

ECONOMICS: US PERSPECTIVES—NOVEMBER 19, 2010

Liquidity Flows Still Support US Economic Growth Cycle

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Since the start of 2010, our liquidity index has shown steady growth of 3.5%, indicating that the US economic recovery is on solid ground despite persistent fears of a double dip. We believe additional monetary stimulus by the Fed may prompt stronger liquidity gains and add momentum to GDP growth in 2011.

Liquidity flows continue to post solid gains, providing an encouraging sign for US economic growth prospects through 2011. In the coming months, liquidity flows may well enjoy further momentum, as the Federal Reserve begins its new quantitative easing program (QE2) by purchasing government securities and injecting more cash into the US financial system.

Our proprietary liquidity flows index is highly sensitive to changes in consumer price inflation as one of the key components is the change in broad money growth, adjusted for inflation. So if QE2 simultaneously boosts liquidity and inflation, the impact on our index will be marginally positive.

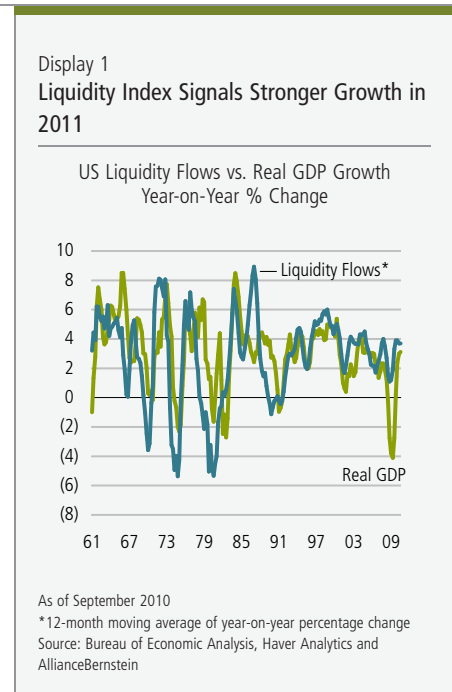
We rely on the liquidity index as an important leading indicator to help gauge cyclical trends in the economy and the acceleration and deceleration in real gross domestic product (GDP) growth. As a rule, changes in the growth of liquidity flows tend to lead changes in real GDP growth by six to nine months.

The liquidity index was initially designed and constructed by the Bureau of Economic Analysis (BEA). But ever since the BEA stopped maintaining cyclical indicators about 20 years ago, it has been our own indicator. Initially known as the money and financial flows index, it served as a leading index by capturing real broad money and liquid asset growth as well as changes in business and consumer credit.

Fund Flows Complete the Picture

Over the past two decades we have made two modifications to the initial series. The first change was to include dollar flows into bond and stock funds, as the money and financial flows series was created before the birth of the mutual fund industry. Yet, even after the mutual fund industry got started in the early 1980s, the flows were not included since they were not part of the banking system.

Failure to include them ignored the fact that mutual fund accounts are highly liquid assets and serve as very close substitutes



for traditional bank accounts. In addition, people were able to tap the accounts almost immediately, so they had the same liquidity dimension as traditional bank accounts. We also changed the index by including the growth in marketable securities held in custody by the Fed for foreign official and international accounts, as our research showed that this was an additional source of liquidity for the US economy.

In early 2009, a rebound in the liquidity index was one of the main factors behind our prediction that the US recession would

end by mid-year and a modest economic recovery would develop in the second half of 2009, which at the time was at least six months earlier than the consensus. About 18 months after we called the turning point, the end of recession was officially dated as June 2009 and the first month of the recovery as July 2009 by the National Bureau of Economic Research, the official arbiter of business cycles.

Double Dip Fears Look Overblown

Throughout this year, the liquidity index has posted ongoing monthly gains of between 3.5% and 3.75%. The consistent and relatively strong gains told us that the economic recovery remained on a solid footing, despite heightened concern

during the summer about the possibility of a recessionary relapse. At the end of the month, BEA is scheduled to issue its second estimate on third-quarter real GDP. Based on new and revised data, we expect the preliminary estimate to be revised from 2.0% to at least 2.5%, indicating that the US economy was never really in danger of a double dip.

There are other hints of improvement in the air. Although we're only halfway through the fourth quarter, data on retail sales and manufacturing production, along with employment data for October, indicate that real GDP is running at a pace of about 3% annualized, and possibly even slightly higher.

Better Performance Lies Ahead

When these trends are viewed against ongoing gains in liquidity flows—even before the QE2 benefits kick in—the US economy looks capable of performing even better in 2011, and we are forecasting GDP growth of 3.3% for next year. This forecast assumes that there will be a full two-year extension of the Bush tax cuts that are set to expire at the end of 2010. A meeting between the White House and Congress on the tax issue has been postponed from November 18 to November 30, leaving little time for all the details to be settled before year-end. So there is a risk that this tax issue might not be settled until the new Congress is seated on January 20, 2011. ■

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