

U.S.: FOMC Poised to Step Up, Home Prices Step Down; Canada: Confirming Weaker Start to H2

By Prajakta Bhide, Christian Menegatti and Rachel Ziemba

Page
2

EXECUTIVE SUMMARY

We kick off our look at North America with the U.S., where the FOMC meeting clearly conveyed that the committee is poised to deliver additional monetary stimulus. We expect to see an announcement to this end at the November meeting. Last week's incoming data on durable goods showed improvement, but on balance the data point to slower investment in Q2. This week, we expect a small downward revision to the Q2 2010 GDP second estimate given weaker construction data in June. Meanwhile, we envisage the ISM index edging lower, after a surprise gain in July. Last week's data on new home sales showed little signs of a pickup in demand. This week's data on home prices should begin to reflect the post-homebuyer tax credit downward correction; the tax credit merely delayed the inevitable downward correction in home prices, which we expect to continue through 2011.

Moving north of the border, we take a look at last week's retail sales data, which highlighted continued weakness in Canadian domestic demand and, together with leading indicators, point to weak consumption in Q3. Meanwhile, we expect real GDP to show a modest contraction for July. The recent spate of softer data, including higher unemployment claims and weaker inflation data, suggest the Bank of Canada may choose to pause at its next meeting in October. Likewise, slower economic growth suggests a pause in the improvement of Canada's fiscal position.

United States: FOMC Poised to Step Up, Home Prices Poised to Step Down

By Prajakta Bhide and Christian Menegatti

FOMC: Poised to Step Up?

Last week's [FOMC meeting](#) marked a significant milestone in the transition of the Fed's outlook over the course of the year. Early in the year, the Fed's communications emphasized the need to have an exit strategy from policy accommodation. However, as signs of a slowing recovery emerged in the data in Q2, the Fed's statements began to acknowledge that the recovery was slower than anticipated. As the weakness in economic data became more widespread in H2, policy makers spoke less about exit strategies and instead issued assurances of the Fed's ability to provide additional stimulus, should it be required.

Last week, this gradual change from a tightening to an easing stance was officially formalized, with the statement: "The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate." Also significant was the change in the emphasis on [inflation](#), as the

September FOMC statement acknowledged: “Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability.” This was in contrast with the August statement, which noted: “Measures of underlying inflation have trended lower in recent quarters.” The contrast is especially notable given there was not a big change in the inflation data between the two meetings. The reference to the low inflation in conjunction with the Fed’s mandate additionally formalizes the Fed’s stance.

We [recognized the gradual change](#) in the tone of the FOMC’s communications some time ago. Given our forecast of a significant growth slowdown in H2, and our expectation that inflation will trend still lower, we knew it would only be a matter of time before the Fed was pushed to provide additional stimulus. We will closely monitor the data between now and the next FOMC meeting in November, at which (as [noted earlier](#)) we continue to expect the Fed to announce additional policy stimulus. Given recent speeches by Fed Chairman Ben Bernanke, the most likely form of additional stimulus appears to be the introduction of a large-scale asset purchase program, comprising Treasuries.

This Week’s Data Musings

Last week’s data on [durable goods orders](#) was better than expected. The headline data showed a sizeable drop of 1.3% m/m, driven by commercial aircraft orders; meanwhile, underlying core durable goods orders bounced back after a sharp drop in July. Orders for non-defense capital goods ex-aircraft gained 4.1% m/m after a 5.3% drop in July. Meanwhile, even with the gain, the level of orders in August was still below the June level, suggesting that, although we expect investment in equipment and software to continue growing in Q3, the gains will be significantly slower than in Q2.

Meanwhile, this week’s ISM manufacturing index should show a downward correction following the surprise acceleration in July. The gain in July was at odds with regional manufacturing indexes as well as the signals emanating from the forward-looking new orders component. It is not unusual to see production gains outpacing the gains implied by the new orders index; however, such unsustainable divergence inevitably precedes a downward correction in production.

Moreover, gains in the backlog of orders have slowed since May, and in August stood very close to neutral territory, with a reading of 51.5. This suggests that backlogs will not be strong enough to drive gains in production in the coming months. The [first of the regional manufacturing surveys](#) for September show a continued downturn in U.S. manufacturing activity—the Philadelphia Fed manufactured remained in contraction territory in September, with new orders falling further. The Empire State survey remained positive, but fell back to 4.1, with declines in manufacturers’ assessments of future business prospects. On a positive note, however, both indexes showed continued gains in employment.

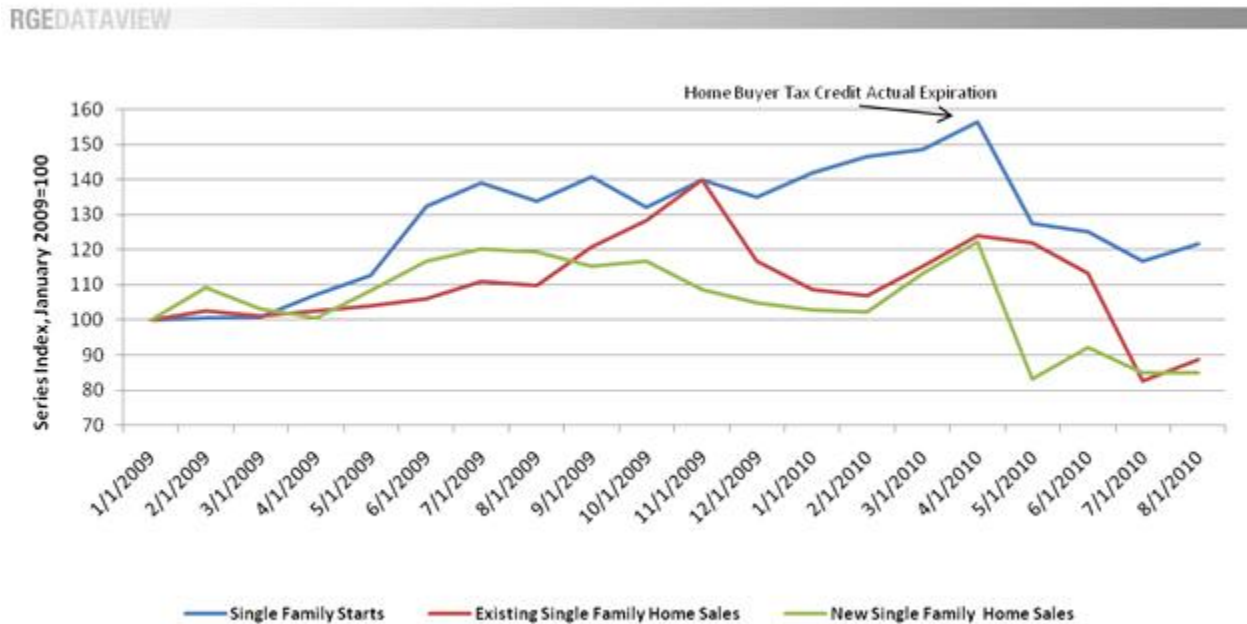
This week, the second revision of Q2 GDP will be released. The first print showed a 2.4% pickup in GDP, revised all the way down to 1.6%, as subsequent data showed weaker-than expected inventory accumulation, and a sharp deterioration in the trade balance. Meanwhile, the downward revision to the construction-spending data suggests that the second estimate may be revised down slightly, to about 1.4%.

This week, we will also see additional data on consumer confidence in September, with the Conference Board consumer confidence index as well as the Reuters/University of Michigan index of consumer sentiment. The Reuters/University of Michigan sentiment index [fell back sharply in the preliminary survey](#) in September. The future business conditions index showed a significant drop, and the decline in the one-year ahead expected inflation component was particularly noteworthy, from 2.8% in August to 2.5% in September. While jobless claims have improved slightly in September, the weak preliminary consumer sentiment still points to a softening of confidence indicators for this month, which is likely to be reflected in retail sales. In August, the consumer caution was reflected in retail sales, with consumers shying away from big ticket items like autos, electronics and furniture.

Last week's data on [home sales](#) pointed to continued weakness in housing demand. As expected, existing home sales showed a slight recovery in August after the July collapse, but sales remain sharply below last year's level. Meanwhile, new home sales, a better indicator of the trend of underlying housing demand, posted a disappointingly flat reading in August, with the rate of sales unchanged at an abysmal 288,000 seasonally adjusted annual rate, about 79% below the peak level reached in July 2005. Inventories of new and existing homes on the market are sharply elevated; at the rate of sales recorded in August, unsold homes represented 8.6 months-worth of supply, sharply above the long-term average of about 6.2 months.

Meanwhile, there were 3.98 million unsold existing homes on the market in August, a stark 11.6 months-worth of supply at the ongoing pace of home sales; a number that does not include homes currently being held off the market. The NAHB Housing Market Index (HMI) showed that the index for buyer traffic fell back by one point in August, signaling that demand continues to be held back by anemic job creation, near-stagnant wage growth, still-excessive household leverage and economic uncertainty. This signals that there is little incentive for a pickup in construction and continued pressure on home prices.

Figure 1: Housing Sector: Stabilizing at Weak Levels



Source: U.S. Census Bureau, National Association of Realtors

Home Prices: Poised to Correct Lower?

On Tuesday, we will see the final data point on the U.S. housing sector this month—the S&P/Case Shiller home price index for the month of July. Housing activity tends to feed into home prices with a lag. Home prices gained for four consecutive months through June (although the June reading would have likely shown downward pressure, were it not for the fact that the index is published as a three-month moving average). This week, we expect to see a negative m/m print for home prices in July. This dovetails with the FHFA home price index published last week, which showed a 0.5% m/m decline in July, the second consecutive month of downward correction, and the CoreLogic Home Price index, which showed a 0.6% m/m drop, the first decline after four consecutive months of gains.

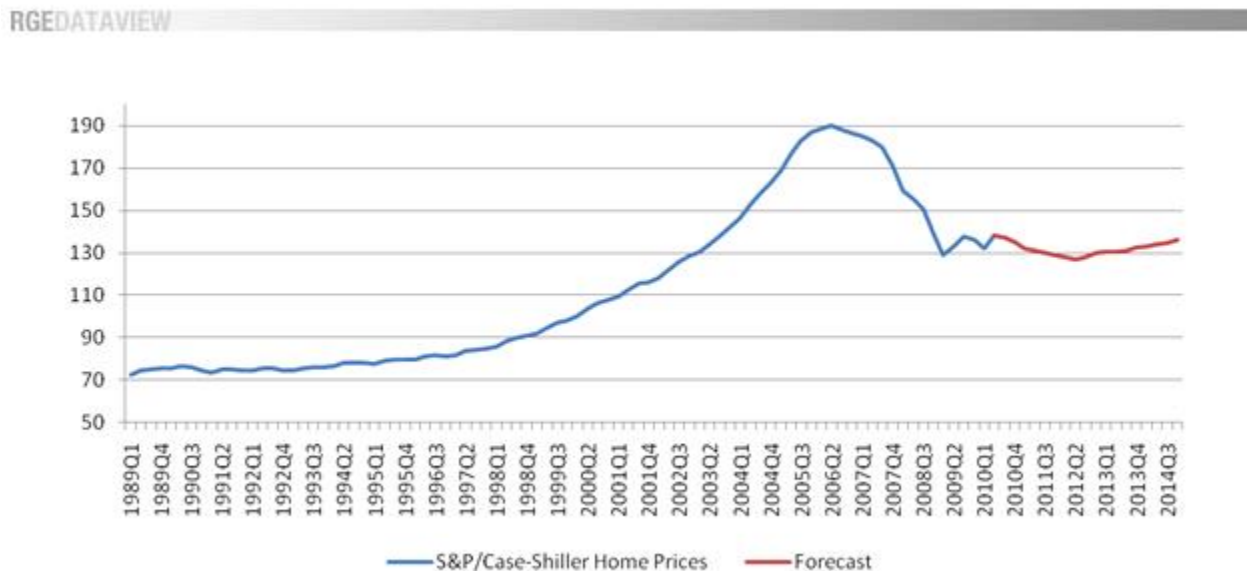
At RGE, we pay particularly close attention to the housing sector and the trends in underlying fundamentals. Residential investment is a key catalyst for job creation. Continued pessimism among homebuilders and the bleak outlook for construction given the elevated housing inventories suggest slow job creation. Meanwhile, we continue to closely track and forecast home prices: a variable with significant implications for U.S. consumers, particularly middle class homeowners, who have taken a sharp hit to household net worth during the housing market collapse, and are left with very little equity in their homes. While households appear to have embarked on a course of slowing

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spending and boosting savings, any further decline in home prices will weigh even more heavily on household balance sheets.

As early as [September 2009](#), we noted underlying fundamentals in the housing sector indicated the homebuyer tax credit could only bring about a temporary stabilization in home prices. The tax credit was extended, but we noted that it would only delay the inevitable downturn. While the effects of the extension have been significant, we still expect home prices to close out the year 1% below 2009’s level. In 2011, we expect prices to fall by an additional 4%. We regularly reassess and update our home price forecasting model, and contribute our medium-term home price forecasts each month to a [home price expectations survey](#) conducted by MacroMarkets LLC.

Figure 2: Home Prices Expected to Correct Further (S&P/ Case-Shiller National Home Price Index)



Source: S&P, RGE forecast

Canada: Confirming a Weak Start to H2

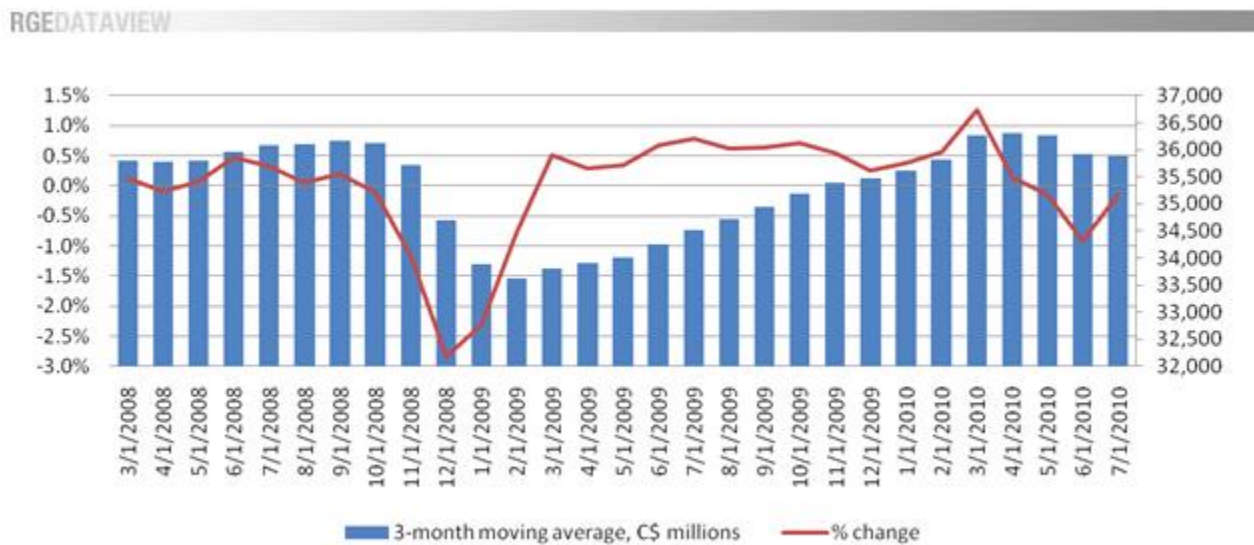
By Rachel Ziemba

Last week’s release of [retail sales](#) data highlighted continued weakness in Canadian domestic demand, particularly as both volumes and prices of retail trade fell in July. Retail sales have been roughly flat since April, rising by only 0.3% q/q in Q2, before falling by 0.1% in July (they jumped by 7% in Q1). In part, July’s figures were distorted by the

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implementation of the Harmonized Sales Tax (HST) in Ontario and British Columbia and a 2% jump in the level of the tax in Nova Scotia. All three provinces reported declines in retail sales, accounting for most of the national decline and the sectors afflicted by higher effective tax rates showed the most significant declines, giving back some of the gains from Q2 in sectors like home furnishing. However, given the underlying weakness of retail sales, we do not believe that the HST is the only culprit. Retailers have been discounting heavily in a variety of sectors, particularly in the auto sector, contributing to strong sales volume in July. Leading indicators (including auto purchases) indicate that retail demand may be as weak in August—suggesting that consumption growth will again be weak in Q3.

Figure 3: Canadian Retail Sales Softening



Source: Bloomberg

The most recent data are in line with RGE's view that consumption would slow from its rapid and unsustainable pace of the beginning of 2010. The decline has been exacerbated by the HST implementation and the weakness of the housing market, but weakness in the global economy and rising debt levels will restrain consumption going forward. At present, despite the increase in the overnight rate, debt service costs remain relatively manageable for Canadian consumers, and we agree that the quality of debts are better in Canada than in the U.S., but we suggest that the massive structural shift in support of consumption is in the past. Given our expectation of slower job and income growth, private consumption will grow below the trend of recent years. In fact, we expect a more modest growth in consumption—around 2%, compared with the 3.5-4% of recent years.

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Real GDP data for July will be released this week (September 30). The weak retail sales numbers suggest that output modestly contracted in July (0.1-0.2%) after sluggish growth in Q2. This contraction reflects weakness in consumption, as well as manufacturing. Other leading indicators support our preliminary forecast of around 1.5% growth q/q annualized in Q3, similar to the range we presented in the recent [update to our economic outlook](#).

The slowdown of economic growth likewise suggests that the improvement of the [Canadian fiscal position](#) may stall. Data released last Friday suggested the deficit narrowed to C\$7.7 billion in April-July 2010, from C\$18.3 billion in 2009. Finance Canada estimated that fiscal stimulus measures including tax cuts and changes in employment insurance (EI) accounted for about C\$5 billion of the C\$7.7 billion deficit. Stronger growth and the expiry of certain corporate and personal tax benefits likewise boosted revenues, which climbed by C\$3.9 billion or 5.5%. Meanwhile, program spending fell by C\$6.8 billion (8.6%), in part due to the drop off of the large contribution to the Canadian subsidiaries of several large automakers in mid-2009. Weaker economic growth and the expectation of weaker demand from Canadian households and corporations imply revenues will cool.

With growth remaining below trend, the deficit should remain wide in 2011 even though the government looks set to meet and possibly exceed its C\$49 billion deficit target this year. We continue to believe that fiscal consolidation will remain difficult and expect this to be addressed in this fall's economic statement (pre-budget), when the Conservative government is likely to scale back its deficit targets for the 2011-13 period. Despite a protracted period of deficits, Canada's fiscal position, along with its growth trajectory looks strong compared with the weak position of its G7 counterparts, and we do not expect Canada to have trouble meeting its financing needs. Some of Canada's provinces, which have weaker fiscal outlooks and even less credible plans to narrow gaps (like Ontario) will have to pay more to finance their deficits.

Early indicators suggest that social spending needs will pick up. The number of initial and continuing EI claims picked up again in July, a reversal of recent trends. Should this trend continue, not only might social transfers increase, but it could also be a leading indicator of softer [labor market conditions](#). We expect that job gains will continue in September, as educational workers continue to be hired back following a summer hiatus, but uncertain domestic and especially external environments should encourage caution among employers.

Another outcome of the more sluggish economic growth trajectory continues to be weaker inflationary pressures. The continued slack in the Canadian, and especially the global economy, is helping to keep price pressures in check. The most [recent inflation data](#), released last week for August, show that inflationary pressures continue to be moderate. Headline CPI, like retail sales, was distorted by the implementation of the HST, but prices nonetheless slowed on an annual basis (1.7%). Core prices rose by 1.6% y/y in August, in line with July's pace. Absent the price increase on goods affected by the HST, headline inflationary pressures would be even more muted, due to slowing housing costs and heavy retail discounting. With housing prices and activity cooling, there are downside risks to RGE's 1.7% headline inflationary forecast for 2010.

In aggregate, the recent spate of softer data suggest the Bank of Canada (BoC) may choose to pause at its next meeting in October. As we have noted in the past, the relative strength of Canada's economy, puts the BoC in a difficult position. With the Fed laying the groundwork for more quantitative easing, and likely to remain on hold for a much extended period, Canada's slightly higher yields and exposure to commodities should continue to drive inflows, which would make domestic conditions slightly looser than the BoC would like. Yet, some of the cyclical factors behind Canada's recovery are waning and we do not think that the strengthening in domestic demand and changes in the Canadian economy in the past half decade will allow it to decouple from the U.S. business cycle. We maintain our view that the BoC will choose to wait a bit longer to assess the scale of the domestic and global slowdown, lest it have to reverse the hikes it has already made.