AllianceBernstein

ECONOMICS: US PERSPECTIVES—JULY 2, 2010

Outlook for US and Global Recovery Clouded by a Litany of Fundamental and Policy Issues

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Challenges to a sustainable economic recovery have surfaced across the globe and have been compounded by confusion over regulatory and policy issues. We think strong emerging markets are likely to keep the US recovery on track in the second half, but the outlook may be more volatile than initially expected.

Concern about the global economic recovery has mounted since April, as investors began to worry that sovereign debt problems in Europe might spread and undermine growth trends in other economies. These fears have intensified in recent weeks as further challenges have surfaced across regions.

In Europe, the fiscal crises appear to be deeper and broader than initially thought. In the US, consumer spending softened and confidence weakened toward the end of the second quarter. Even growth in China is now perceived to be slowing. Meanwhile, confusion surrounding the details and timing of financial reform legislation, cap and trade legislation to address greenhouse gas emissions, and tax law provisions that expire at the end of the year all make for a very uncertain world.

Two Key Questions

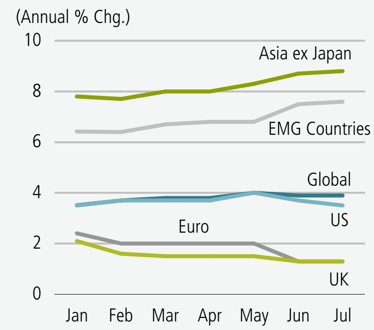
We believe that the answers to two key questions will determine whether the economic recovery remains on track, both globally and in the US. First, will emerging markets continue to provide end-market demand growth to power the global economic cycle? Second, has the US economy sufficiently adjusted its sources of economic growth to sustain its recovery with the help of strong export markets after the effects of fiscal stimulus wane?

Since the start of the year, our global economic outlook has been fairly steady, with our forecast for real GDP growth increasing from 3.5% in January to 3.9% in July. But beneath the steady headline growth trend, the composition of global economic growth has changed significantly through the year, as emerging markets strengthened and Europe weakened **(Display 1)**. Manufacturing surveys support a relatively solid outlook for global growth **(Display 2)**.

We recently raised our forecasts for full-year real GDP growth in emerging markets by 1.2 percentage points from 6.4% to 7.6%. In contrast, we slashed our outlook on European growth from 2.4% to 1.3%, while reducing our UK forecasts

Display 1
Global GDP Forecast Unchanged but Regional Growth Trends Shift

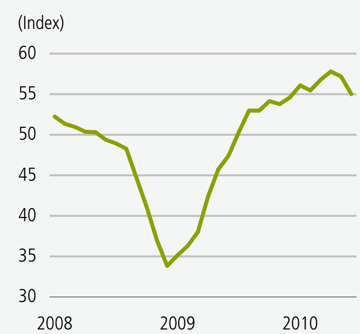
2010 AllianceBernstein Forecasts



Source: AllianceBernstein

Display 2
Bright Global Growth Prospects Still Evident in Manufacturing Survey

Global PMI



Source: Institute for Supply Management and Market Economics from 2.1% to 1.3%. In our view, this shift in regional growth rates bodes well for the US-export led cycle because about 56% of US exports are currently directed towards fast growing emerging markets. In absolute terms, US exports to emerging markets are growing rapidly, and are currently worth more than 3.5 times the value of exports to Europe.

Emerging Markets Remain Robust

Of course, we are attuned to the likely slowdown in some emerging market economies. But it is important to keep in mind that our 2010 forecasts for emerging markets effectively had assumed a slowdown in the second half from the pace of growth in the first half, which was faster than expected. Yet, even though second-half growth will slow, we still expect real GDP to advance by 7% to 7.5% in non-Japan Asia and by at least 5% in Latin America.

Moreover, domestic demand growth in these economies is running a few points faster than real GDP growth. Importantly, all of these economies have the self-sustaining dynamics of strong employment, income growth and robust investment. This bodes well for the global growth cycle as well as the global trade cycle, which is so critical to the US recovery.

US Companies Benefit

In the US, the corporate/manufacturing sectors have been the primary beneficiaries of the rebound in global economic activity and the increase in trade flows **(Display 3)**. Indeed, industrial production has risen, order bookings and backlogs are rising, profits have rebounded, cash flow is at a record level and companies are spending again. Given these improved fundamentals, all of the ingredients for an even stronger rebound into in capital spending are in place. It's now up to companies to make the right decisions about how to spend their cash in order to keep the economic recovery moving forward.

However, we can't rule out the possibility that companies may be deterred from capital spending amid the uncertainty surrounding fiscal sovereign issues in Europe as well as tax and regulatory uncertainty in Washington. It's hard to estimate the potential impact of new regulations as well as potential changes in tax law. But these are important issues to watch because companies will invest capital where it is most welcome and in economies that offer the highest after-tax rates of return. According to a new study by the McKinsey Global Institute, US tax policy has a "major impact" on the competitiveness of US multinational companies and their investment decisions.

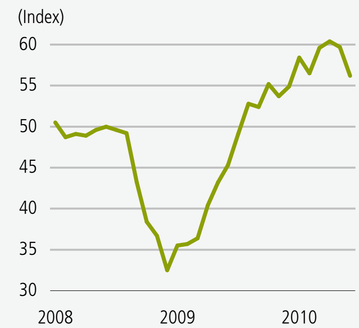
Companies may decide to sit on their cash mountains until there is more clarity on several policy issues, ranging from financial reform to energy policy and tax law provisions that dissipate at the end of the year. Such a pullback in corporate spending would weaken the growth environment, especially as other private sectors—consumption and housing—are still struggling and cannot fill the growth void in the short run.

Seeking Insight from 2Q Earnings

Hopefully, some clarity on the growth outlook will be provided when second -quarter earnings reports are released, beginning later this month, and companies provide guidance on their outlook for the rest of the year. Across the production and distribution chain, companies usually detect changes in economic trends long before they appear in the government economic data, so their insight into current and future trends will be helpful.

Display 3

US Manufacturing Still Leads the Cycle



Source: Institute for Supply Management and Markit Economics

We are particularly interested in comments and guidance on production and investment plans, because these two areas signal whether firms view the current slowdown as a temporary pause or a more serious threat to business conditions. Hopefully, congressional deliberations on financial regulatory reform will be settled by the time the second-quarter earnings season gets underway, so at least one piece of the fiscal puzzle will be settled. How quickly Congress will move on other tax issues is hard to say, but with November elections looming, it would seem to rank high on the list in terms of political importance.

Given the strong underlying trend in liquidity flows and solid growth in emerging markets, we think the US still has a good chance of securing a sustained cycle of economic growth. However, with so many serious issues remaining unresolved, the GDP growth path for the US may be more volatile than we expected, and could swing beyond the range of 3.5% to 4.0% that we currently forecast for the second half of 2010. ■