



This Issue

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gives his view.

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Fed Promises More Action If Recovery Stalls

The US recession which began at the end of 2007 finally ended in mid-2009. GDP growth has averaged 3.5% annualised in the period since then. However, much of the rise in GDP is due to a marked deceleration in the pace of destocking rather than a pick up in spending - growth in real final sales of domestic product has averaged just 1.3% annualised in the first three quarters of the upswing.

It is also the case that activity has been helped by fiscal stimulus measures which resulted in a boost to the housing market, auto sector and general consumer spending. These measures, though, were temporary and have generally run their course at this stage.

Thus, it is not that surprising that leading economic indicators are now pointing to a slowdown in the pace of growth in the second half of 2010 as the support from fiscal policy and inventories fades. There are even fears of a double-dip recession.

Recent indicators have generally been quite disappointing, coming in well below expectations. The ISM indices for manufacturing and services both fell in June, while the Empire and Philly Fed surveys were down again in July. Housing data have been particularly weak, with big declines in housing starts and sales in May and June. Mortgage applications have fallen to a 13 year low. Factory orders fell in May for the first time in nine months, while manufacturing output declined in June.

Both headline and core retail sales fell for a second consecutive month in June. Consumer confidence fell sharply in June, with the Michigan consumer sentiment index declining sharply in July. Payrolls also declined in June as temporary census workers were laid off, while the trade deficit widened unexpectedly in May. It's very clear then that the economy has lost considerable momentum.

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The economy continues to be saddled with many problems. Household balance sheets are weighed down by heavy debts and pressures on disposable income, with the focus very much on rebuilding savings. Meanwhile, credit availability is still very constrained, especially for smaller firms. There are also large overhangs of unused industrial capacity and vacant homes which are holding back investment, while firms are reluctant to hire.

The economy, though, should avoid a double-dip recession. Income growth is reasonably strong and spending power is being boosted by falling inflation. Business surveys, although off their peak, remain at levels consistent with relatively solid growth. The housing sector is contracting again but it is now a small part of the economy. The world economy is performing reasonably well, helping exports.

It is also the case that if the US economy does lurch towards a double-dip, we are likely to get a response from both monetary and fiscal policymakers to stimulate activity. At its policy meeting in June, the Fed indicated that it “would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably”.

There was some expectation that the Fed’s Chairman, Ben Bernanke, might go further than this in his economic testimony to Congress last week given the recent marked weakening of indicators. He described the economic outlook as “unusually uncertain” and said that the Fed is ready to take further action to support the economy if needed, especially if the kind of improvements that the Fed is hoping for and expecting in the labour market do not materialise. However, he did not give much indication that any such actions are imminent.

However, further loosening cannot be ruled out with the economy losing momentum and unemployment still at a very high level. With short term rates already close to zero, any further Fed loosening is likely to be aimed at lowering longer term interest rates via renewed asset purchases and changes to Fed statements indicating that it will keep official rates low for an even more prolonged period of time.

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