

Strategy Matters

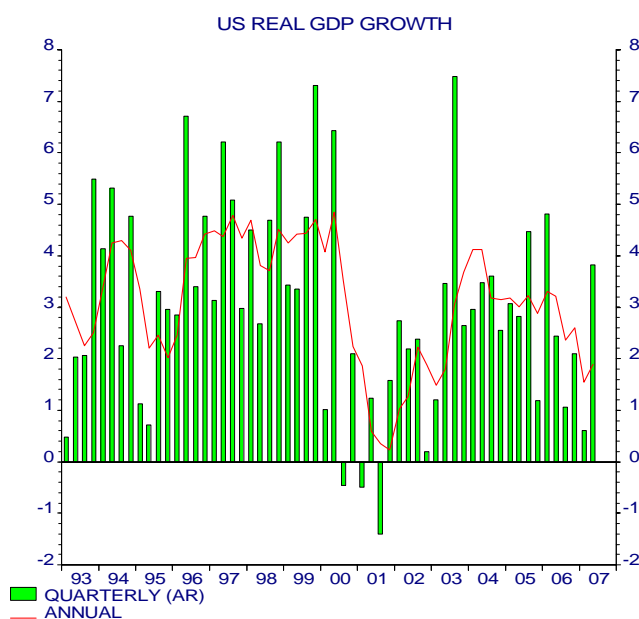
Issue 2007 - 9

Is the US economy headed into recession?

Recent turmoil in credit markets and the continued weakness of the US housing market has led to fears that the US economy may be heading for recession. How worried should we be?

Weak growth

The US economy has been growing at a below-trend rate for several quarters. Real GDP growth over the last year was just 1.9%, compared to a trend rate of around 3%. This weakness has been the result of a slump in the homebuilding industry. A drop in residential construction activity over the last year has subtracted 0.9 percentage points from growth. The worry now is that weakness in the housing market will spill over into the rest of the economy, dragging down growth to recession levels.



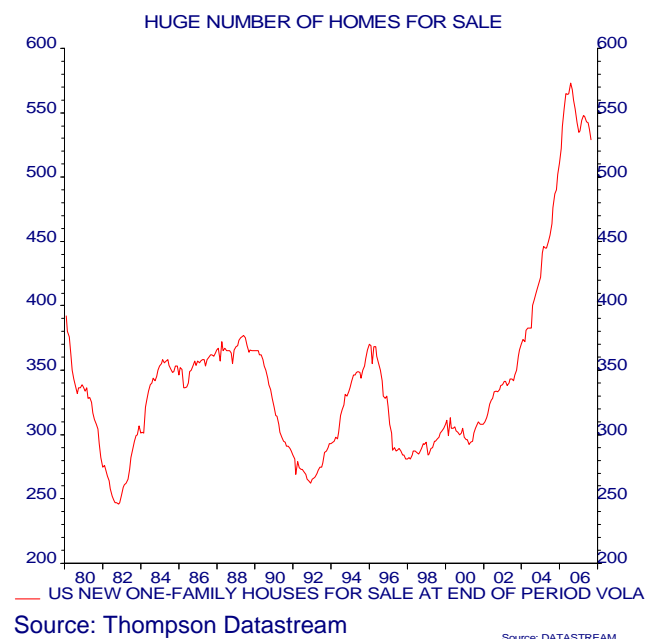
Source: Thompson Datastream

Source: DATASTREAM

Housing market slump

The US housing market is in recession. Existing home sales are down 27% from their peak, new home sales are down 43% and housing starts down 42%.

Things seem likely to get worse before they get better. Leading indicators, such as pending home sales, building permits issued and confidence among homebuilders are all still falling. The inventory of new homes for sale has dropped slightly in recent months but remains at a very elevated level and, with mortgage defaults rising, foreclosures seem sure to increase, leading to more homes coming onto the market.



Source: Thompson Datastream

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In these circumstances, homebuilders are very likely to make further cuts to their building programmes. Housing starts will probably fall a good deal further and residential construction activity will continue to be a drag on overall

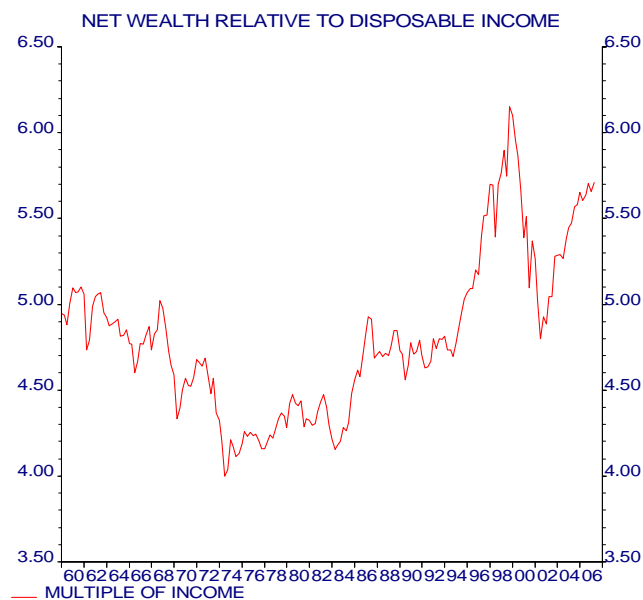
economic growth. Over the next year it could take at least another 0.5 percentage points off growth, probably more.

At the same time, the overhang of unsold homes on the market is likely to push prices down. The most closely watched measure of US house prices is the Case-Shiller index. This shows prices down 3.2% over the last year. Further falls of 5 to 10% seem very likely over the next twelve months.

Household vulnerability

It is the effect of these likely house prices falls on households and consumer spending that is the real worry.

A look at US households' balance sheets suggests that they are in a strong position. Net wealth – the difference between assets and liabilities – is close to its 1999 peak, relative to disposable income, having increased steadily in recent years. However, housing accounts for one-third of US households' wealth and substantial falls in house prices could reverse the recent upward trend.

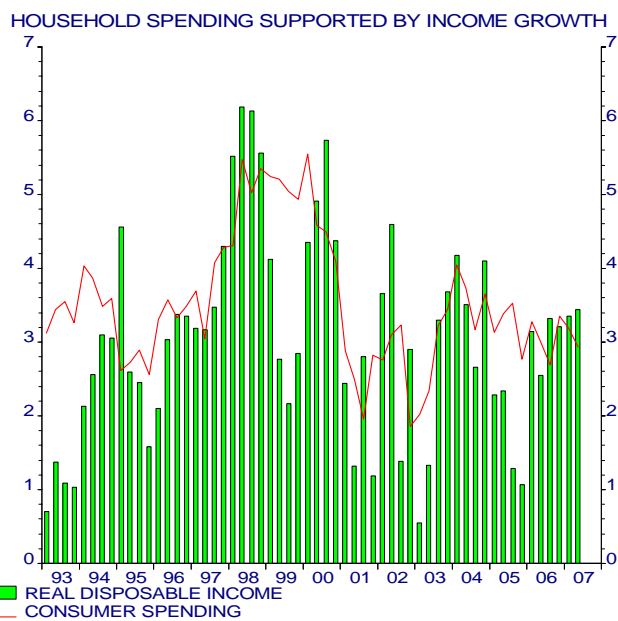


Source: Thompson Datastream

This would come at a time when households' spending on non-discretionary items is at a high level. A build-up in debt over recent years has left US households with a high level of interest

payments, relative to disposable income. At the same time they are also facing high gasoline prices, increased energy costs and rapidly rising food prices. These factors all tend to squeeze the amount of money left to spend on discretionary items.

So far, though, consumer spending has continued to grow at a healthy pace thanks to strong incomes. Although employment growth has moderated, it is still running at around 1¼% over the last year. Add in wage growth of around 4%, increased bonuses and other additions to income, and US households have enjoyed total income gains of around 6%. This has been enough to cushion them from the effects of higher interest payments and rising food and energy costs. Real incomes, after allowing for inflation have grown by around 3%.



Source: Thompson Datastream

The risk over the next year is that companies become less generous than they have been in the recent past. If they feel that the outlook for the economy has deteriorated, they may become reluctant to increase employment. Lay-offs could rise in some industries – especially those associated with the housing market. And wage growth could be pushed lower too.

This might hit consumer spending in two ways. First, lower income growth is likely to have a direct effect on spending growth. Second, rising

unemployment might have an indirect effect by making some households decide to save a little more and spend a little less.

Consumer spending accounts for 70% of economic activity in the US. If it slows, then output growth is almost certain to slow too and there would be a serious risk of a downward spiral as lower spending growth led to more cuts in employment, which led to even lower spending growth and so on.

The rest of the economy

What about the rest of the economy? Could it grow fast enough to offset weakness in consumer spending? Unfortunately, that is unlikely to be the case.

With the rest of the world growing at a rapid pace, and the lower dollar boosting US firms' competitiveness, export growth should provide some support to the economy. Additionally, the fact that the budget deficit undershot in the fiscal year that ended in September might tempt politicians, especially in an election year, to boost government spending or cut taxes (or both). But business investment spending is mainly driven by sales prospects and it would probably weaken if consumer spending slowed.

Conclusion

Weakness in the housing market is likely to make the US economy vulnerable to the possibility of recession throughout the rest of this year and most of 2008. As yet, there is no compelling evidence to suggest that growth in consumer spending, which accounts for over two-thirds of output, is about to slow. However, the risks are mounting. High debt payments, high energy prices and falling house prices are putting a strain on households. Any significant rise in unemployment could trigger much weaker consumer spending growth and, ultimately, tip the economy into recession. The chances of such an outcome may be as high as one in three.

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