

ECONOMICS: US PERSPECTIVES—JANUARY 6, 2012

Consumer and Construction Gains Set Stage for Stronger US Growth in 2012

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The fourth quarter showed encouraging signs in consumer durables and construction, two sectors that usually drive the early stages of a recovery. With a modest improvement in job markets, gains in new orders and a rebound in stock prices, we believe the US economy is poised for stronger growth in 2012.

Contrary to earlier fears, the pace of US economic activity showed no sign of stalling in the fourth quarter. Incoming data on retail sales, housing and production indicate that fourth-quarter real gross domestic product (GDP) advanced at an annualized pace of 3% to 3.5%.

It was not only the fastest quarterly growth rate in a year, but the composition of GDP gains was also significant. According to our analysis, consumer durables and housing accounted for roughly half of the increase in real GDP during the fourth quarter. We believe that this may mark a turning point for the US economic recovery, which has been burdened by weakness in these two consumer cyclical sectors since the official end of the recession in mid-2009.

In the early stages of economic recoveries, spending on consumer durable goods and housing usually drives GDP growth. But the current recovery was different. The combination of sluggish job creation, high debt service burdens, weak balance sheets

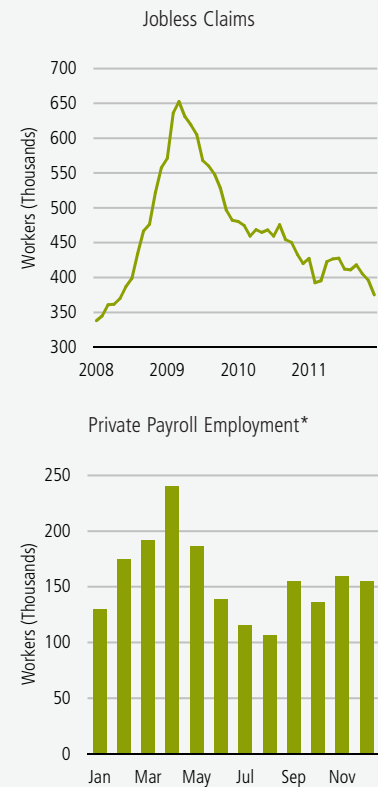
and a large overhang of housing inventory led to a much more subdued contribution than usual from consumer spending and housing.

Debt Burden Has Fallen

This was not a surprise. We expected subpar contributions from these sectors early in the recovery because consumer debt had reached extremely high levels during the financial crisis. Now, after US households made good progress in restoring debt service burdens to more tolerable levels, while labor market conditions have started to improve (**Display 1**), consumers are in a much stronger position to contribute to the recovery through spending and investment.

About a year ago, we anticipated that consumers would begin to reassert their spending power in early 2011. But the process was disrupted by an unprecedented surge in commodity prices—especially oil. Rising energy prices delayed the transition by raising the cost of doing business (which in turn depressed hiring)

Display 1
Labor Market Conditions Improve



As of December 2011
 *Three-month moving average
 Source: Bureau of Labor Statistics, Department of Labor and Haver Analytics

and reducing real consumer spending power. Neither of these trends usually occur in the early stages of a recovery.

Homebuilders Surge in Equity Rally

Beyond consumers, we believe there are additional signs that the US economy is getting back to a more normal business cycle. For example, equity markets rallied in the fourth quarter, with the S&P 500 Index advancing by 11.1% **(Display 2)**. Shares of homebuilders surged by 36% during the quarter, as optimism increased that the depressed sector—which usually performs well in the early stages of an economic recovery—might be starting to bounce back.

Leading indicators also continued to rise, helped in part by a 10% decline in jobless claims to the lowest level in over three years. And, as the recovery has begun to broaden, confidence is building. Consumer surveys have shown a sharp improvement in sentiment for the past two months, while business confidence readings have also strengthened among both big and small to mid-sized companies.

Are Recent Signals Reliable?

It's true that we've seen similar signs of recovery before, which were not followed by the robust GDP growth that was expected. So what makes this rebound more sustainable and more powerful?

We think the current signals are more reliable for several reasons. First, the December purchasing managers' survey showed a solid rise in new order bookings and a decline in inventory positions **(Display 3)**. Perhaps what's even more important is that the ISM survey showed a

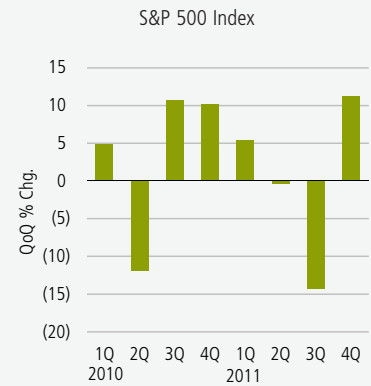
rather sharp decline in customer inventory positions, suggesting stronger new order commitments are in the pipeline.

Second, the inventory of existing homes for sale has dropped back to 2004 levels and the cost of renting has risen above the cost of homeownership in several major metropolitan areas. In our view, this adds credence to signs of recovery in the US housing sector, such as an increase in building permits **(Display 4)**.

Third, worries about a sharp drop in exports due to the European crisis have not materialized as new export orders have risen, according to the December survey of manufacturing purchasing agents. Fourth, fears that a European banking crisis may have contagious effects in the US eased after the European Central Bank recently granted relatively cheap financing for member banks for the next three years.

Of course, it isn't going to be smooth sailing for the US economy in 2012. There's still a long list of unresolved problems—including budget paralysis, large deficits, relatively high unemployment and a recession in Europe—that threaten to create headwinds, which are capable of slowing the recovery process. However, recent signals are encouraging, and we believe that there is enough pent-up demand in consumer spending, housing and business investment to help the US economy overcome challenges and grow by a healthy 3% in 2012. ■

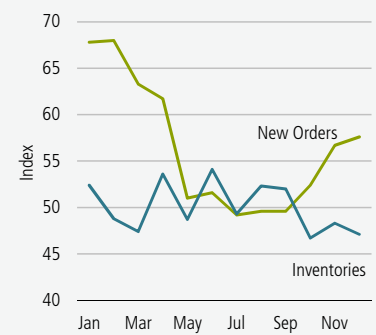
Display 2
Homebuilders Help Drive Stock Rally



As of December 2011
Source: Haver Analytics and *The Wall Street Journal*

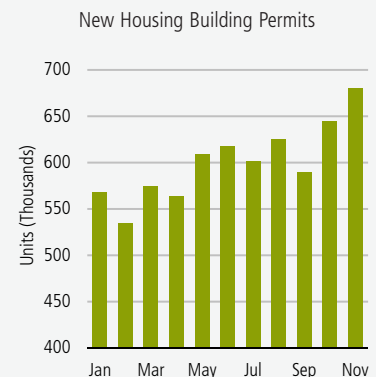
Display 3
Business Trends Are Improving

Manufacturing: New Orders vs. Inventories



As of December 2011
Source: Haver Analytics and Institute for Supply Management

Display 4
Moderate Rebound in Construction



As of December 2011
Source: Bureau of Labor Statistics and Haver Analytics

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