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Don't call it a comeback

Dow Jones
The US economy seems to have weathered the immediate impact of a major financial crisis much better than many had been expecting. The longer-term test of its resilience, however, remains unanswered.

Recent economic data have given some cause for optimism among investors, as the consumer appears to be holding steady, even amid persistent labour market weakness, and inflation seems to have receded somewhat. Peering into the future, however, raises nagging doubts about the health of the consumer, who may eventually buckle under the combined weight of a collapsing housing market, rising oil prices and tightening credit.

"We believe the sharp curtailment in household buying power alongside a negative shock to income emanating from rising headline inflation will exert a strong negative influence on the economy, enough to keep its growth rate well below trend for the foreseeable future," said Deutsche Bank economist Joseph LaVorgna in a research report.

Economic growth in the first quarter surprised many by remaining above water, with gross domestic product expanding 0.6 per cent. There's more uncertainty about the second quarter, although there's a fair chance at this point that it may squeeze in slightly positive. The concerns ease significantly in the third quarter, as there's near unanimous agreement that the third quarter will be helped by the Government's $US152 billion stimulus package.

None of this seems to indicate there will be a formal recession, based on the rule-of-thumb requirement of two consecutive quarters of contracting economic growth. Of course, whether or not there's a recession may be moot: the point is, growth has slowed sharply and could remain low for a while.

So the real question is, what happens in the fourth quarter and beyond? The outlook is incredibly murky. Growth will almost certainly slow again, as the effect of the tax rebates wears off and the housing, credit and oil threats push to the forefront.

The degree of uncertainty at that point is alarming. Some see a slight slowdown followed by a fairly robust recovery; others are heralding a much sharper slowdown that could turn out to be especially prolonged.

The broad range of estimates in large part reflects the new ground that is being broken by the US consumer, the stalwart of the US and global economy for so many years now. In the past few years, spending was fuelled by a credit binge fostered by the bubbles in housing, among others, with disastrous consequences. How the consumer recovers from this financial storm will be crucial to understanding how the economy will perform.

So far, evidence that the consumer is sharply cutting back on spending has been mixed. Consumer sentiment has spiralled lower and lower since the start of the credit crunch last summer, hitting lows in mid-May not seen since 1980, according to the latest Reuters/University of Michigan survey.

At the same time, retail sales for April - when consumers told the survey compilers that the economy was in recession and they were going to save their rebate checks rather than spend the money - rose 0.5 per cent, excluding automobile sales, a much stronger than expected reading. But as Lehman Brothers noted, the plunge in motor vehicle sales - down 2.8 per cent - should be seen as an "early warning sign," reflecting higher gasoline prices and a reduction in the availability of credit.

With gasoline prices eating up an ever-larger chunk of consumers' income - in some parts of the country average prices are already above $US4 - consumers are in for a tough driving season this summer. Anecdotal reports indicate that households are cutting back on holiday plans in the face of ever-rising fuel prices.

In the face of higher food and energy prices, the tax rebates may appear to many as a minuscule drop in a very large bucket. For sure, the economic stimulus will give the economy a fillip - adding $US152 billion in cash to households and businesses is after all a hefty injection - but if consumers spend most of the rebates on food and gas, or stick the funds in a savings account, the impact will be limited.

Consumers will remain under pressure as long as house prices fall and, so far, there's no indication that they are stabilising. A surprise surge in April housing starts published Friday doesn't mean the industry is out of the woods, and this market could plunge further if the consumer is truly debilitated.

Another looming concern is inflation which has, so far, stuck remarkably close to the Federal Reserve's script. The minutes of the March meeting of the Federal Open Market Committee revealed that central bank officials expect inflation to moderate through the rest of 2008 and 2009, although this outlook was clouded by higher energy and food prices. Others are much more concerned.

"Forgive us if we strenuously disagree," said Joseph Brusuelas, chief economist at Merk Investments. There's a long-lasting change in global demand for commodities and energy, and "as such, the relative change in pricing for energy and commodities will not be transitory and prove quite durable. Both headline and core rates of pricing will see moves well above what both the Fed, the market and the public will find tolerable," Brusuelas said.

The uncertainty over the health of consumer, combined with the risks to inflation, make it hard to judge where the Fed will go next with interest rates. Market participants seem to be clear that the Fed is on hold at the current 2 per cent, but after that it could go up, to reflect inflation concerns, or down, if worries about growth re-emerge.

"For the Fed to cut again, it will likely need to see a higher unemployment rate and evidence that headline inflation is moderating," Deutsche Bank said. "At the same time, the Fed will have to lose confidence in a self-sustaining, albeit moderate, recovery in economic growth in the second half of the year."

Even as investors are enjoying a lift from the clarity that is emerging in financial markets, the growing clouds over the horizon may mean there's plenty more trouble to come.

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