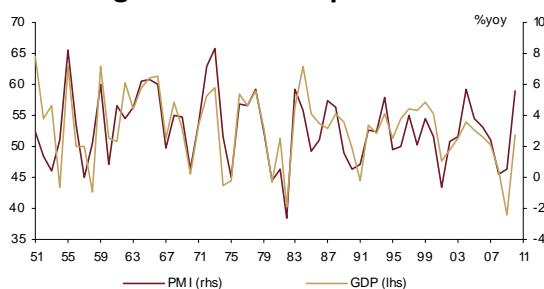
Consumer spending accounts for about 70% of US GDP. In the medium term it is determined primarily by developments in wage income, wealth effects and changes in the savings ratio. Wealth effects are related to the housing and stock markets. In the absence of strong gains in assets prices, developments in labour markets will be key.

US GDP: Contributions to growth



Source: Bloomberg, as at 30/06/10.

US GDP growth and composite ISM



Source: Bloomberg, as at 30/06/10.

The recovery has been clearly V-shaped until now, and faster than initially expected. Government stimulus measures helped start the recovery in 2009, while inventory rebuilding contributed around 60% of total GDP growth in the last two

Employment, as measured by monthly non-farm payrolls, has been recovering, but at a slow pace. Leading indicators suggest that private payrolls will increase by 200-250,000 per month at best in coming months, translating to annual employment growth of 1.5-2%. But if employment growth is not significantly higher than the increase in the labour force, around 150,000 per month, unemployment will remain high. High unemployment reduces workers bargaining power and therefore real wage growth is unlikely to top 1% in 2011.

Neither should we expect a falling savings ratio to boost spending. The savings ratio trended lower

Carl Astorri
Head of Economics & Asset Strategy
James Butterfill
Equity Strategist
firstname.lastname@coutts.com

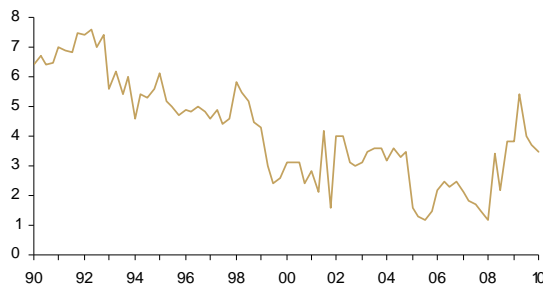
Alan Higgins
Head of Investment Strategy UK
Henry Lancaster
Senior Investment Strategist

Jean-Maurice Ladure
Head of Investment Strategy Europe
Julien Seetharamdoo
Bond Strategist

Norman Villamin
Head of Investment Strategy Asia
Georgios Tsapouris
Investment Strategist

from the early nineties to reach all time lows around 1% in 2007. It increased to around 5% during the recession and currently stands at 3%, driven lower by the 2009 recovery in assets prices and government programs to encourage consumer spending. However, in the absence of significant asset price gains we expect that it will increase over the next few years as consumer deleveraging is still in its early stages.

US Savings ratio (% disposable income)



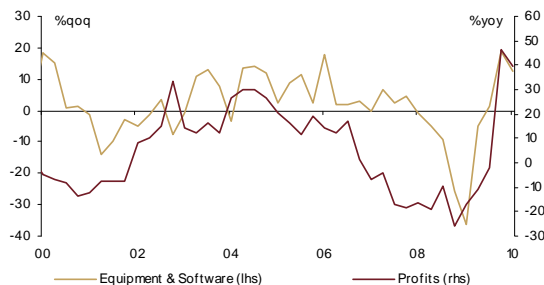
Source: Bloomberg, as at 30/06/10.

Taking all these together - weak employment and wage growth and a rising savings ratio - suggests consumer spending will grow at around 2-2.5% y/y, well below the 3.4% average from 1992 to 2007.

Can businesses come to the rescue?

If consumers are going to contribute less than in past recoveries, could the business sector provide an extra boost to the US economy? Corporations, which cut spending severely during the recession, are now increasing their investment in equipment and software at around 20% quarter-on-quarter annualised (QoQA). However, this is the level that capex investment has usually peaked at in the past and we don't expect it to grow at more than a 10% QoQA rate next year. This would add around 0.8 of a percentage point to GDP growth in 2011.

US Profits and business investment



Source: Thomson Datastream, as at 30/06/10.

Carl Astorri
Head of Economics & Asset Strategy
James Butterfill
Equity Strategist
firstname.lastname@coutts.com

Alan Higgins
Head of Investment Strategy UK
Henry Lancaster
Senior Investment Strategist

Jean-Maurice Ladure
Head of Investment Strategy Europe
Julien Seetharamdoo
Bond Strategist

Norman Villamin
Head of Investment Strategy Asia
Georgios Tsapouris
Investment Strategist

Fiscal consolidation to be a drag on growth

The coordinated fiscal support that fuelled the recovery in 2009 is now being succeeded by synchronised global fiscal tightening. The EU and the UK have already engaged in severe fiscal tightening programs in an attempt to assuage bond investors' concerns.

We expect the US to follow the same route and start its fiscal consolidation plan next year. However, the level of fiscal tightening remains uncertain for the moment. According to our calculations, if the US is to stabilise its debt-to-GDP ratio at around 100% by the end of 2013, it would need to reduce spending by 5% of GDP between 2011 and 2013. Considering the reserve currency status of the dollar, there may be less pressure on the US to front-load these measures and 2011 cuts may be less severe than those announced so far by the euro-zone and UK.

However, some fiscal drag will be inevitable as the Bush administration tax cuts are set to expire in 2011, and some or all will not be renewed. At the same time local and state governments, which have already started tightening their spending, will continue having a negative impact on GDP growth in 2011. As a result we expect a fiscal drag of at least 1% of GDP in 2011.

Conclusion

Considering the impact from consumer spending, business investment and expiry of government stimulus we estimate that the US will only grow by between 1.8-2.3% in 2011, significantly below the 3.1% consensus. Earnings forecasts for 2011 have been revised down a little, but will need to go further. Nevertheless, as we have shown in a previous Daily Theme, even our low GDP forecast leaves room for modest further equity gains over the next 12 months given already-low valuations. But the process of adjusting to lower expectations for GDP and earnings growth will keep equity markets volatile and we may yet see fresh lows in 2010.

At the same time bond markets will come to the realisation that fiscal tightening and low growth mean the Fed will keep interest rates close to zero for much longer than generally expected and will stand ready to intervene quickly with further injections of quantitative easing.

Issued by Coutts & Co, which is authorised and regulated by the Financial Services Authority. Coutts & Co is registered in England No. 36695. Registered office: 440 Strand, London WC2R 0QS.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down.

The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment or banking product, nor does it constitute a personal recommendation. The information is believed to be correct but cannot be guaranteed. Any opinion or forecast constitutes our judgement as at the date of issue and is subject to change without notice. Any Coutts company, or a connected company, its clients and officers may have a position or engage in transactions in any of the securities mentioned.

The analysis contained in this document has been procured, and may have been acted upon, by Coutts & Co and connected companies for their own purposes, and the results are being made available to you on this understanding. To the extent permitted by law and without being inconsistent with any applicable regulation, neither Coutts & Co nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such analysis.

Not all products and services offered by the individual Coutts companies are available in all jurisdictions, and some products and services may be available only through particular Coutts companies.

None of the overseas Coutts companies or offices is an Authorised Person subject to the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors and depositors, and compensation under the Financial Services Compensation Scheme will not be available in respect of business transacted with them.