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Economic Theme: US Demand Dynamics Trump European Exposure

While there is no shortage of global risk factors, a significant portion of the recent slide in equity prices is related to worsening economic conditions in the eurozone. We share this concern. In our August 21st commentary (please see the Commentary/Hoot & Holler section of the Beacon Trust website), Flat Tone in the Eurozone, we revised our second half GDP growth outlook from 1% to zero, based on a decelerating trend in the Composite Purchasing Managers Index (PMI). Fundamentally, the eurozone is bogged down by a lack of demand, which Financial Times writer Martin Wolf describes as "a battleground for meagre scraps of demand." Monetary prescriptions are limited, or as we suggested in our August 21st commentary, "the European Central Bank (ECB) is late to the party and is short on party favors." Admittedly, weak eurozone growth, coupled with a slowdown in China, Japan, and emerging markets, poses contagion risks for the US. Some solace may be taken, however, in limited reliance on exports by the US. Only 13.5% of nominal GDP is derived from exports. As the global financial crisis unfolded, the economic and financial condition of eurozone peripheral countries, referred to as the PIIGS (Portugal, Italy, Ireland, Greece, and Spain), was of major concern. By contrast, in recent months, weakness in the eurozone's three largest economies, the FIGs (France, Italy, and Germany), has evoked downward growth revisions. While this trend is not positive, it is important to realize that the US derives only 7% of its exports from the FIGs.

The structure of the US economy is such that economic expansion could continue while the eurozone falters. This would not be unprecedented. Growth cycles diverged in the early 1980's, during the 1992-1994 period, and in recent years. The US can best be described as a consumer-led economy with Personal Consumption Expenditures (PCE) comprising nearly 70% of GDP. Further, Nonresidential Fixed Investment, which encompasses structures, equipment and intellectual property, accounts for 13% of GDP. We believe the near-term outlook for these two GDP components is relatively good. PCE in nominal dollars was 3.9% higher during the first half of the year versus the year earlier period. We believe this rate of gain can be maintained through the first half of next year.

Our research pinpoints a strong (74%) correlation between PCE growth and trends in Personal Income and the Bloomberg Consumer Comfort Index. Personal Income is a broad measure, which includes wages and salaries, rental income, receipts on assets, and transfer payments. By using this measure, we need not concern ourselves with the thorny question of whether wage rates are picking up or not. The Bloomberg Consumer Comfort Index is a random sample of consumer opinions on the economy, buying climate and personal finances. The accompanying chart shows the close relationship between these variables beginning with the first quarter of 2006. We would add parenthetically that lower energy prices act as a tax cut, and lower interest rates could spur mortgage refinancing activity. Both would be a tailwind to consumer spending.

Roughly one year ago, we forecast that an inflection point in Nonresidential Fixed Investment was close at hand. (See Market Monitor dated September 11, 2013, The Coming Rebound in Corporate Fixed Investment on the Beacon website.) Specifically, we anticipated a 15%-20% gain in fixed investment for 2014. An update of our model suggests the low end of that range, or 15%, might be attainable. While escape velocity has not yet been reached, second quarter results made progress toward this goal with an 11% gain. Our model contains two leading indicators of fixed investment growth: Policy Uncertainty and Nondefense Capital Goods Orders Ex Aircraft. Together these two variables explain 81% of the change in Nonresidential Fixed Investment since 1998. The Stanford University Policy Uncertainty Index captures policy-related economic uncertainty, expiring federal tax code provisions and disagreement among economic forecasters. As policy uncertainty recedes, which has been the case since the beginning of 2013, corporations increase fixed investment spending.

Although global growth risks are apparent, we believe underpinnings of Personal Consumption Expenditures and Nonresidential Fixed Investment will support continued expansion of the US economy.