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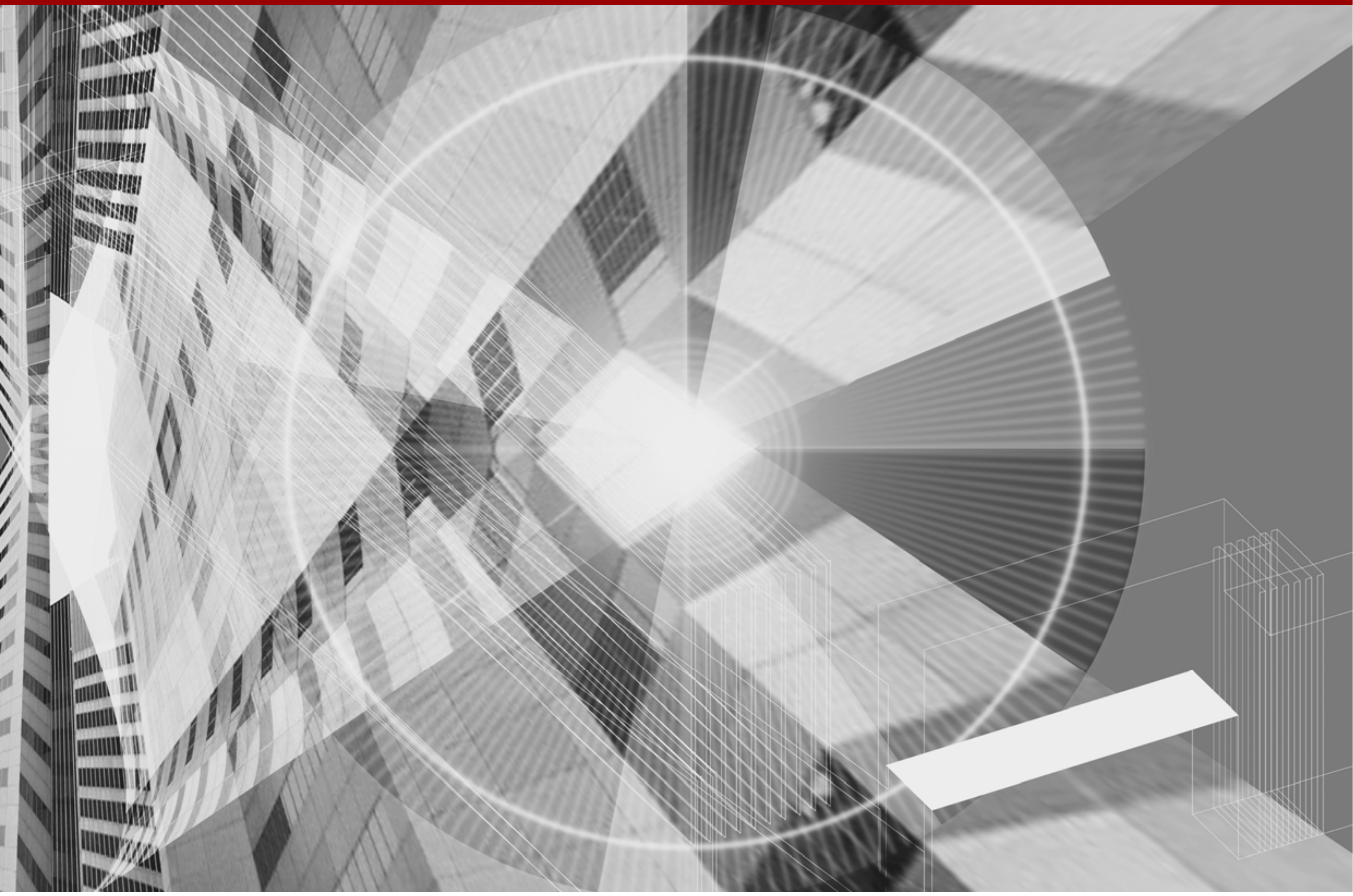
Flash Update

Recent strength in US economic data not sustainable



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GENERALI Investments

Recent strength in US economic data not sustainable

Over the last couple of weeks, economic data from the US surprised on the upside. Above all, this is true for Q3 GDP growth, October payroll gains, and the services ISM.

In this note, we would like to caution that this is unlikely to be sustained. In our view, the real economic impact from the subprime crisis is still to be felt.

Given markedly tighter lending standards, we expect US activity to slow over the winter months.

Over the last couple of weeks economic data from the US has surprised on the upside. This is above all true for real GDP growth in Q3, October payroll gains, as well as the November services ISM. However, these data points have shown excessive strength in our view, and we expect economic data to come in weaker over the coming winter months.

Strong export push to GDP

Real GDP growth in Q3 advanced at 3.9% in annualized terms. This was not only well above market expectations, together with the 3.8% clip in Q2 it also marks a period of growth which is well above the prior five-quarter average of roughly 2%. This high pace of activity came as a surprise as it happened amidst one of the worst liquidity crisis seen in recent history.

Key driver of this high level of activity was once again private consumption. It alone added 2.1 percentage points to growth. That said, net exports were also unusually strong, contributing 1.8 percentage points to growth. Had net exports stayed in negative territory (as they have done for most of the past 15 years), would real GDP growth have come in at less than 2.1%.

Going forward, we do not expect the high summer pace of activity to be sustained. Above all, private consumption is likely to suffer from a combination of higher energy prices, reduced tailwinds from home equity extraction, slower employment gains, as well as a recent drop in consumer confidence. As far as net exports are concerned, they are likely to remain a source of growth given the weakness of the US dollar and the still robust global economy, but the very high growth rate of 16% annualized does not look sustainable in our view. For these reasons, we expect US GDP growth to slow again to 2.2% annualized on average over the winter quarters.

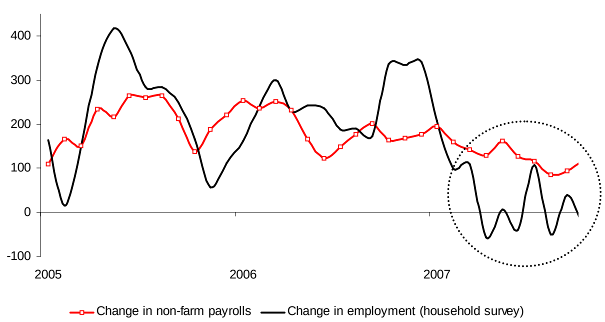
Payroll Gains at odds with household survey data

Just like GDP growth, the recent gain in non-farm payrolls beat market expectations by a wide margin (166K vs. a Consensus of 80K). To be sure, the number is highly welcome because it keeps the aggregate debt servicing capacity of US households high. With job losses, delinquencies even in the prime borrowing segment would be likely, thereby causing further losses in ABS structures and, ultimately, an even lower capacity of banks to extent credit. But as good as the October number may seem, we anticipate the pace of employment growth to slow for a number of reasons:

i) Comparing the numbers from the establishment survey (company data) with the household series (household interviews) it is striking how big of a gap has built up (see chart). The average number of new jobs created according to the household survey (which, by the way, is used to calculate the unemployment rate) is just 7K per month in 2007. This compares with 109K from the establishment survey. While part of the very low number can be explained as a payback to the prior overshoot in late 2006,

US Labor Market

monthly change in employment, 3MMA, in thsd.



another explanation lies in the way the establishment series is calculated. In 2003, the Bureau of Labor Statistics has started to estimate a number of jobs coming from the creation of new companies which are not yet included in the monthly survey. The adjustment coming from the so called "net birth/death factor" is quite sizable and there is a strong conjecture in the market at present that this adjustment may overstate the true number as it does not seem to work properly in times of a cyclical downswing.

ii) The seasonal adjustment factor in October was larger than in October of last year (+58K). In November, the seasonal factor is unlikely to be as favorable again.

iii) While 20K jobs were lost on average in Q3 in the construction sector, only 5K disappeared in October. Due to the fact that the housing correction has, if anything, intensified during fall, higher losses seem likely. In a similar vein, while during the prior two months, jobs were shed in the financial services sector, there was a slight plus in October. Given the renewed strain in the commercial banking sector, aggregate job losses seem more likely here.

iv) Finally, initial unemployment claims rose from a four-week average low of 311K in early October to 332K at present. This jump, which started in the week of October 25, is not jet reflected in the October employment numbers as it came after the payroll survey week.

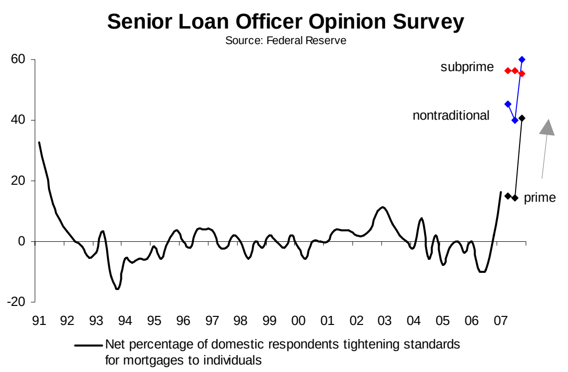
All in all, therefore, we stick to our view that employment growth over the winter months is more likely to be at less than 100K than above. This marks a crucial difference because at this level, the unemployment rate tends to rise. Compared to its low in March, when it had reached 4.4%, it is now 0.3 pp higher. For early 2008, we expect the unemployment rate to rise to 5%. This is crucial for our Fed call: In the past, the Fed has always cut rates when the unemployment rate was tending higher. Despite its inflation concerns, we anticipate the Bernanke Fed to follow a similar route. This is why we expect the Fed Funds Rate to reach 4% in early 2008.

Services ISM positive but manufacturing index clearly trending lower

Finally, the services ISM rose to a stronger than expected 55.8 in November which marks an acceleration from the October reading of 54.8. While this strong figure supports the idea that the economy will not slow sharply near-term, the number suggests excessive strength again. This is due to the fact that the services ISM is based on a single question about production. In contrast, the manufacturing ISM is the weighted sum of the sup-components of the index. Applying the manufacturing weights to the services subcomponents results in a November reading of 53.5. While this is still an acceleration compared to October (52.8), it is below the Q2 average of 55.5. Calculated this (more reliable) way, the messages from the services and the manufacturing sector do not conflict any longer. In both instances we see a tendency towards – controlled – weakening.

Further tightening in credit standards

Apart from these considerations above there is another factor which strongly favors economic weakening over the winter months. According to the latest Senior Loan Officer Survey, both households and businesses are now faced with considerably tighter lending standards. In fact, the tightening of credit standards which was up until Q2 contained in the lower quality segments of the credit market, is now spilling over to the higher segments. For instance, the number of banks reporting tighter lending standards for prime mortgage borrowers has shot up sharply in recent months (see chart). The reduced availability of credit implies, that the large stock of unsold homes will be around for longer so that the pressure on house prices will persist. According to the latest S&P Case/Shiller survey, house prices are now down by more than 4% yoy. Going forward, we expect even a sharper drop.



Conclusion

The latest bout of strong US economic data will in our view not stand the test of time. Over the coming winter months we foresee more weakening as a result of a fallout from the housing correction and the related credit market woes. While we feel reasonably confident that more slowing is in the offing, we are less certain about its likely strength. Our base case still calls for what we have long dubbed "subpar growth" but any marked deterioration in the labor market will immediately induce us to adjust this call downward. The number one index to watch for the medium-term prospects of the US economy remain initial unemployment claims in our view.

Imprint

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