Market & Investment Insights

Can a growing U.S. economy "decouple" from weakness overseas?

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Article Highlights:

- The U.S. economy is gaining strength, expanding at a 3.5% annual rate in the third quarter.
- Meanwhile, Europe may be nearing recession, Japan is still struggling with deflation, and growth is cooling in China and other emerging markets.
- Although the U.S. economy will be affected by slower growth abroad, we think the impact will be minimal.
- We see the U.S. achieving a 3.25% average growth rate by the end of 2015.

It's been a solid year for the U.S. economy. After an early hiccup, economic output has rebounded. U.S. GDP growth clocked in at a robust 4.6% annual rate in the second quarter, followed by 3.5% growth in the third. It now appears that the economy will grow at an average 2.3% clip in the 2014 calendar year and top 3% in 2015 for the first time since 2005. Job growth, a key consideration for the Federal Reserve's interest-rate policies, has averaged about 229,000 per month this year—its most consistent performance since the Great Recession of 2008-2009. Meanwhile, inflation has stayed low, the housing market has improved, and manufacturing activity is on the rise. Confidence that the U.S. economy is gaining strength has helped push the stock market to record highs in recent months.

That confidence, however, is not mirrored across the world's major economies, where growth is weak and in some cases getting weaker. Concerns that Europe may be entering a new recession at the same time that China's economy is slowing and Japan is struggling to break free of a decades-long economic stagnation took their toll on the equity markets in mid-October. The S&P 500 suffered its biggest one day fall in six months and fell 5.4% in the course of five trading days. Rising stock market volatility drove a surge in demand for lower-risk assets, pushing the yield on the 10-year Treasury note briefly below 2%.

TIAA CREF Financial Services

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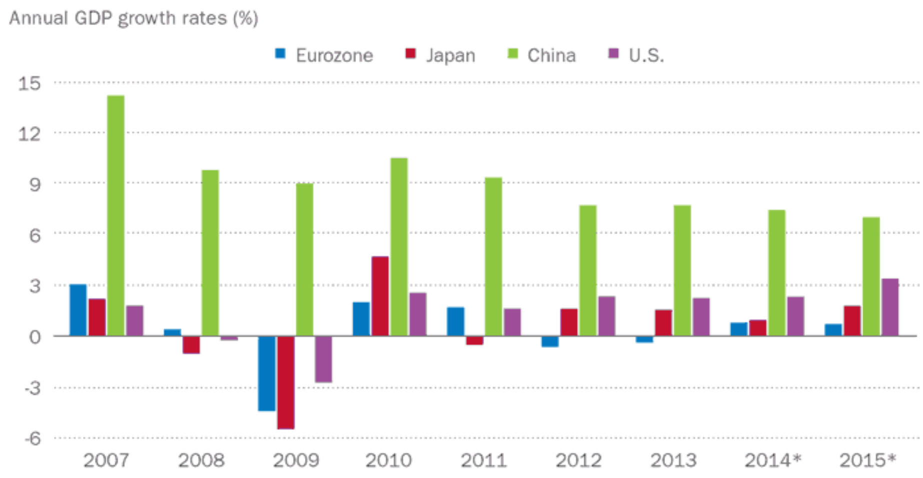
Growth slows abroad as the U.S. picks up



*TIAA-CREF forecasts
Sources: Haver Analytics, TIAA-CREF

Massive New Stimulus Programs

To counter the persistent economic weakness in their respective countries, the European and Japanese central banks are embarking on a series of massive, unprecedented stimulus programs that they hope will lead their respective economies out of the danger zone of weakening growth and zero inflation and onto a path of stronger expansion that will drive employment gains, increased consumer spending and new investment. (China is adding stimulus as well, though not as aggressively.) In doing so, they are using the U.S. experience with quantitative easing as their template. And while critics have often warned that such stimulus programs risk creating a spike in inflation, that would be a welcome outcome for nations where deflation is viewed as a more imminent threat.

Ultimately, these programs will serve as a placeholder for growth, rather than creating growth directly. They will buy time for their respective economies to gain strength and implement the reforms that are needed to achieve sustainable long-term growth in the future, as the Federal Reserve's recently concluded quantitative easing program did for the U.S.

The process is furthest along in Japan, where annual growth has exceeded 3% only once in more than 20 years. Prime Minister Shinzo Abe has embarked on an aggressive stimulus program since he took office in late 2012, but so far, the effects have been mixed. Growth totaled just above 1.5% in 2013, similar to its 2012 performance, and we expect to see less than 1% growth in 2014 as the effects of a higher consumption tax take effect.

Reviving Inflation in Japan

For Japan, much of the problem has been the environment of no inflation or outright deflation, which has entered the national psyche and has been extremely difficult to dislodge. At Abe's urging, the Bank of Japan (BOJ) has doubled its inflation target to 2%, though the lengths it would go to achieve that goal have been unclear.

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In October, as the BOJ’s policy makers were meeting to update economic forecasts, it became clear that the nation’s expectations for future inflation – as important to central bankers as actual inflation rates—were not rising to meet its 2% goal and in fact might be set to decline again. To keep the momentum of reform on track, BOJ Governor Haruhiko Kuroda recently won approval to boost the stimulus program further by raising the bank’s purchases of government bonds to as much as 80 trillion yen (US$710 billion) annually. The BOJ will also raise its purchases of Japanese stocks and real estate investment trusts to stimulate those markets as well.

While the announcement surprised markets, the BOJ was even bolder in its statement that it will maintain its stimulus programs “as long as it is necessary” to maintain inflation at a 2% rate. This effectively makes the stimulus program open-ended and will likely push the yen much lower, which has the effect of raising revenue from exports and lifting the price of imports. We expect to see the yen fall to 130/U.S. dollar by the end of 2015 from its rate of about 116 as of November 17.

China Uses Targeted Stimulus

In China, where growth hasn’t topped 8% since averaging more than 10.5% from 2007 to 2011, policy makers are turning to stimulus packages as well. Faced with reports of declining industrial production and a slowdown in the growth of retail sales and new loans, the nation’s central bank injected about $81 billion into the economy in September, just five months after it announced new spending targeted at railways, low-income housing, and tax cuts for small businesses. It may not be long before further stimulus measures are announced as well.

Europe, which has the clearest need for stimulus, also has the longest path to actually implementing it. By charter, the European Central Bank (ECB) is prohibited from buying government bonds directly, and political opposition from Germany makes it unlikely that will change before the end of 2014. However, with the eurozone posting zero growth in the second quarter of 2014 as the German and Italian economies contracted, the region is flirting with the very real possibility of entering its third recession in six years. European political leaders won’t be willing to risk the chance that a new recession might encourage or even force a member nation to leave the eurozone, and will probably opt instead for a program of massive quantitative easing to avoid that.

ECB President Mario Draghi has spent the last few months laying the groundwork for quantitative easing. In October, the ECB began a series of relatively small purchases of covered bonds and asset-backed securities, and in November, Draghi said he expects the ECB’s balance sheet will return to the size it was in early 2012, which implies stimulus totaling about 1 trillion euros, or U.S. $1.25 trillion. In its most recent statement, the ECB said “the governing council is unanimous in its commitment to using additional unconventional instruments within its mandate.” We expect the ECB to announce a formal stimulus program in early 2015, with full rollout to occur over several months.

Can the U.S. Decouple?

With growth weak in major foreign-developed economies and slowing in important emerging markets such as China, Brazil and Russia, the question inevitably arises as to whether the U.S. can maintain its current path towards stronger growth while other major economies falter. The answer to this question, we believe, is yes. While the weakness abroad will have an impact on the U.S. economy, we think the effect will be minimal.

The U.S. economy is much less export-oriented than Japan or Germany. Also, most U.S. corporations are now well aware of the weakness in Europe and Japan, and have factored that into their future plans. Furthermore, the issues that have been detracting from U.S. economic performance—the lack of wage growth, weak consumer spending, a stalled housing market recovery and weak business investment—are not closely tied to trends in overseas markets. Other major risks to a stronger U.S. economy, such as the conflict in eastern Ukraine and escalating hostilities in the Middle East, likewise present little real threat, in our opinion.