

# INTERNATIONAL CYCLICAL OUTLOOK

## POSITIVE GLOBAL OUTLOOK DESPITE U.S. SLOWDOWN

### Slowing U.S. Growth

The surge in energy prices following the recent hurricanes is clearly hurting U.S. consumer spending. Apart from the element of surprise in the price rise, which has historically encouraged consumers to increase precautionary savings, rising gasoline prices boosted nondiscretionary expenditures, squeezing spending on discretionary items, especially for those at the lower end of the income scale.

While gasoline prices are now off the recent record highs, the impending threat is a sharp rise in home heating bills, where expenditures are also nondiscretionary. Thus, especially if there is a harsh winter, consumers' budgets are likely to be squeezed further. It does not help that this hit to consumer spending is arriving during the holiday shopping season, which involves substantial discretionary spending.

Fortunately, the growth rate of existing home prices, which is a reasonable leading indicator of consumer spending growth, is still holding near all-time highs. Therefore, the expected damage to consumer spending from the energy price surge is likely to be cushioned by the perception of still-lofty home values.

*While U.S. growth is slowing, growth in Germany and the U.K. is likely to firm.*

Of course, this is true only for home-owners, who account for five-sixths of U.S. consumer spending. It is no consolation for people who do not own homes. Such consumers are concentrated at the lower end of the income scale and are already more vulnerable to the squeeze from higher energy prices.

The resilience of existing home prices helps explain why, in the face of an oil shock rivaling those in the 1970s and early 1980s in terms of magnitude, the U.S. economy has not slowed drastically, even though families of more modest means are clearly suffering. The question is whether national home prices are about to turn down. ECRI's U.S. Leading Home Price Index (USLHPI), featured in this month's *U.S. Cyclical Outlook* (Vol. X, No. 10), is designed to answer this question.

Talk of a home price bubble has been going on for years, ever since people belatedly recognized the recession four years ago. Yet the "bubble" has stubbornly refused to burst. What is notable is that, over all these years, in the face of a consensus of pessimistic analysts, the USLHPI kept correctly predicting that home prices would hold up.

However, USLHPI growth has now dropped to a four-year low. Based on just a three-month decline, it is not yet in a clear cyclical downturn, though it would be if it kept falling. If so, there would be a danger of a slowdown in homeowner spending, which accounts for five-sixths of the total. The weakness in the USLHPI suggests that such a downturn in spending is not imminent, but may already be on the horizon.

It is not surprising, therefore, that growth in the U.S. Long Leading Index (Chart 5b, [page 7](#)) is pointing to a slowdown in U.S. growth. With growth in the Canadian Long Leading Index also at a four-year low (Chart 7b, [page 9](#)), North American growth is set to ease.

### Rays of Hope May Cause Overheating

From a global perspective, however, the gloom is far from pervasive. We noted last month that growth in the long leading indexes for every European economy monitored by ECRI had improved of late. While those growth rates all dipped in August, prospects for most European economies, notably Germany and the U.K., remain positive. In the case of Germany, a detailed analysis ([pages 3 to 4](#)) shows that German economic growth is set to strengthen.

*Continued...*

**TABLE 1: DIVERGENT OUTLOOKS**

	<b>Current Growth</b>	<b>Consensus Growth Outlook</b>	<b>ECRI Growth Outlook</b>
<u><a href="#">U.S.</a></u>	Average	Slow/Average	Slow/Average
<u><a href="#">Canada</a></u>	Average	<b>Average</b>	<b>Slow/Average</b>
<u><a href="#">Mexico</a></u>	Slow	Slow/Average	Slow/Average
<u><a href="#">Germany</a></u>	Slow/Average	Average	Average
<u><a href="#">France</a></u>	Slow	Slow/Average	Slow/Average
<u><a href="#">U.K.</a></u>	Slow	<b>Slow</b>	<b>Slow/Average</b>
<u><a href="#">Italy</a></u>	Slow	<b>Slow/Average</b>	<b>Slow</b>
<u><a href="#">Spain</a></u>	Average	Slow/Average	Slow/Average
<u><a href="#">Switzerland</a></u>	Average	Average	Average
<u><a href="#">Sweden</a></u>	Average	Average	Average
<u><a href="#">Austria</a></u>	Average	Average	Average
<u><a href="#">Japan</a></u>	Slow/Average	Slow/Average	Slow/Average
<u><a href="#">China</a></u>	Strong	Average/Strong	Average/Strong
<u><a href="#">India</a></u>	Average/Strong	<b>Average</b>	<b>Average/Strong</b>
<u><a href="#">Korea</a></u>	Slow/Average	Slow/Average	Slow/Average
<u><a href="#">Australia</a></u>	Average	Slow/Average	Slow/Average
<u><a href="#">Taiwan</a></u>	Slow/Average	Average	Average
<u><a href="#">New Zealand</a></u>	Slow/Average	<b>Slow</b>	<b>Slow/Average</b>
<u><a href="#">South Africa</a></u>	Slow/Average	Average	Average

**FOCUS:**  
**German Recovery**  
**[pages 3 to 4](#)**

# GLOBAL INDUSTRIAL GROWTH TO PICK UP

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What is also worth noting is that underlying inflation pressures are rising in both the U.K. and the Eurozone, including Germany in particular. Thus, the uptrend in inflation in those economies is not about to reverse, even if the impact of the recent oil price spike dissipates soon.

Moreover, U.K. home price inflation, which had been falling sharply until earlier this year, appears to be bottoming. In fact, ECRI's U.K. Leading Home Price Index suggests that a revival in U.K. home price inflation is likely ([page 11](#)).

Despite the slowdown in U.S. growth, the good news is that a recession remains improbable. The bad news is that underlying inflationary pressures are in a clear uptrend, with the U.S. Future Inflation Gauge rising in September to a five-and-a-quarter-year high ([page 6](#)). As we discuss ([page 5](#)), one reason for the rise in U.S. inflation pressures is the upswing in U.S. import prices, which reinforces domestic inflation pressures.

Asian economic prospects also remain positive, with the outlook brightening in India, Korea and Taiwan, and to some extent in Japan. Part of the reason may be the likely improvement in global industrial growth.

## Global Industrial Growth to Improve

While overall U.S. growth is set to slow, it is notable that growth in ECRI's U.S. Leading Manufacturing Index rose in September to a 15-month high. The worsening in U.S. growth prospects is actually concentrated in the non-manufacturing portion of the economy, where consumer spending is largely focused. Similarly, growth in the German Leading Manufacturing Index has now risen to a 13-month high ([pages 3 to 4](#)).

For a broader perspective on industrial cycles, which are transmitted in part through trade, it is worth examining

ECRI's Industrial Production Diffusion Index (IPDI), which measures the proportion of 18 economies monitored by ECRI where industrial production had risen over the most recent six-month span (Chart 1, bottom line). Thus, the IPDI measures the breadth of upturns in global industrial growth.

The cyclical swings in the IPDI are usually anticipated by corresponding cycles in the Manufacturing Related Diffusion Index (MRDI), which measures the proportion of manufacturing-related components of the long leading indexes of the economies monitored by ECRI that had improved over the most recent six-month span (Chart 1, middle line). Cyclical swings in the MRDI, in turn, are typically anticipated by corresponding cycles in the Financial Related Diffusion Index (FRDI), which is the proportion of financial-related components of the long leading indexes of the economies monitored by ECRI that had improved over the most recent six-month span (Chart 1, top line).

What is evident from the chart is that the FRDI is holding near a two-year high, implying that the longer-term antecedents of an upturn in the global industrial cycle remain in good shape. The MRDI has also turned up, as has the IPDI. Thus, it appears that the global industrial slowdown has ended, as anticipated months ago by the FRDI, which still shows no signs of weakness.

In sum, global economic prospects remain positive, especially outside North America. In the near term, a revival in global industrial growth should help the world economy.

In the longer term, the foundations of this upswing may eventually be undermined by a rise in interest rates. But for now, given the concerted cyclical upturns in inflation pressures in most major economies, the most pressing near-term issue is likely to be inflation, not recession.

**Chart 1: Financial Related, Manufacturing Related and Industrial Production Diffusion Indexes**

