

# Investing Opportunities in the USA

## October 2011

- *Short-term rates may not remain low for as long as markets are pricing*
- *Bond yields are unsustainably low and are likely to rise*
- *The currency is too low and will rise, particularly when interest rates rise*

The economy is in its third year of the current expansion and employment growth resumed last year. Extraordinarily loose macroeconomic policy has supported economic activity but the pace of growth has slowed in 2011 with some items of private sector expenditures still far below “normal” levels. There is a real possibility that the current financial market turbulence may delay the expansion of business spending and residential investment. Indeed, a renewed decline in these areas of spending cannot be ruled out. Nevertheless the private sector is well placed to increase its expenditure from current low levels so the most likely outcome remains moderate economic growth through the coming couple of years with the public sector acting as a brake on the pace of expansion. This would contribute to a gradual improvement in the labour market. Consumer price inflation has been boosted by rising energy prices but should soon decline and thereafter remain constrained by competitive pressures and surplus capacity (see table of key forecasts).

The Federal Reserve embarked upon a second round of quantitative easing last November and has recently signalled that “emergency” policy settings may be kept in place into 2013. High unemployment and the risk that inflation could be driven down by the existence of surplus capacity have been cited by the Fed as areas of concern. Futures market prices imply that official interest rates are expected to still below 1% in the final months of 2013 (see top chart). The exact timing of the tightening cycle is highly uncertain but when it begins, interest rates are likely to rise by substantially more than current market pricing indicates.

Government bond yields have fallen sharply in the past couple of months and have moved down to multi-decade lows (see middle chart). Extremely low short-term interest rates and the Federal Reserve’s quantitative easing are combining with contained inflation to restrain bond yields. Real 10 year bond yields are now negative and the yield curve is very flat. Unless inflation drops to Japanese levels, the current level of yields appears unsustainable and a rebound in bond yields is likely.

The dollar has rebounded in recent weeks and is now slightly above recent multi-decade lows (see bottom chart). The extremely loose policy stance is probably contributing to these low levels of the USD and longer-term concerns still linger over the external deficit. Nevertheless, the current level of the dollar has placed US firms in an abnormally strong competitive position which is unlikely to be maintained indefinitely. Upwards pressure on the USD appears likely, particularly when policy begins to tighten.

Equity markets have declined substantially during recent months despite high corporate profit margins. Unless the current period of financial market turbulence has a significantly negative impact on economic activity, the backdrop for the corporate sector should remain supportive.

Key Forecasts			
	Dec-11	Dec-12	Dec-13
GDP	2	2	3
CPI	3	2	2
Fed Funds	0.25	1.50	4.00
10 year	3.00	5.50	6.00
EUR/USD	1.40	1.25	1.18
USD/YEN	80	100	110
USD/CAD	0.95	1.10	1.23

