

Is the US headed for a recession?

Growth fears in the US and liquidity concerns in Europe rocked markets overnight. The Dow Jones Industrial Average closed down by more than 400 points for the fourth time this month, with Financials taking a big hit on European banking fears while the S&P 500 index slumped 4.5% to 1,140.65 with all 10 industry groups in the S&P 500 falling at least 1.2%. In Europe, the Stoxx Europe 600 index lost 4.8% (its worst plunge since March 2009) and Germany's DAX index slid 5.8% (the most since 2008). Associated price action was fairly predictable: the VIX volatility index spiked up to 42.7; Gold broke above US\$1,830/oz; and Oil fell back to US\$81/bbl.

Early in the US trading session, rumours that a Euro Area bank had sought US\$500 million of short dated liquidity from the European Central Bank (ECB) unnerved the market; as did news of a bilateral agreement between Greece and Finland, requiring the former to pledge collateral in future debt talks thereby effectively 'structurally subordinating' all other bond holders. The main catalyst for the market action however appeared to be the appalling performance of the Federal Reserve Bank of Philadelphia's August manufacturing outlook survey.

Dismal US data heightens recession fears

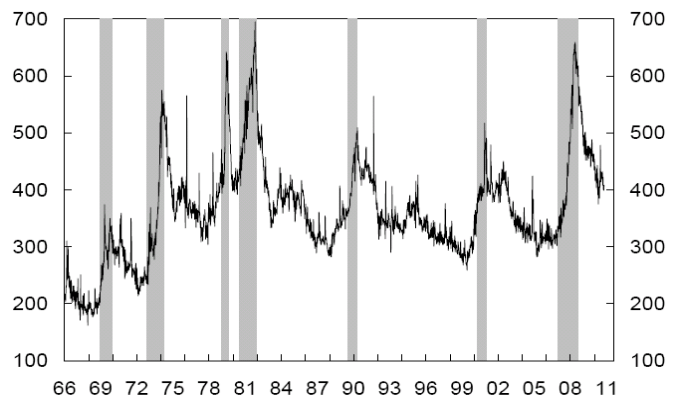
The Federal Reserve Bank of Philadelphia's August manufacturing outlook survey showed a plunge in its general business index to -30.7 in early August from +3.2 in July, the lowest since March 2009 and well below market expectations of +2.0. Readings less than zero signal contraction in the area covering eastern Pennsylvania, southern New Jersey and Delaware.

Meanwhile, jobless claims and consumer inflation rose and existing home sales fell. The Consumer Price Index (CPI) rose 0.5% in July as energy costs jumped 2.8% and food costs rose 0.4%. The core rate rose 0.2%. The overall CPI was higher than expected, while the core rate was in line. Away from another moderate jump in tobacco pricing, the remainder of the core CPI showed restrained pricing. New vehicles prices rose 0.1% after 1.0% jumps in the prior two months as production has resumed. This bodes well for vehicle sales ahead.

While Citi analysts doubt the CPI core rate is likely to rise 0.2% every month ahead, yesterday's data provides little relief for policymakers on immediate inflation concerns. The 1.8% year-on-year gain in the core rate is not high or terribly troubling, but it is not subsiding as was the case at this time last year.

Initial unemployment insurance claims rose 9,000 to 408,000 in the week ending August 13. While this was slightly above street estimates, the four-week average fell to a four-month low (402,500). More importantly, Citi analysts highlight that the rise in unemployment insurance claims are currently not at levels that had preceded past periods of recession.

Initial Unemployment Insurance Claims and Periods of Recession



Note: Shaded areas denote US recessions.
Source: BLS, NBER. As of August 13, 2011.

Revisions to our US forecasts

GDP growth

In a matter of weeks, the outlook has shifted down sharply as the economy faces new headwinds from increased market uncertainty and tighter financial conditions. Citi analysts have marked down their growth projections for the balance of the year and into 2012. These projections still are fluid because markets have yet to stabilize.

For 2011, Citi analysts now forecast a full-year GDP average of 1.6% (previously 1.7%), with the second half close to 1.7% (previously 2.2%). For 2012, they have cut the estimate for full-year GDP to 2.1% from the 2.7%. The significant cut to the 2012 GDP growth rate now includes an assumed continuation of the payroll tax cut of 2011. Declines in equity wealth and the likely slower entry point for growth heading into 2012 may however more than fully offset this benefit. But lower private interest rates and energy costs could help at the margin.

Barring another substantial financial shock to the economy, Citi analysts do not believe that a recession is the most likely outcome. Although sentiment indicators have mirrored the plunge in markets, hard data such as retail sales and industrial production indicate that the economy was actually gradually pulling out of the first-half malaise. Lower rates and oil prices may also help the economy withstand the latest shock. Sluggish demand could however cause a small rise in the unemployment rate. If so, Citi analysts believe the Fed may seek to lengthen the duration of its Treasury portfolio. But elevated inflation readings take new expansion of the balance sheet off the table for now.

Corporate earnings

With the lower GDP growth estimates, Citi analysts have cut their S&P 500 earnings-per-share (EPS) forecasts for 2011 to US\$97 (previously US\$98) and 2012 to US\$101 (previously US\$105).

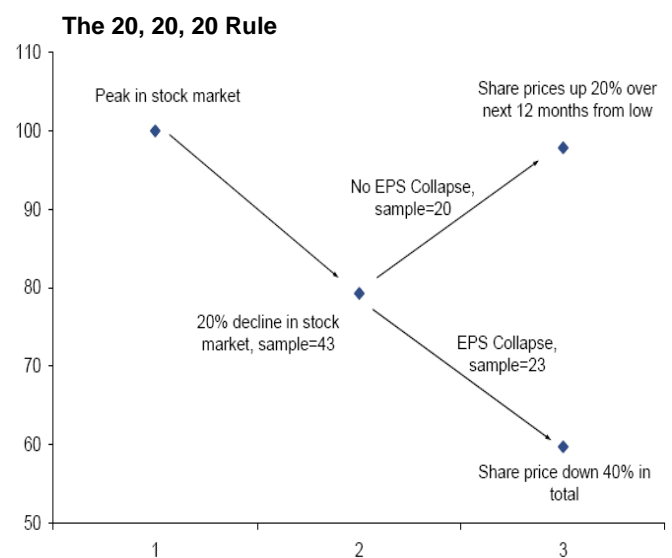
Even with cuts in the US outlook and presumably much of the developed world, Citi analysts do not assume the entire global economy will slow to the same full extent. While investors reasonably fear for cyclical industries everywhere, they see evidence that US multinationals may still have further earnings gains to reap from overseas business expansion plans. While an emerging concern for investors, profits earned abroad could still be a standout source of strength and one of the few small sources of upward risk in Citi analysts' new estimates.

Another assumption behind Citi's latest forecasts is that sovereign debt and banking strains in Europe or elsewhere are ultimately managed without inducing severe shocks to the global economy. Weakness in growth expectations in Europe or the wider world have yet to generate dangerous credit and banking events, and Citi analysts believe policymakers can, with the will to do so, prevent a recurrence of such financial shocks.

Global equity market outlook

At their lows last week, global stock markets declined by about 20% from 2011 highs. Citi's analysis of initial 20% falls in major equity markets over the last 40 years shows that stock prices have subsequently taken one of two paths. Either an extended bear market decline where prices fall a further 20%. Or a rebound where stock indices rally by 20% over the next 12 months.

Citi analysts believe a rebound in stock prices is the most likely outcome from here. They note that extended bear market declines occur almost exclusively around a corporate earnings recession. These are periods when EPS falls by 10% or more. Their analysis suggests the probability of a global profits collapse (like we saw in 2007-2009) is rising but still low. From here, to get an earnings collapse, they believe we need to see a combination of (1) even higher return on equity (RoEs), (2) faster capex growth (relative to sales), (3) more extreme stress in inter-bank markets and (4) wider global credit spreads.



Source: Citi Investment Research and Analysis. As of August 17, 2011.

That said, GDP forecasts are in the process of coming down to levels consistent with sluggish growth, but not a global recession. This has negative implications for the global corporate earnings outlook. Citi's new forecast for global EPS growth is 12% for 2011 (previously 18%) and 9% in 2012 (11%). Bottom-up consensus forecasts for 2012 currently stand at 15%.

In line with their EPS downgrade, Citi analysts have lowered their end-2011 market target for the MSCI All Country World Index (ACWI) to 360 from 380. They target 390 for end-2012. Global stock prices are expected to continue grinding higher with EPS until there are clearer signs of a peak in the current global corporate earnings cycle.

Conclusion

The ongoing sovereign crisis in Eurozone, worse-than-expected macroeconomic data and roll-over of some lead indicators have added to investors' worries and risk aversion more recently. Despite all the worries and lack of progress in the first half of 2011, Citi analysts remain constructive on global equity markets based on reasonable valuations, low interest rates and positive earnings trends. Their view is for global stock indices to grind higher with EPS. Cheap equity valuations relative to history and ultra-low interest rates also suggest the potential for more de-equitisation (Merger & Acquisition/buybacks).

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