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The Risks of a U.S. 'Soft Spot'

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Markets are now pondering the possibility of a considerable slowdown in U.S. economic activity. The same forces slowing the American economy are restraining foreign economies as well—energy prices and interest rates. Consumer optimism has slipped as gasoline prices hit record highs and the Fed continues to hike interest rates. Contributing to this concern is the still relatively tepid U.S. job market. Business investment likely continues strong, but corporate earnings growth is slowing as the cost of production rises. Trouble spots are everywhere: Think airlines, autos, GSEs, housing, and sub-prime loans. Although still at a relatively high level, the optimism index for U.S. small businesses has taken a nosedive. Moreover, the trade deficit has hit yet another record high, and there is little prospect of a meaningful near-term improvement.

Developing economy industrial production is slowing. And, Japan and core Europe have posted seriously anaemic activity for some time. So the growth in worldwide demand for commodity products might well have peaked.

U.S. retail sales for March were much weaker than expected, suggesting a slower tempo for consumer spending in Q1 compared to the 4.2% pace of Q4 of last year. Tax refunds are no longer lining U.S. consumer pockets, especially in comparison to last year, interest rates are higher (albeit moderately so), and gasoline prices have gone to the moon, up over 20% over the past three months. Chain store sales have continued to slow in early April, following the reduced pace in March. Roughly 30% of outstanding mortgages are of the adjustable-rate variety, so households are more susceptible to rising interest rates than usual. Moreover, many more sub-prime loans are out there, portending a possible rise in delinquency rates and foreclosures if mortgage rates rise much further.

Despite the surge in the CRB futures index, U.S. inflation remains relatively moderate. The core inflation rate is running at 2.3% above year-ago levels, more than double the pace over the same period last year. Even so, 10-year Treasury yields have fallen recently to 4.3% as economic data have disappointed. February's worse-than-expected trade deficit of a record $61 billion on its own reduces U.S. Q1 real GDP by roughly one percentage point, all other things equal. The Conference Board's leading economic indicator has likely plunged further in recent weeks, while the same is true for the rest of the industrialized world.

The U.S. trade balance with the developed world has stabilized, but it continues to deteriorate with developing countries, dominated by China. This stands to reason given that since early 2002, the U.S. dollar has fallen more than 25% vis-à-vis the major currencies, while it has actually edged up a bit relative to the developing currencies. With U.S. imports from China soaring and six times bigger than exports, it will be very difficult for the trade deficit to improve. Without the U.S., China's trade is balanced as it runs net trade deficits with the Asia, Australia, Russia and Brazil. A marked slowdown in U.S. business and consumer demand would no doubt filter through to slow activity in China as well.

Political pressure, especially from the U.S. and Europe, is mounting for import restrictions on Chinese textile products. Since China remains recalcitrant on the issue of currency revaluation, trade restrictions might well be put in place. While this improves the competitiveness of American textile and clothing manufacturers, it could well slow overall global demand. The recent downward drift in oil prices might well be a harbinger of things to come.

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