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Flash Notes

US Macro Forecast: Understanding the Challenges and Assumptions

- The guidance from the various indicators in the first two months of 2008 suggests that overall economic growth is poised to slow further from the sub-1% pace in 4q07. While the more timely regional manufacturing indicators--specifically, the Empire State and Philly Fed--in February suggest greater downside risks to activity, the high-frequency unemployment claims data still imply a slightly positive print on growth in 1q08.

- In particular, the relevant details from the Empire State, Philly Fed and the forward-looking categories in the ISM combined suggest a preliminary forecast of 48.0 for the manufacturing index in February, which would be consistent with a general contraction in manufacturing activity. Still, the forecasted slippage in the ISM manufacturing is not overwhelmingly suggestive of a recession (since 1980, the average ISM manufacturing level during recessions is around 41). While the plunge in the non-manufacturing index in January appears to be more recession-like, the magnitude of the downshift seems exaggerated when compared to a host of individual indicators in the non-manufacturing industry. Moreover, diffusion indexes in general tend to be a better indicator of directional guidance rather than a pure estimate of magnitude. Hence, it might be incautious to conclude from the negative guidance from the ISM releases (manufacturing and non-manufacturing) per se that the economy is guaranteed to slip into recession. But more persistent and widespread readings of sub-50 across the different ISM components would certainly be consistent with a more significant downturn in economic activity.

- An alternative approach--based on tentative readings and assumptions of the respective categories of aggregate demand--suggests that real GDP growth might be tracking close to flat in 1q08 at this time. Although the latest core consumer inflation (core PCE and core CPI) readings have nudged gradually higher, the near-term growth backdrop is clearly more pressing at this juncture. The relevant assumptions in our growth forecast are as follows:

  - Real consumer spending seems to be tracking *at most* around 1.0% annualized in 1q08, with risks of a very mild contraction. The combined effects of tighter lending standards, softer labor market backdrop, still-high gasoline prices, falling house prices, lower future sentiment among consumers and reasonably strained financial market conditions should restrain consumer spending generally. However, the anticipated boost from the tax rebates and the lagged effects from Fed policy accommodation could provide an awkward lift to consumer expenditures, mainly in the second-half of 2008.

  - Real non-residential investment is expected to grow at a mid single-digit pace in 1q08, roughly similar to the average growth rate in the prior five quarters. But the 1q08 composition should show that business structures grew at a markedly slower pace, while growth in equipment and software spending might have improved some from the advance 4q07 reading of less than 4%. To be sure, the fall in architectural billings in early 2008 coupled with anecdotal evidence of reduced demand essentially reinforces the view that growth prospects in non-residential construction should be subdued. Separately, the forward-looking guidance on capital expenditures from the regional manufacturing surveys generally also implies a downward tilt in the growth trajectory in the coming months.

  - Yet again, the rate of contraction in real residential investment is expected to be more than 20% in 1q08, perhaps in the vicinity of the advance 4q07 decline of nearly 24%. On the one hand, the hesitant stabilization of homebuilder sentiment recently implies that further downside risks in residential construction might be curtailed somewhat; on the other hand, the continued slide in single-family permits and starts suggests that expectations of a likely trough in residential investment are still tentative at best.

- The assumptions surrounding the other categories of aggregate demand--namely government spending and contributions from net exports and inventory change--are generally more tentative simply because there is limited guidance and that available estimates are rough. Nonetheless, I still expect net exports to continue to add to growth, perhaps by less than 1% in the current quarter. Similarly, government spending should still contribute positively to growth, probably about close to the average of the prior four quarters. Conversely, inventories should exert some drag on growth, albeit at a less pronounced pace than the 4q07 advance estimate. As such, the preceding limitations basically preclude any conclusive interpretations as to whether or not real GDP growth might be mildly positive or slightly negative in 1q08 at this juncture.

- On the whole, our updated 2008 baseline real GDP growth forecast differs from our previous forecast specifically on two fronts: 1) The quarterly growth composition in the first-half of 2008 underscores an almost stagnant 1q08 but a marginally better 2q08; 2) The average growth pace in the second-half is expected to be higher than the first-half of 2008, mainly as a result of the announced tax rebates and aggressive Fed easing through January. Nonetheless, our sub-1% forecast for real GDP growth in the first six months of 2008 on average is roughly similar to our previous projection. In fact, our 4q08/4q07 growth forecast of 1.3% is actually at the lower-end of the central tendency projection of the Board and Reserve Bank Presidents (in the January FOMC minutes). Finally, although I expect economic growth to recover in the second-half of 2008 to around 2% or slightly higher on average, the sub-par growth environment could conceivably reemerge in 2009. Interestingly, the range of real GDP growth projections by the Board and Reserve Bank Presidents for 2009, which is between 1.8% and 3.2%, is actually larger than in 2008, which is between 1.0% and 2.2%. Indeed, Fed policymakers are attempting to find (and communicate) the delicate balance between one-sided market expectations of policy easing in the near-term, and greater uncertainties (upside and downside) in the medium-term economic projections.

US Macro Forecast

(%)	4q07	1q08E	2q08E	3q08E	4q08E	1q09E	4q07/4q06	4q08/4q07
Real GDP (ar)	0.6*	0.2	1.0	2.0	2.1	1.2	2.5	1.3
Real PCE (ar)	2.0*	0.4	1.0	2.8	2.4	1.7	2.5	1.7
							2007 avg	2008 avg
Unemployment Rate (avg)	4.8	5.1	5.3	5.4	5.5	5.6	4.6	5.3
Core PCE Price Index (oya)	2.1*	2.2	2.3	2.3	2.0	2.0	2.1	2.2

Note: Over-a-year-ago (oya); annual rate (ar); average (avg)
* Advance estimate

Source: Actual data sources and UOB forecast

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