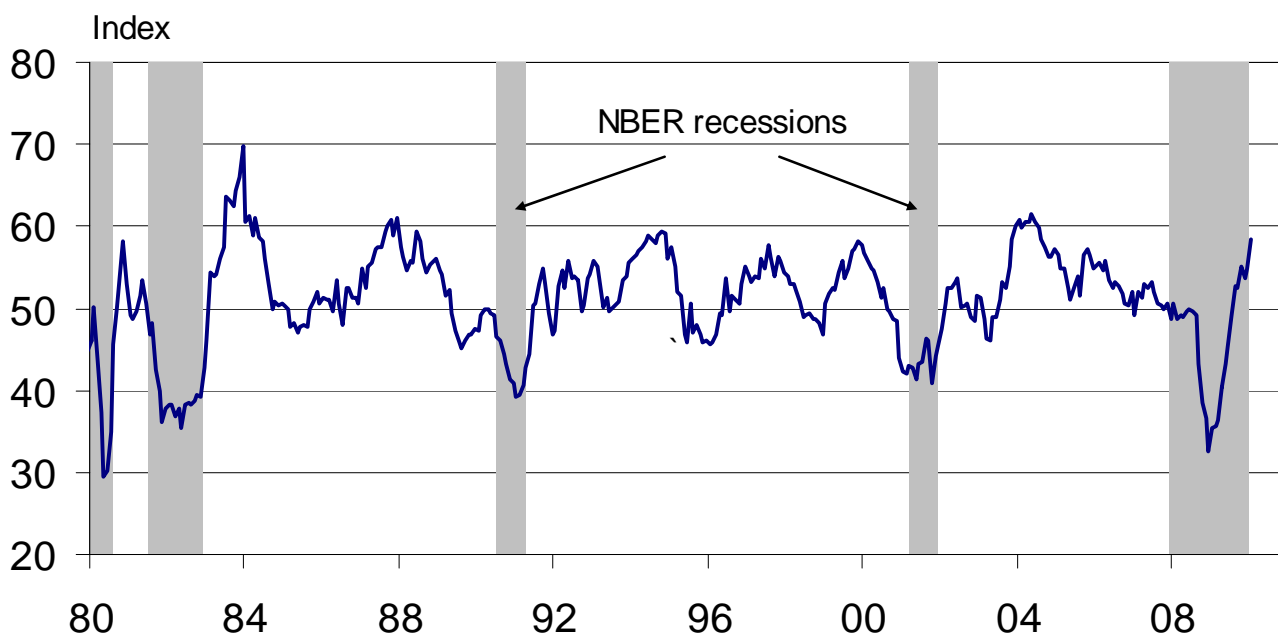


US Economic Update

Key Points

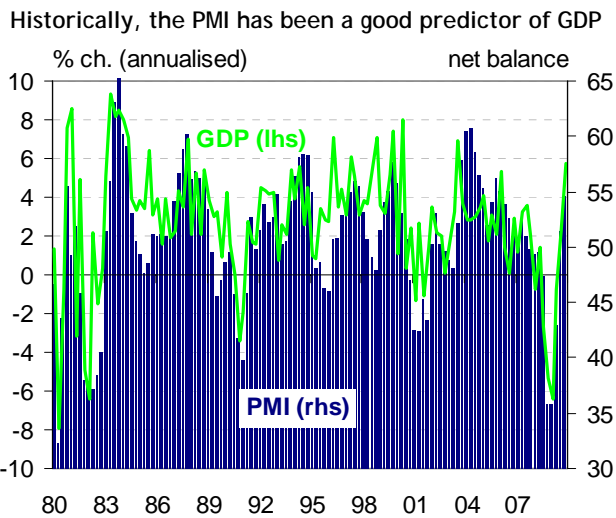
- The recent surge in the Institute for Supply Management's manufacturing PMI - historically a good leading indicator of overall GDP growth - suggests significant upside risk to our current outlook for a sub-trend recovery through 2010.
- While it is possible that these data represent a stronger recovery in the US economy than currently expected, it seems more likely that recent strength in the manufacturing PMI reflect a range of sector-specific, temporary, or survey issues that limit the generality of its results in this instance.
- In particular, the manufacturing sector appears to have been boosted to a greater degree by fiscal stimulus measures (such as the 'cash for clunkers' initiative) than the services economy. In this event, the manufacturing PMI can be expected to ease back to levels closer to the non-manufacturing PMI as the effect of the stimulus wanes.
- Also, the manufacturing PMI, by its nature, tends to over-represent medium to large business and exporters, both of which have experienced a more significant bounce in conditions that the broader economy.
- While our core view that the recovery will be subdued by historical standards remains intact, the next few PMI's will bear close watching.

ISM non-manufacturing index



Sources: Institute for Supply Management, National Bureau of Economic Research

The Institute for Supply Management’s manufacturing index (PMI) has surged in recent months to levels consistent with a very strong expansion in the manufacturing sector. This is significant because historically, the PMI has been a good leading indicator of GDP growth. Recent levels, if sustained, suggest significant upside risk to our current outlook for a more modest, sub-trend recovery through 2010.



Sources: Bureau of Economic Analysis and Institute for Supply Management

The key uncertainty here is the extent to which current robust conditions in the manufacturing sector reflect broader (economy-wide) and ongoing trends as distinct from sector-specific and/or temporary influences. On balance, we favour the latter explanation, but acknowledge the risk that underlying economic conditions in the US are simply stronger than we currently expect. The next few PMI’s will bear close watching.

Recent developments

The most recent reading, for January 2010, saw the manufacturing PMI jump to a level of 58.4, up 3.5ppts in the month and its highest level since 2004. This was also the sixth consecutive month where the index had been above the critical level of 50 that separates expansion from contraction, having hovered between 52 to 55 from August and December 2009.

The surge in the overall index reflects a strong recovery in the production and new orders sub-indexes. The production index stood at 66.2 in January up from a cyclical low of 25.5 at the end of 2008, while the new orders index now stands at 65.9 compared with a low of 22.9 in December 2008. Elsewhere, the employment index has just moved above into expansionary territory in recent months while the inventories index sits just below that level. The remaining sub-index for supplier delivery times has improved along with the other components, though has remained much more stable over the course of cycle.

Regional manufacturing surveys paint a more mixed picture. For instance, the Philadelphia Fed survey suggests similarly robust manufacturing conditions to the ISM survey, but both the Empire State and Richmond Fed surveys show a dip back toward more neutral conditions in recent months. Meanwhile, the Kansas City Fed survey points to more modest but stable manufacturing conditions in that district in recent months.

Notwithstanding conflicting signals provided by the regional surveys, the ISM survey remains the most credible indicator of nation-wide conditions in manufacturing. In this regard, it is worth analysing the underlying drivers of its recent strength to assess whether it should be considered indicative of broader and ongoing momentum in the US economy.

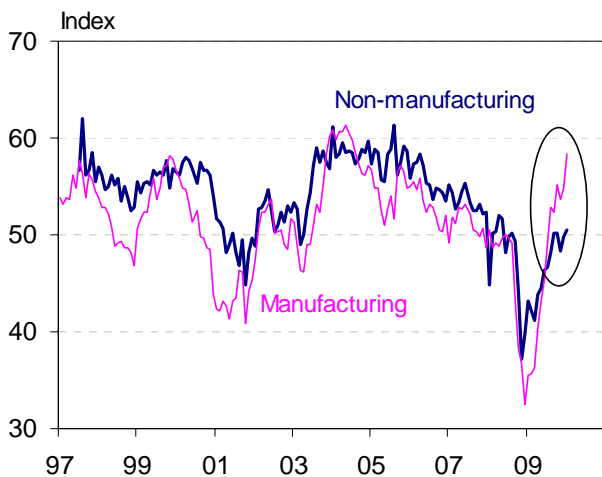
A temporary boost?

Perhaps the primary reason to be suspicious of the PMI and the extent to which it signals a stronger recovery more broadly through the economy is the fact that it’s not replicated in the corresponding non-manufacturing survey (which represents the overwhelming majority of the economy).

While the non-manufacturing PMI has recovered over the course of 2009 it has been far more muted than the manufacturing index, and the current reading of 50.5 in January is only marginally in expansionary territory. The

business activity and new orders components of the non-manufacturing PMI are performing slightly better, but the overall index is being held back by still sluggish employment conditions in the services sector.

The recovery in manufacturing is not reflected in the rest of the economy



Source: Institute for Supply Management

One possible explanation for the divergence in the recent performances of the manufacturing and services sectors is that fiscal stimulus measures supported the manufacturing sector more directly and effectively. A prime example of this is the so called 'cash for clunkers' initiative, which was so successful in stimulating automotive demand. Business tax breaks and investment incentives are likely to have had a similar, albeit less high profile impact on manufacturing.

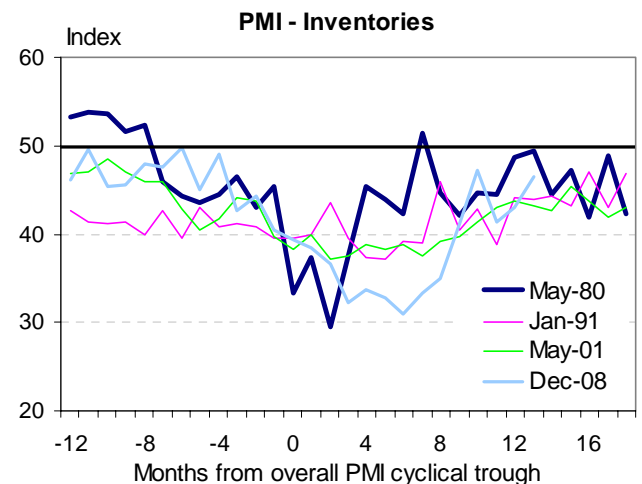
To the extent that manufacturing demand has been propped up by temporary fiscal incentives, manufacturing conditions can be expected to come back to more moderate levels of expansion as these measures unwind.

The inventory cycle

It is possible that with inventory levels so depleted - private inventories finished 2008 at just 2.3 times final sales compared with 2.44 times at the start of 2009 - production is being, and will continue to be, sustained in the short-term by a slower pace of inventory depletion followed by a

rebuilding of stock levels. This argument only goes so far, however, with manufacturing firms typically avoiding an aggressive rebuilding of stocks in previous cycles, even after an extended period of de-stocking.

History suggests there won't be a big boost to production from firms rebuilding inventories



Source: Institute for Supply Management

In this event, production can be expected to more closely mirror trends in demand, which as noted above, is expected to ease as the effects of fiscal stimulus wanes.

Some upward biases

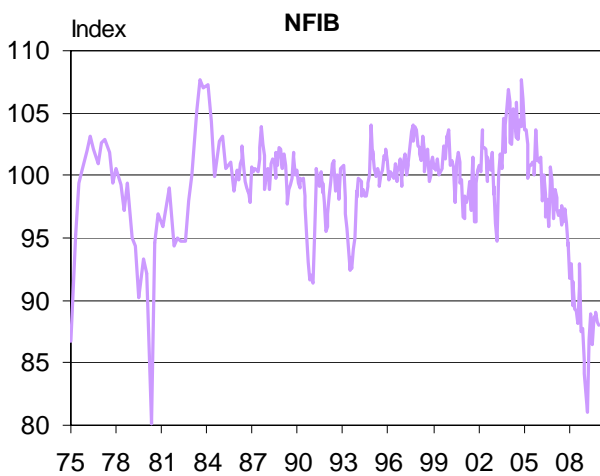
The remaining concerns with the amplitude of the recovery implied by the manufacturing PMI surrounds inherent biases within its construction.

First, manufacturing firms are more likely to be medium to large businesses as a result of the scale required, which makes generalising results difficult if conditions differ between the small and big ends of town.

This is the case at present. The most comprehensive survey of small business trends, conducted by the National Federation of Independent Business, reported that small business optimism remains weak, with a reading of 88 in December 2009, some 12% below the benchmark level of 100. One of the biggest constraints on small business remains the availability of credit. 15% of respondents

reported credit as harder to get in the NFIB survey, among the highest at any time in the past 23 years. The divergence in credit conditions between large and small business was highlighted in the January Senior Loan Officer Opinion Survey, which showed a modest easing in credit conditions for large and medium commercial and industrial borrowers, compared with a continued tightening for small commercial and industrial borrowers.

Small business sentiment remains at historically weak levels



Source: National Federation of Independent Business

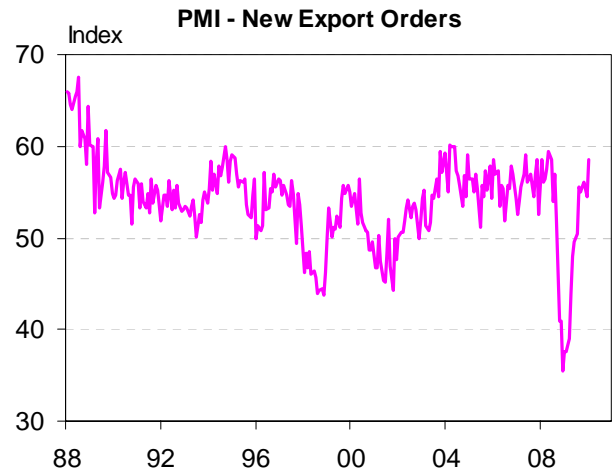
To the extent that the manufacturing PMI does not capture these more subdued conditions for small business, it may well provide an overstated picture of broader economic trends.

Finally, exporters tend to be over-represented in manufacturing, creating similar problems when generalising results if trends for exporters are different to domestic-oriented business. And indeed they are at present.

The weak US\$ and pick up in foreign demand has underpinned a strong recovery in exports in the second half of 2009. Export volumes rose by 4.2% in each of the last two quarters of 2009 and are now only 1.7% lower over they year, compared with a peak decline of 18.5% in the year to the June quarter 2009. In the manufacturing sector, the new export orders index has moved into expansionary

territory at 58.5 in January, up sharply from the cyclical trough of 35.5 at the end of 2008.

Export conditions have recovered sharply



Source: Institute for Supply Management

To the extent that the recovery in conditions has been stronger for exporters than across the broader economy, then the manufacturing PMI would once again tend to overstate the recovery in the economy.

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