Has the US avoided a recession?

Summary

Over the past few months, the United States has reported a slew of positive surprises in its economic data, and that has predictably buoyed sentiments in the stock markets and lifted consensus forecast for US economic growth this year. Currently, most street economists are forecasting a one to two per cent economic growth for US in 2012, with stock analysts thinking that the markets may be close to a bottom.

Nevertheless, we find it is too early to give the all clear signal for the US economy as there are several models we use that are still signaling caution.

The first of this is the ratio of coincident to lagging indicator. In the case of the US, this indicator has been falling since the early part of 2011 and it definitely bodes ill for the economy. Additionally, we have created a recession signal system based on a composite of five indicators – bond spreads, ISM reading together with nonfarm employment growth, term spread and stock prices. The latest readings suggest a heightened risk of downturn, even though we acknowledge that the system may not be as reliable as before due to the dramatic shift in the economic structures over the last two years.

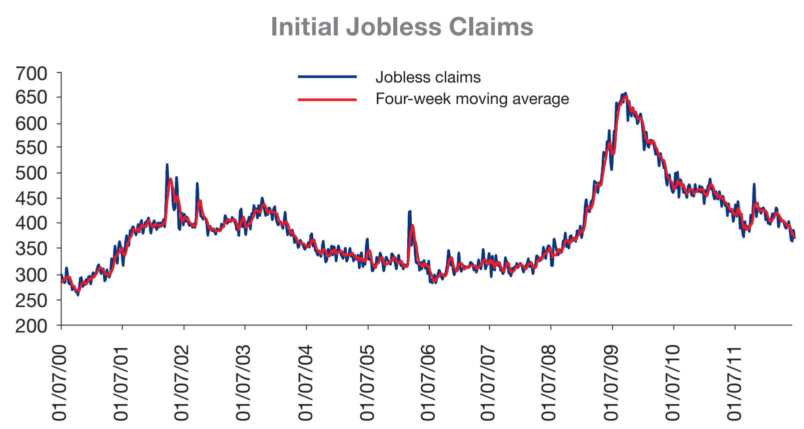
It is in this context that we have adopted a neutral stance in equities, with a view of adding risks later on if it is clear that conditions in Europe, China and US continue to improve. This is our advice for our retail clients as well.

Has the US avoided a recession?

Over the past few months, the United States has reported a slew of positive surprises in its economic data, and that has predictably buoyed sentiments in the stock markets and lifted consensus forecast for US economic growth this year.

Currently, most street economists are forecasting a one to two per cent economic growth for US in 2012, with stock analysts thinking that the markets may be close to a bottom. To be sure, the string of positive surprises in the US cannot be discounted, given that most involved key leading indicators that typically shape the path of the US economy.

Take jobless claims, for example. The weekly indicator – a measure of the speed of job creation – has finally broken below the 400,000 level, and has stayed below that level for the previous month or so. Meanwhile, unemployment rate in the US fell below nine per cent in November 2011, while consumer confidence continued to improve.



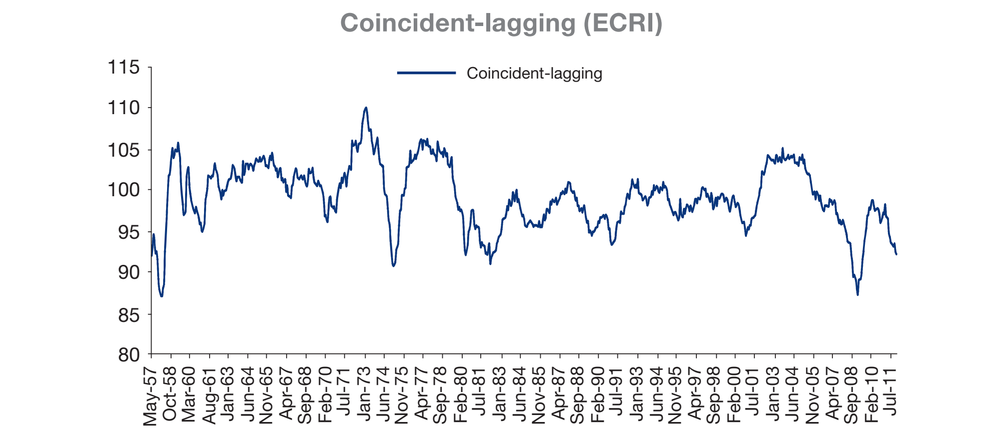
Source: Bloomberg, 6 January 2012

Taken together with the improvement seen in ISM new orders (minus inventory) and improved ISM employment data, there is a good chance that the US should survive 2012 without a contraction.

Additionally, there are signs of improvement in several of the structural overhangs in housing and employment. There is the potential for house building and increasing income from new jobs sustaining economic growth into 2012. While most economists have worried that the US economy is too fragile to withstand external shocks, we find that we are impressed with how resilient the economy has been in the face of the US debt downgrade, the European turmoil, and the global economic impact of the Japan earthquake in 2011.

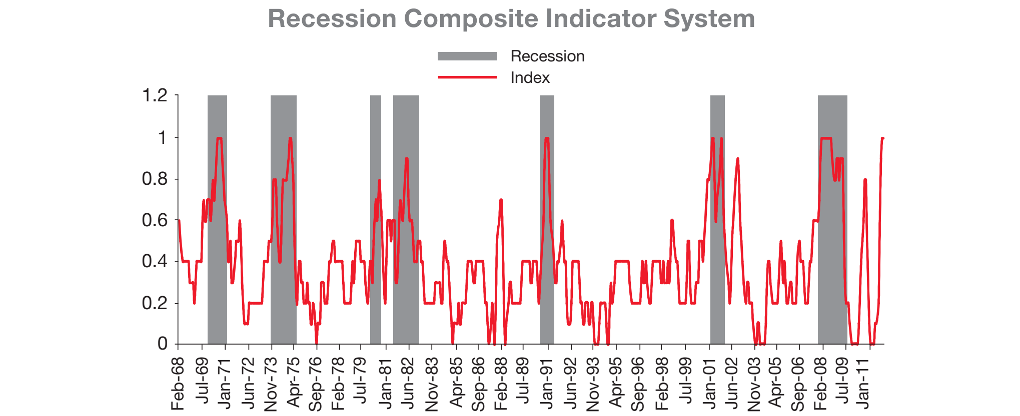
Nevertheless, we find it is too early to give the all clear signal for the US economy as there are several models we use that are still signaling caution. The first of this is the ratio of coincident to lagging indicator. The coincident indicator represents the current pace of expansion in segments such as factory output, retail sales and employment. The lagging indicator, however, captures the cost pressures that typically build up as the economy approaches the mid-phase of its expansion.

As the economic cycle approaches the tail end of its expansion, the coincident indicator typically expands but at a slower pace than the lagging indicator. For this reason, research has shown that the ratio of the two is usually a leading indicator for the aggregate economic cycle. In the case of the US, this indicator has been falling since the early part of 2011 and it definitely bodes ill for the economy.



Source: Bloomberg, 6 January 2012

Additionally, we have created a recession signal system based on a composite of five indicators – bond spreads, ISM reading together with nonfarm employment growth, term spread and stock prices. Each of these indicators is a weak indicator of economy downturn, but when combined together, the aggregate index becomes a far more accurate signal of recessions. The latest readings suggest a heightened risk of downturn, even though we acknowledge that the system may not be as reliable as before due to the dramatic shift in the economic structures over the last two years.



Source: Bloomberg, 6 January 2012

On balance, we are encouraged by the positive slew of economic data from the US, and we believe that there's a good chance that the economy will pull through 2012 with at least a decent growth score. The recent surprises from ISM new orders, employment and continued improvement seen in jobless claims confirmed our assessment.

However, we still urge caution on the part of investors as the global macro risks remain formidable, and there are at least a few other leading indicators that point to possible recession even in the US. It is in this context that we have adopted a neutral stance in equities, with a view of adding risks later on if it is clear that conditions in Europe, China and US continue to improve. This is our advice for our retail clients as well.

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