

US Economic Outlook

14th February 2007

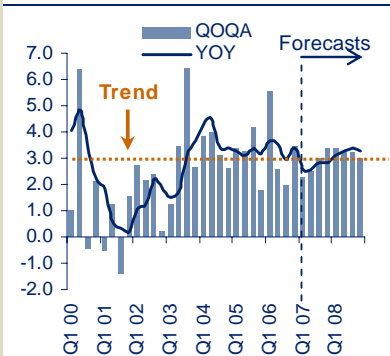
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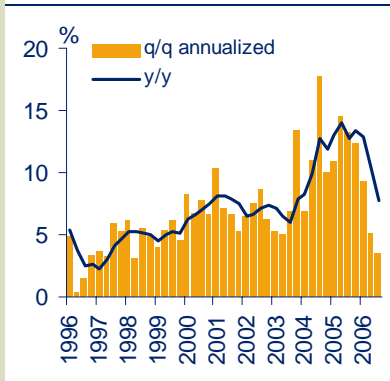
Real GDP growth (%)

Source: Thomson Datastream/RBS Group Economics



House price growth has slowed sharply, but we expect a soft landing

Source: OFHEO



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**US Housing Market:
Rusting not Busting**

Strength beneath the surface

Despite a few quarters of sluggish growth in 2006, fundamentals remain solid. Indeed, outside of the housing and auto sectors, demand continues to expand briskly. Even after seventeen interest rate hikes, monetary conditions remain fairly supportive, with a weak dollar and low long-term interest rates offsetting the restraining impact of higher short-term rates. While the economy may grow a little below its long-term rate of 3% in the first half of 2007 it is likely to move back above trend as the housing market stabilises.

Inflation still out of the Fed's comfort zone

Inflation gauges remain elevated. Since the economy is currently operating at close to full capacity and is expected to regain momentum as the drag from the housing market fades, talk of rate cuts appears misplaced. Indeed, further rate hikes are likely to prove necessary before the end of 2007/2008 in order to ensure that price stability is maintained.

Re-balancing in the domestic economy

The key challenge over the next two years will be to manage the transition from a consumer-led to a more balanced economic expansion. Households have been spending more than they've been earning, relying on rising asset values – especially real estate - to fill the gap and bolster their financial position. The cooling housing market and higher interest rates have closed the door on this activity. Nevertheless, stronger earnings growth should allow for a modest increase in the savings rate while supporting respectable gains in consumer spending.

Corporate sector pulling its weight

Firms look well placed to take up the growth baton. A lack of spare production capacity and strong profitability are providing the motivation to invest and strong balance sheets and favourable credit conditions are ensuring the finance is in place. Similarly, more robust demand growth abroad and the competitive exchange rate should help the trade sector start to contribute to, rather than subtract from, the overall growth performance.

Housing market should achieve a "soft landing"

There is a risk that a sharper housing market correction could prompt households to retrench more rapidly than we currently expect, dealing a significant blow to economic prospects (consumers account for around 70% of all spending in the economy). Indicators in recent months are consistent with an orderly adjustment, although activity is slowing sharply. You can read more on this topic by clicking [here](#).

Main macroeconomic forecasts	2005	2006	2007f	2008f
Real GDP Growth (%)	3.2	3.4	2.7	3.3
CPI (%)	3.4	3.2	2.3	2.6
Core CPI (%)	2.2	2.5	2.7	2.7
Unemp. Rate (% End Period)	4.9	4.5	4.7	4.4
Fed Funds Rate (% End of Period)	4.25	5.25	5.50	5.75
Fiscal Balance/GDP (% Fiscal Year)	-2.6	-1.9	-1.5	-1.5
Current Account Balance/GDP (%)	-6.4	-6.5	-6.0	-5.7

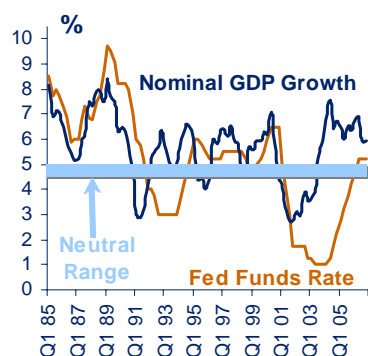
New home sales and building activity

Source: Thomson Datastream



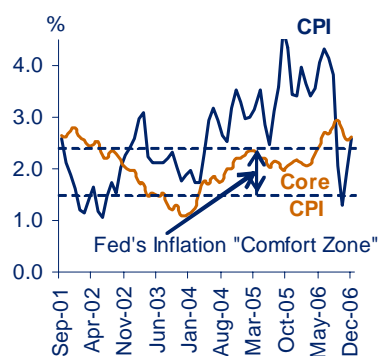
Policy settings not overly restrictive

Source: Federal Reserve/Bureau of economic Analysis/RBS Group Economics estimates



Inflation still too high....

Source: Bureau of Labor Statistics



Slowing not stalling

At first glance it's not hard to understand why some analysts expect a significant slowdown in economic activity. After all, the Federal Reserve has implemented seventeen interest rate hikes over the past two and a half years, the housing market slowed rapidly in the second half of 2006, and the pace of economic growth slipped on a number of occasions last year. Nevertheless, we believe that the US economy remains in good shape and expect GDP growth to slow only modestly below its 3% trend rate in the first half 2007, before accelerating above trend later in the year and into 2008. Indeed, given that price pressures are still evident, the Federal Reserve will probably have to raise interest rates a little further in order to ensure that underlying inflation stays within its preferred range (1.5% to 2.5%).

Recent data consistent with a "soft landing"

Demand for new homes slumped over the course of 2006 and construction activity followed, declining by almost 20% in Q3 and Q4, sending a chill down the spines of most economy-watchers (chart). Nevertheless, demand conditions outside of the residential construction sector have remained buoyant. Excluding home building, real GDP growth was an impressive 3.8% last year rather than the 3.4% recorded for the overall economy. Moreover, there have been no signs that the rapid cooling in the housing market is spilling over into other sectors of the economy. Consumer spending is being supported by rising employment and healthy wage growth. Businesses are also in rude health and likely to keep ramping up investment – plant and equipment are operating close to capacity and profitability is close to all-time highs. Lower energy prices are also helping to boost confidence – oil prices fell towards \$50 a barrel in January 2007, almost 35% below the peak of \$75 recorded last year.

Monetary conditions still fairly supportive

Crucially for the outlook, policy settings are not overly restrictive, despite the seventeen rate-hikes implemented since June 2004. We estimate the neutral fed funds rate (the level of interest rates that neither restricts nor stimulates economic activity) to be in the 4.5% to 5% range. As a result, the current fed funds rate of rate of 5.25% is only just starting to dampen economic activity. Moreover, the restraining impact of higher short-term interest rates has been partly offset by a decline in long-term interest rates (the yield on ten-year government bonds has fallen from 5.25% in mid-2006 to 4.75% in January 2007). Moreover, the decline in the dollar, which gives a lift to US producers by making their products more competitive at home and abroad, will also help ensure that the economy maintains its forward momentum.

The rate hiking cycle probably isn't over yet

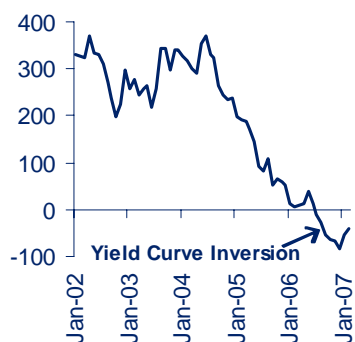
We believe that, as the drag from the housing sector fades in the second half of 2007, GDP growth is likely to move back above 3% - its long-run sustainable rate. This will concern policymakers. A range of measures suggest there is little slack left in the economy, so above-trend growth could feed through quickly into higher inflation, which is already too high. Core inflation (the measure which excludes volatile items like food and energy prices), reached 2.7% in Q4, above the Fed's comfort zone (see chart). Further policy tightening will therefore be required in the second half of 2007 and 2008, in order to ensure price pressures moderate. 5.75% should mark the peak in the fed funds rate for the current economic cycle, but the risks around this forecast appear balanced. The Fed may have to tighten policy even more to keep the economy on an even keel if growth rebounds more strongly than we expect, while a sharper slowdown in the housing market could persuade the Fed to stay its hand.

Long-term interest rates remain historically low

The yield on ten year treasuries securities, at 4.75% in early February, was 50bps below the fed funds rate - technically referred to as a yield curve inversion. Historically, this is an unusual occurrence - long-term interest rates are normally higher than short-term interest rates to compensate investors for the risks involved in lending over a longer term horizon. A number of factors are at play. Investors appear to be attaching a high probability that the economy will stall, and that, as a result, the Fed will lower interest rates in the years ahead. In addition, pension funds have a voracious appetite for long-term assets that

Gap between short and long-term interest rates (10Y note yield less fed funds, bps)

Source: Thomson Datastream



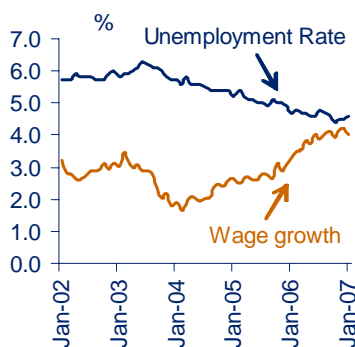
Share of wages and salaries in national income (%)

Source: Thomson Datastream



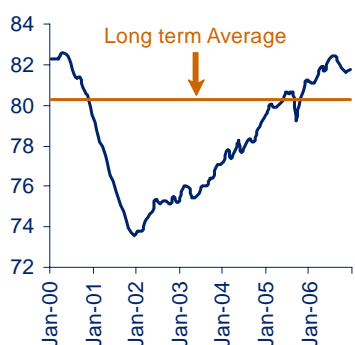
Labour market conditions are tight

Source: Bureau of Labor Statistics



Capacity utilisation rates (%)

Source: Thomson Datastream



match the long-term nature of their liabilities (i.e. the pensions they will have to pay out to retirees), pushing up the price of long-term bonds and hence holding down the yield (bond prices and yields move inversely). Foreign central banks have also been purchasing dollar assets in large quantities, especially government bonds, in order to keep their exchange rates stable against the dollar, inadvertently holding down long-term interest rates.

We would normally expect the yield on ten year government bonds to be up at 5.25% or 5.5% at present, if not higher. After all, policy settings are not very restrictive, inflation is above policymakers' comfort zone (1.5% to 2.5%) and, as the Fed notes, the inflation risks are skewed to the upside. This should really be reflected in higher longer term rates. However, long-term interest rates are unlikely to rise significantly until investors are convinced that the economy (and housing market) has achieved a "soft landing". Even then the increase in long-term interest rates is likely to prove relatively modest, since demand for long-dated securities from pension funds/central banks is likely to remain strong.

Consumer sector - standing firm

The consumer has been the backbone of the current expansion. This is demonstrated by the fact that household spending currently accounts for around 70% of all spending in the economy, far above the long-term average of 65%. The sustainability of spending patterns has been questioned, since households have been spending an ever increasing proportion of their incomes. Indeed, over the past two years households actually spent more than they earned for the first time since the Great Depression. Nevertheless, concerns that the consumer sector is about to falter appear wide of the mark.

Despite the apparent "dis-saving" of recent years, **household net wealth still reached a new record high of \$54.3 trillion in Q3 2006**, thanks to the increase in the value of household assets (especially housing). Indeed, it's important to note that house prices have continued to rise in recent quarters, albeit at a much slower rate. The recent buoyancy of the equity market, with the main indices reaching all time highs, has provided another fillip to wealth. Not only are household balance sheets in robust shape, but income trends are also becoming increasingly supportive.

Until recently, wage growth had been subdued – so much so that the share of national income made up by wages and salaries has fallen to its lowest level since records began (see chart). However, as the amount of spare capacity in the labour market has diminished, with the unemployment rate now well below most estimates of full employment, incomes are starting to rise more quickly. Hourly wage growth accelerated to 4.2% y/y in Q4 – its fastest rate for five years. This provides comfort that, as home price growth continues to slow and households start saving from their take-home pay, incomes will be rising fast enough to support continued healthy rates of spending as well as a gradual increase in the savings rate. We expect household spending growth to slow only modestly, rising by around 3% in real terms in 2007 and 2008 – slower than recent years, but close to the longer-term trend.

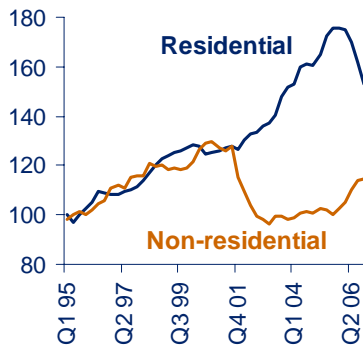
Corporate sector – plenty of forward momentum

The headline investment figures show a marked slowdown over the course of 2006. However, this reflects the weakness in home-building, where spending fell in each of the last five quarters, slumping by a massive 19% in Q3 and 20% in Q4 on a quarter-on-quarter annualised basis. By contrast, spending on equipment and software has remained much more buoyant, rising by almost 7% over the course of 2006. Even within the construction sector its not all doom and gloom – there has been a sharp upturn in non-residential building outlays (offices, industrial plants, infrastructure), which advanced at a blistering 15% pace in Q3 after a 20% jump in Q2.

There is every reason to expect capital spending outside of housing to remain strong. Firstly, firms need to put more capacity in place. Capacity utilisation rates have moved above their long-run averages (chart), which suggests that they will struggle to keep up with domestic demand without adding to or upgrading their plant and equipment. Profits remain at historic highs, both in absolute terms and as a share of corporate output, which gives firms a strong motive to invest. The evidence suggests that the upturn in non-

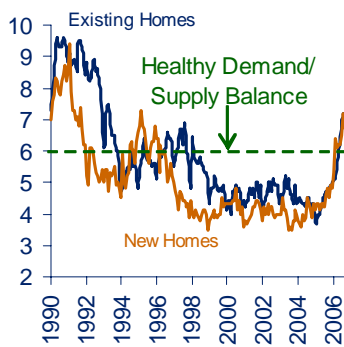
Construction output – a tale of two sectors (Index 1995 = 100)

Source: Thomson Datastream



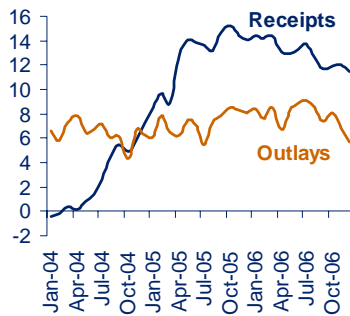
Housing inventories (months of supply)

Source: Thomson Datastream



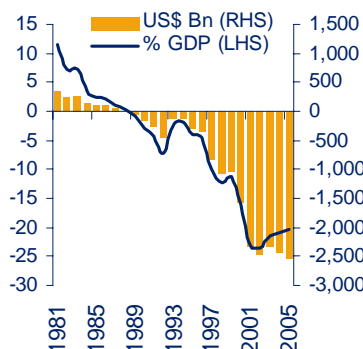
Trends in federal spending and receipts (% change y/y)

Source: Datastream



US moves from net creditor to net debtor (net international investment position)

Source: IMF/BEA



US Economic Outlook

residential investment has a long way left to run - spending on structures (in real terms) is still around 11% below the peak recorded in 2000 (chart). Anecdotal evidence is also encouraging. The Fed's Beige Book of regional business conditions reports that commercial property vacancy rates are declining and rents edging up in many areas, where the firming in conditions is starting to trigger increased construction activity in a number of locations.

There are certainly few constraints on the funding side. The non-financial corporate sector is currently running a financial surplus, i.e. lending funds to the rest of the economy, rather than the usual situation where firms make use of household savings to fund investment. Many firms don't require access to external funding at present as much of the sector remains flush with cash. This unusual situation is unlikely to persist, as profit growth slows back to more sustainable levels and rates of investment continue to rise. Favourable credit conditions will ensure that this will not hamper investment prospects. Long-term interest rates remain at historically low levels and intense competition between lenders hungry for business means that loan spreads remain narrow and lending terms attractive.

There have even been tentative signs of stabilisation in the housing market. Home sales firmed at the tail end of 2006 and the stock of unsold homes on the market flattened off, albeit at fairly high levels (chart). Ongoing cutbacks in construction activity will reduce the pipeline of new homes coming onto the market, helping to bring the demand and supply side of the market back into balance. Monthly data on new home starts indicate that the rate of slowdown in building activity is starting to moderate, suggesting that the most wrenching part of the adjustment in the residential construction sector may already be behind us.

Government sector – less red ink

There has been a marked improvement in the public finances in recent years. The government racked up a deficit of \$248 billion (1.9% of GDP) in the 2005/06 fiscal year (which runs from October to September), down from a \$317 billion (2.6% of GDP) in 2004/05 and \$411 billion (3.6% of GDP) in 2003/04. The reduction has largely been achieved thanks to a strong rebound in tax revenues after a prolonged slump, which more than offset the impact of rising government expenditures (see chart). The improvement was most pronounced in the corporate sector, where tax receipts increased by over 22% in fiscal 2005/06 after jumping by 46% in 2004/05 thanks to surging profits. However, this positive trend has been complemented by a strong increase in personal income taxes (+11% y/y in 2005/06) and higher employment contributions (+5.4% y/y) as labour market conditions strengthened.

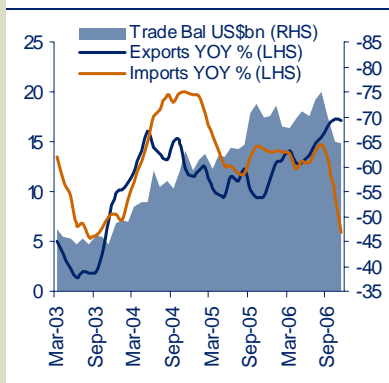
Our forecast for healthy economic growth over the next two years will provide support for the public finances in the near term, but structural problems remain. While government spending is likely to continue to rise at a 5-6% annual pace over the next two years, revenue growth is likely to stay one step ahead. (Receipts from the corporate sector are likely to do less of the heavy lifting as profit growth slows back to more sustainable levels.) We expect the deficit to come in at around \$200 billion, 1.5% of GDP, in 2006/07 and remain broadly flat as a share of GDP in 2008/09. Given the relatively low public debt burden, such modest deficits are easily sustainable over the long-term. Unfortunately, due to mounting demographic pressures, the deficit is likely to increase substantially further out. The baby-boom generation start to retire en-masse from 2009/10, which will increase the demand for pensions/healthcare while at the same time shrinking the tax base.

External trade – gradual unwinding of imbalances (hopefully)

The trade gap reached yet another record high of \$764 billion last year (6% larger than 2005), while the current account deficit (which includes overseas interest and income payments/receipts as well as the trade in goods and services) is estimated to have been even larger at over \$850 billion. This widening trend is unsustainable over the longer term. Last year the US had to borrow the equivalent of over \$7,500 for every US household from the rest of the world. Indeed, thanks to over a decade of large current account deficits the US has moved from being a net creditor nation in the global economy to a net debtor, with the liabilities owed to the rest of the world currently around 25% larger than the assets

Trade imbalance remains a concern

Source: Thomson Datastream



Where next for the dollar?

Click [here](#) to read our view on longer-term prospects and risks

owned overseas (chart). There is a risk that international investors will become unwilling to fund the deficit, triggering a further sharp decline in the dollar, and possibly a move up in long-term US interest rates, which could lead to slower growth. (You can read more about this scenario and the potential implications for the global economy by clicking [here](#)).

Global re-balancing and a weak dollar will help the adjustment

Thankfully, the risk of a disorderly adjustment appears relatively modest. Indeed, there were encouraging signs of improvement towards the end of 2006. Import growth moderated significantly (thanks in part to falling oil prices), while US exports continued to perform strongly, with sustained double-digit rates of growth (chart). The conditions are in place for a further gradual reduction in the trade gap. Growth is picking up in the US' main trading partners – especially the Eurozone. Indeed, even in China (where growth is not expected to accelerate), we expect a gradual shift in the pattern of growth in the region, away from exports and towards domestic consumption. These trends should give a lift to US exports. At the same time, a modest slowdown in the pace of US household spending growth, together with lower oil prices, should help to restrain imports.

The exchange rate should also facilitate the adjustment. The greenback is likely to gain ground in the quarters ahead, as investors come around to our view that the next US interest rate move will be up rather than down (see table below). Nevertheless, the extent of the gain is likely to be limited by ongoing concerns about the magnitude of the US trade deficit, and so will remain at comparatively weak levels against the other major currencies. Indeed, once US interest rates peak in 2008, the dollar is likely to depreciate once more. This is good news for exporters - a weak dollar will help lift the competitiveness of US producers in international markets.

Nevertheless, the improvement in the trade gap will almost certainly be a very gradual affair. After all, US demand growth is expected to remain fairly robust and US imports are already 80% larger than its exports. This means that exports have to rise much faster than imports to achieve an improvement in the deficit. Overall we expect the current account deficit to decline to around 6% of GDP in 2007, down from an estimated 6.5% last year, before narrowing further in the years ahead.

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS								
	Exchange Rates		Interest Rates (%)					
	\$ per £	\$ per €	Funds Rate	3M \$ Libor	6M \$ Libor	12M \$ Libor	5 year Swap	10 year Swap
2006 Q1	1.73	1.21	4.75	5.00	5.14	5.29	5.25	5.29
Q2	1.85	1.28	5.25	5.48	5.59	5.69	5.64	5.68
Q3	1.87	1.27	5.25	5.37	5.37	5.30	5.10	5.08
Q4	1.96	1.32	5.25	5.36	5.37	5.33	5.16	5.10
2007 Q1	1.94	1.28	5.25	5.35	5.40	5.40	5.40	5.30
Q2	1.91	1.26	5.25	5.40	5.40	5.40	5.40	5.30
Q3	1.88	1.26	5.25	5.40	5.50	5.40	5.40	5.40
Q4	1.88	1.28	5.50	5.60	5.70	5.60	5.50	5.60
2008 Q1	1.83	1.30	5.50	5.60	5.70	5.60	5.50	5.60
Q2	1.83	1.30	5.50	5.65	5.70	5.60	5.50	5.60
Q3	1.86	1.34	5.75	5.90	5.90	5.60	5.70	5.80
Q4	1.88	1.35	5.75	5.85	5.85	5.50	5.60	5.80

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