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Good News to Come on US Income and Spending

Toward the end of the month we will learn that US economy continued to contract sharply in the first quarter. The economy is also likely contracting in the current quarter. Unemployment is still rising and house prices are continuing to fall. But to conclude, as many of the cynics do, that all the government spending has proven for naught, is premature.

In fact, in the current quarter, income and spending are likely to be more robust than many suspect. The reason it may surprise is because of the exclusive focus on the market, in this case the market for labor. The deterioration of the labor market and the decline in household net worth, as the price of homes and equities tumbled, slashes income and consumption.

The only way to ensure a recovery in the labor market, so the argument goes, is for businesses to boost investment in plant and equipment. In order to do this, banks have to be "fixed" so they lend again. This is most certainly not happening. Hence the economic gloom.

Income

Leave aside the fact that investment has not led economic recoveries in the US since the Great Depression. Leave aside the fact that many industries are plagued with redundant investment in the form of excess capacity. Focus instead on the alternative source of income for American households—the government. Of course this cannot be a solution in the long-term, but it can have substantial impact on a short-term basis and can buy time, if you will, for other sectors to pick up the slack.

There are a number of government actions in addition to the obvious unemployment insurance and food stamps (which while important, are relatively small), that will boost income. First, an impact from the commodity shock that lasted until around the fourth quarter last year means that Social Security recipients received a 5.8% boost in their monthly checks beginning January 1st. Roughly speaking, this represents around a \$3 billion increase in monthly income. Second all Social Security recipients will receive a separate one-off payment of \$250. These checks are expected to be sent out in May and could boost income by as much as \$13.5 billion.

Third, the Obama Administration's "Making Work Pay" reduces the payroll withholding tax starting this month by \$400 per individual and \$800 for joint filers, but phases out for higher income earners. This can boost after-tax income by around \$4 billion. A fourth source of income, outside of wages and salaries, are the tax refunds. Preliminary estimates suggest that tax refunds in the first quarter are more than \$25 billion above year ago levels.

Expenditures

These four fiscal sources (cost of living adjustments, one-off payment, reduction in withholding taxes, and tax refunds) will more than offset the loss of wage and salary income through mid-year. The higher income will likely boost both savings and consumption. It is in the estimate of the boost in consumption that many economists disagree.

Often at the root of the differences lies a judgment of whether the tax cut will be perceived as temporary- which would have a smaller impact or permanent- in which case a larger boost to consumption would be expected. Generally speaking, about a quarter of a temporary tax cut is spent, while as much as two-thirds of a permanent tax cut will often be spent.

The most likely scenario, of course, is something in between. Technically it is a temporary cut, but the Obama Administration is pushing for it to become permanent (though what this means for Social Security's own fiscal challenges is rarely addressed). Additionally the nature of the tax cut, in the payroll withholdings, may also make it feel permanent.

The boost in non-wage income will increase expenditures. In fact, the preliminary data already suggests that the US consumer, in the face of marked deterioration in the labor market and continued decline in asset prices, will be net additive to first quarter GDP for the first time since the second quarter of last year. With the tax cuts, consumption will be even stronger in the current.

As a small digression, the 12% tax increase on cigarettes may impact both consumption measures and inflation. The increase in price rather than volume may contribute on the margins to retail sales. Tobacco accounts for about 1% of the basket of goods that compose the consumer price index. This tax may boost core CPI by about 0.1%.

And Then...

The positive impact that these fiscal measures have will be short-lived and would have run their course. What comes next is not exactly clear. Under pressure from Republicans and conservative Democrats, Roosevelt took away the fiscal stimulus that fueled the 1933-1937 recovery, successfully returning the economy into the depression, which was only exited when WWII forced government spending on an even greater scale. Obama has already committed himself to reducing the budget deficit before the end of his (first?) term. Bernanke and other Fed officials have discussed exit strategies.

Yet it is possible that these measures will succeed in helping steady the economy long enough for other economic drivers to kick-in. For example, the inventory overhang is being unwound aggressively (not just in the US, but Japan as well) and this process has cut into production. There are preliminary signs that auto production is stabilizing and this could have a multiplier effect on other industries. A job-creating program that has not yet appeared on many radar screens is the government's hiring of census workers that will likely begin soon.

Here in the second quarter many key issues surrounding the rehabilitation of the financial system will likely be clearer as well. The stress testing of the banks will be complete. Several small banks have already returned their TARP money and it is possible that one to two larger banks will return also their funds. The public-private partnership option-like scheme will likely begin. TALF is liable to enjoy at least modest success in re-opening the securitization market for auto and credit-card loans.

At the same time, the stimulus efforts of other countries, especially China, may also help the US economy. The boost will not just be through exports, though the most recent trade data for the month of February, showed an almost 9% rise in vehicle exports, while overall exports were up a modest 1.6% on the month. Consider that some estimates suggest that the tax incentive China is giving for auto purchases provides General Motors with more money than the Federal government (thus far).

Greenback

After an initial decline in response to the Federal Reserve's announcement in mid-March that it would increase the purchases of mortgage related securities and buy \$300 billion of Treasuries, the US dollar has been unexpectedly resilient. The euro has traded below its 100-day moving average against the dollar since March 18th. In addition, its 5-day moving average has slipped below the 20-day moving average, a useful trend indicator, for the first time since March 11th. A similar pattern is also evident in the Swiss franc.

Sterling, on the other hand, has held in better than the continentals. It remains above its 100-day moving average against the dollar, which comes in near \$1.4550 now. And the 5-day moving average (~\$1.4710) is holding above the 20-day moving average (~\$1.45). Against the yen, the dollar moved above its 100-day moving average two months ago. It was retested around last month's FOMC meeting and it held, allowing the dollar to rise to eight month highs in early April.

In the larger picture, the dollar has been caught in a leverage-de-leverage dynamic over recent years. The dollar's decline in the 2001-2007 period was a function of the leveraging process—the use of the dollar as a financing currency. Its recovery, beginning in late 2007, against half the G7 currencies, was a function of the de-leveraging process.

We anticipate the end of this dynamic and look toward macro-economic variables, particularly relative growth/profits prospects, to become an increasingly important driver of the dollar. The very aggressiveness of US policy response and inventory adjustment should be dollar positive. One indication that this transition is happening may be found in the correlations of the euro-dollar and dollar-yen with the S&P 500. The stock market has been a less useful guide in the dollar's direction than had been the case. The fact that the S&P 500 and the dollar (vs. euro and yen) are both above their 100-day moving averaging illustrates this.

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