ROBECO

Financial Markets Research

Growth momentum slows

Léon Cornelissen
Lukas Daalder
Ronald Doeswijk

financialmarketsresearch@robeco.com

Highlights

- The momentum of the world economy is slowing. Worries about increasing inflationary risks are set to fade into the background in the coming months. Instead, the focus will be on two other themes: the "double dip" and "QE3".

- We do not expect too much from equities in the months ahead. On a 12-month horizon, however, we do forecast positive returns. Although earnings are still a driver, significant positive earnings surprises are unlikely, as margins are high and the economy will not generate strong growth.

- The outlook for corporate bonds, while still positive, is deteriorating. Spreads widened over the last month. Recent economic data suggests that growth in the global economy is slowing. Even so, producer confidence is close to historical highs, which means there is no reason to become pessimistic at this stage. Corporate bonds are not cheap, but these spreads are still attractive.

- The correction in commodity prices can be attributed to the declining risk that oil production in Saudi Arabia will be affected by the social unrest in the Middle East. In addition, the market appeared to be overbought; in other words, mass psychology played a role. Furthermore, recent macro data has tended to disappoint. It might take a while before commodity prices reach new highs.

- Within equities, emerging markets are still our favorite region. Inflation risks have declined now that growth is slowing. Nevertheless, some further tightening will be needed. Even so, the outlook is still for continuing growth. Moreover, these countries will not be troubled by sovereign-debt restructuring.

- **This month's special focuses on the US consumer, who appears to have surrendered his role as the engine of the world economy to the growth miracle of emerging markets. This does not mean that low growth is inevitable; rather, the US consumer will—on average—track growth and not lead it.**

Summary

Signs are increasing that global economic growth is weakening. We do not expect too much from equities in the months ahead, though we do forecast positive returns on a 12-month horizon. On a three- to six-month horizon, we have a neutral view on both equities and real estate. The outlook for corporate bonds, while still positive, is deteriorating. After the recent correction, it might be some time before commodity prices set new highs. The outlook for commodity prices in the long run continues to be good, however. Within equities, emerging markets are still our favorite region. We have a slight preference for defensive sectors over cyclicals and financials.

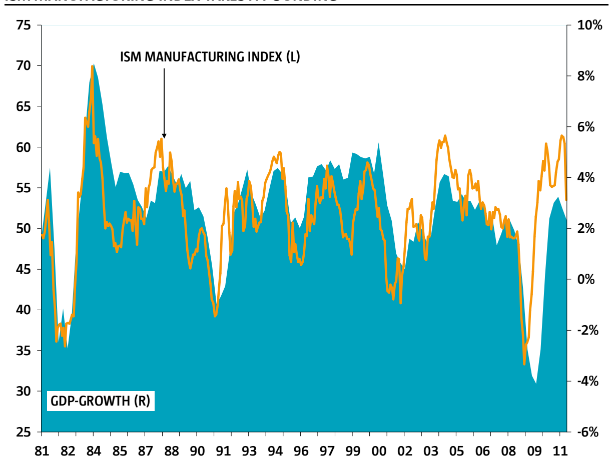
Macroeconomic view

The momentum of the world economy is slowing. Worries about increasing inflationary risks are set to fade into the background in the coming months. Instead, the focus will be on two other themes: the "double dip" and "QE3".

North America

After months of better-than-expected data, a string of disappointing US economic reports hit the wires. Industrial production was flat over the month (+0.4% expected), durable goods orders excluding transport dropped by 1.5% (+0.5% increase expected), and retail sales excluding cars increased by only 0.2% (+0.5% expected). In addition, the various confidence reports declined sharply, with the release of the ISM manufacturing index grabbing the headlines. The overall index declined from 60.4 to 53.5, with orders shedding more than 10 points in a single month (from 61.7 to 51.0). The main factor behind this weakness was the rise in oil prices, while the industrial sector was also hit by a shortage of industrial parts related to the Japanese earthquake. The latter effect is also having a negative impact on jobs data, with some car makers temporarily laying off employees, as has become clear from the turnaround in weekly claims, as well as the weak ADP report. But given that the oil price has retreated since the start of May and the shortage problem is being addressed, the slowdown should be a temporary one. Even so, with the recovery in a fragile state, it should come as no surprise if the words "double dip" and "QE3" start to do the rounds.

ISM MANUFACTURING INDEX TAKES A POUNDING



SOURCE: BLOOMBERG, ROBECO

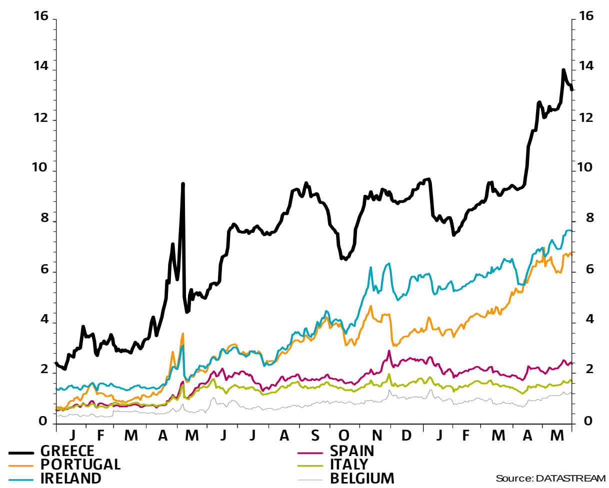
A more structural issue is the ongoing weakness in the housing sector. Housing starts reached 523,000 units in April, which is at the lower end of the post-2009 trading range and just a quarter of the level at the peak in 2006. Given the relatively low importance that the production of housing now has in total production, this number cannot be called shocking. In fact, it could even be argued that low production is the best way to burn through the existing overhang of houses for sale (including the shadow inventory). A more threatening problem is related to the continued decline in house prices. In Q1 2011, house prices declined by 4.3% from Q4 2010. This took them to a new post-bubble low (-34%). Given the importance of house prices for the development of net wealth (see our special on US consumer spending on p. 10), this steady decline could well have an adverse impact on consumer spending.

Europe

The UK economy is slowing, amid disappointingly high inflation. The PMI for the UK service sector fell from 57.1 to 54.3 in April, reflecting the impact of the cuts in government spending. UK inflation accelerated further in April to 4.5%, exceeding expectations once again. This surge is being driven by the higher VAT rate and increased energy and import prices. The severe fiscal tightening planned by the UK government gives the Bank of England room to remain passive for a while.

The divergence in the eurozone economy shows no signs of abating. The core is doing well, although forward-looking indicators are pointing to a slowdown. The peripheral economies continue to struggle. The seemingly never-ending European debt crisis is showing signs of intensifying. Greece is behind schedule and the IMF is threatening to withhold funding. The EU is working desperately to avoid a Greek default amid rising bailout fatigue in the core and austerity fatigue in the periphery. At the time of writing, it is unclear if the EU will succeed in a second bailout for Greece. Speculation suggests that Ireland will need a second bailout as well. It is difficult to forecast how events will unfold, but ultimately we consider that the restructuring of Greek, Irish and Portuguese debt is very likely at some point. The strategy of Europe's political leaders appears to be based on gaining time, preferably until mid-2013, when the temporary EFSF is replaced by the permanent ESM. In the meantime, solvency issues are unlikely to be addressed sufficiently, though the playing-for-time strategy should help countries to soldier on for as long as possible, giving European banks more time to recuperate. The ECB is preparing an additional rate hike in July, despite inflation having slowed to 2.7% in May. The channel by which an additional rate hike will hurt growth prospects in the periphery is not so much the money market, but rather the exchange rate. An additional rate hike will increase the interest-rate differential with the other major economic blocs, pushing up the euro, until it is countered by a deterioration of the sovereign-debt crisis.

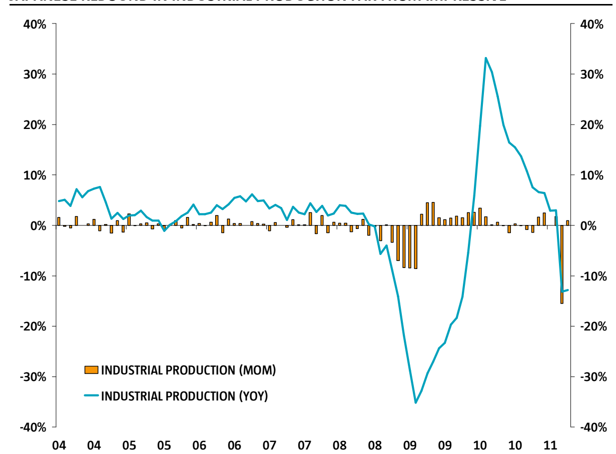
YIELD SPREADS VS GERMANY (PERCENTAGE POINTS)



Pacific

Assessments of the state of the Japanese economy lie somewhere on the spectrum between hope and fear. Hope is related to the remarkable resilience exhibited by the Japanese, who have reacted to the blow handed to them with the utmost efficiency. Roads have been rebuilt within days, rubble has been removed at record speed and new energy blackouts have been averted, thanks to sensible energy consumption throughout the economy. Surely, the argument goes, the Japanese deserve a break. Be that as it may, all the data published in the last month has been much weaker than expected. GDP declined by 0.9% in Q1 and is expected to be followed by another negative reading in Q2. Industrial production rebounded in a tepid fashion (+1.0%) following the –15.5% drop in March. And household spending is 3% below the level of April 2010. For sure, the rebound will gather strength, as indicated by the May-June forecast for industrial production. But—so far—hope is all that we have. By putting Japan on a negative rating watch, Moody's indicated that it was not in the business of selling hope. In addition to the "much larger than initially expected economic and fiscal costs", the ratings agency also mentioned the lack of budgetary-deficit reduction and demographics as the main factors driving its decision. Japanese bonds, as usual, hardly reacted to the news.

JAPANESE REBOUND IN INDUSTRIAL PRODUCTION FAR FROM IMPRESSIVE



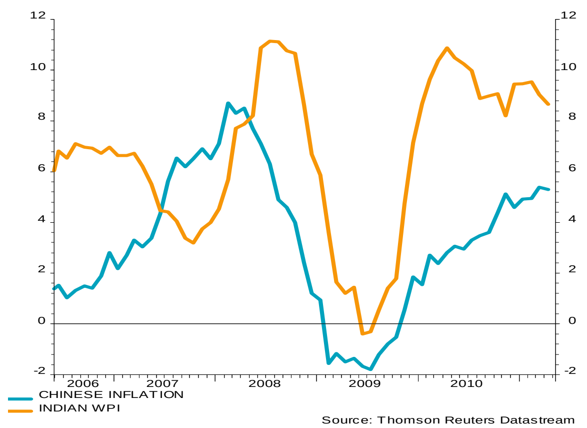
SOURCE: BLOOMBERG, ROBECO

With the focus on Japan, limited attention has been given to the state of the Australian economy recently. GDP declined by 1.2% in the first quarter, with exports slumping by 8.7%, a decline that was related to January's flooding. Both consumer spending (+0.6%) and investments (+6.0%) expanded, suggesting that the decline is likely to be a temporary one.

Emerging markets

The Chinese economy is slowing, as the Chinese authorities planned. Higher reserve requirements for banks, restrictions on new mortgages and reduced investment in infrastructure have all contributed to the slowdown. The PMI for May came in at 52, the lowest level for nine months. Inflation edged down from 5.4% in March to 5.3% in April. The Chinese government has ample room for maneuver in kick starting growth, should the landing of the economy turn out to be too hard.

CHINESE CPI (% YOY) AND INDIAN BENCHMARK WPI (% YOY)



India's economy is slowing as well. In the first quarter, growth amounted to 7.8%, down from 8.3% in Q4 2010. Inflation, as measured by the benchmark WPI, has also declined, dropping from 9.0% in March to 8.7% in April. Some further modest monetary tightening is expected in the coming months.

Inflation is also a headache for Brazil's policymakers, reaching 6.5% in April on a yearly basis. The economy, though, is showing signs of deceleration as well.

The Russian economy is exhibiting signs of weakness, too. Monetary policy, though still loose, was tightened again in May, partly in an effort to combat steady outflows of capital.

GDP GROWTH BY REGION (%)

	2010	2011	2012	Δ -1M 2011	ROBECO*
US	2.9	2.9	3.3	-0.3	=
EUROZONE	1.7	1.7	1.7	0.1	=
UK	1.4	1.8	2.2	0.0	-
JAPAN	3.9	0.3	2.7	-1.2	=
CHINA	10.3	9.3	8.9	0.1	=
INDIA	8.7	8.2	8.5	-0.1	+
BRAZIL	7.5	4.1	4.5	-0.3	+
RUSSIA	4.0	4.6	4.6	0.2	+
WORLD	3.8	3.2	3.6	-0.2	=

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) GROWTH RATE THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011

SOURCE: CONSENSUS ECONOMICS, ROBECO

CPI BY REGION (%)

	2010	2011	2012	Δ -1M 2011	ROBECO*
US	1.6	2.7	2.1	0.8	=
EUROZONE	1.6	2.4	1.8	0.4	+
UK	4.7	4.8	2.9	0.4	+
JAPAN	-0.7	0.2	0.2	0.3	-
CHINA	3.3	4.6	3.7	0.1	=
INDIA	10.2	7.9	7.0	0.6	=
BRAZIL	5.9	6.0	4.9	0.5	=
RUSSIA	8.8	8.5	7.5	0.1	=
WORLD	2.3	3.1	2.4	0.5	=

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) CPI THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011

SOURCE: CONSENSUS ECONOMICS, ROBECO

Responsible Investing
www.robeco.com

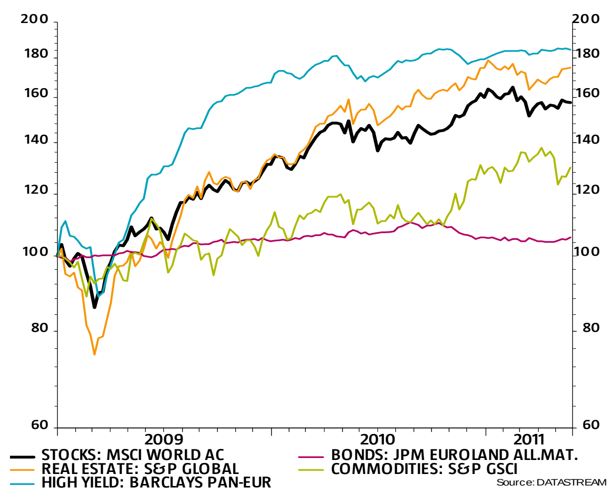
Outlook financial markets

Asset mix

Last month's review

Risky assets generally continued to drift sideways. The exception was commodities, which were hit by a correction during the month. Commodities dropped by 3.9% over May as a whole, after a double-digit correction from peak to trough. Equities were up by 1.1%, while real estate gained 3.5%. High yield was flat over last month. Over the last three months, all risky assets were slightly down. Returns on a six-month horizon are reasonable. Government bonds were in positive territory after a period of lousy returns. The euro has been volatile, falling from a peak of 1.49 against the US dollar to a trough of 1.40, and is now trading at 1.44. With the eurozone debt crisis still in full swing, the currency market is likely to remain volatile.

PERFORMANCE OF ASSET CLASSES (TOTAL RETURN EUR)



PERFORMANCE OF ASSET CLASSES (TOTAL RETURN IN EUROS)

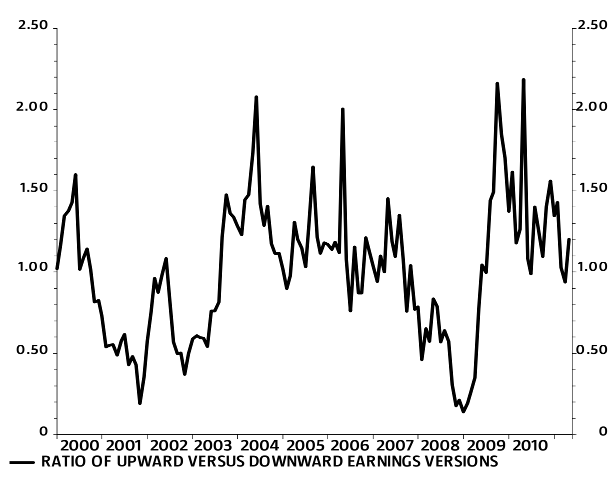
	-1M	-3M	-6M	-12M	-3Y	-5Y
STOCKS (MSCI AC WORLD)	1.1%	-2.1%	3.6%	9.9%	5.3%	8.8%
REAL ESTATE (S&P GLOBAL REITS)	3.5%	-0.4%	5.1%	15.1%	6.0%	1.9%
HIGH YIELD (BARCLAYS PAN-EUR)	0.0%	-0.1%	4.8%	8.2%	11.2%	-4.0%
BONDS (JPM EUROLAND ALL MAT.)	1.2%	0.4%	-0.5%	-2.0%	14.9%	20.1%
COMMODITIES (S&P GSCI)	-3.9%	-2.5%	7.4%	14.1%	-40.1%	-30.5%

SOURCE: THOMSON FINANCIAL DATASTREAM

Equities

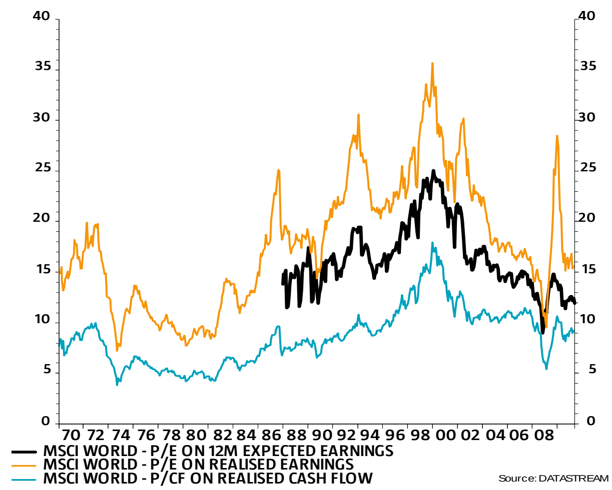
We do not expect too much from equities in the months ahead. On a 12-month horizon, however, we do forecast positive returns. Earnings remain a driver. Positive earnings revisions no longer outnumber negative earnings revisions by a wide margin. The current consensus growth rate forecast for 2011 earnings is 14%, which is close to our estimate of around 10%. We believe significant positive earnings surprises are unlikely: margins are high and the economy will not generate strong growth. In other words, positive surprises are increasingly unlikely as the economic cycle progresses.

UPWARD VERSUS DOWNWARD EARNINGS REVISIONS



The valuation of equities is neutral. In assessing valuation, we only consider absolute measures, as the valuation of equities relative to bonds has no predictive power. For those who doubt this statement, think about what would happen if bond yields were to drop to new lows. That would not be good news for equities. Looking at the price-to-earnings or price-to-cash flow ratios, it is hard to argue that equities are attractively valued. It might look attractive in the perspective of the last 20 years but a longer timeframe leads to the conclusion that equities are neutrally valued. On the other hand, balance sheets are strong. This is supporting the mergers & acquisition market, which should be a positive factor for the stock market. Even so, we do not expect too much from equities in the months ahead. The economy is already as good as it will get, while the eurozone debt crisis remains a challenge.

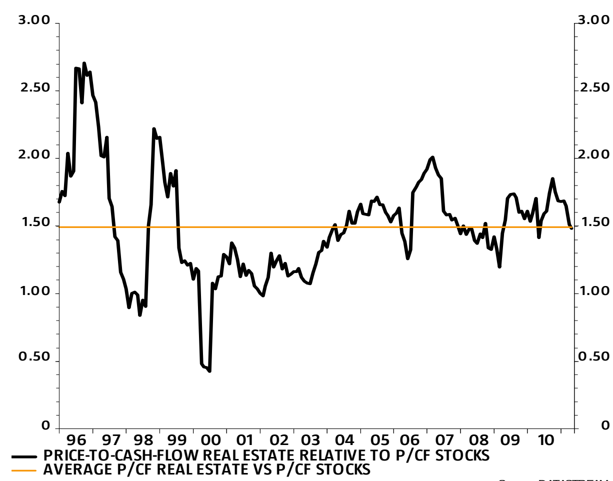
VALUATION OF EQUITIES (x)



Real estate

On a three- to six-month horizon, we have a neutral view on real estate, as well as on equities. Analysts expect earnings growth of around 9% in 2011 and 2012. This will drive returns. With labor markets improving, demand for office space should increase. Valuation is neutral. The price-to-cash flow ratio for real estate is 1.5x the one for stocks, which is exactly in line with the historical average.

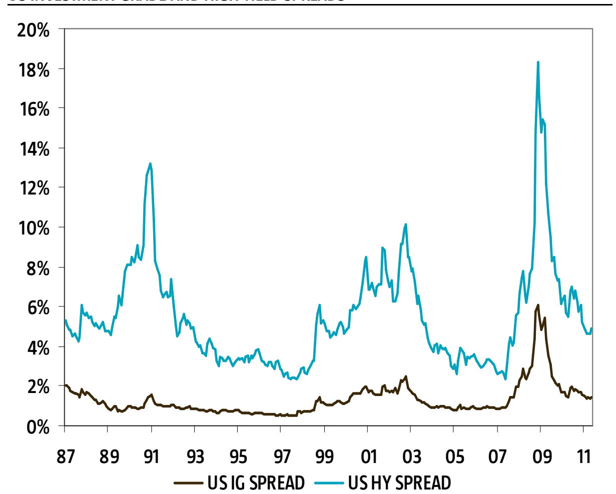
PRICE-TO-CASH FLOW REAL ESTATE VERSUS EQUITIES (x)



Corporate bonds

The outlook for corporate bonds, while still positive, is deteriorating. Spreads widened over the last month. Recent economic data suggests that growth in the global economy is slowing. Even so, producer confidence is close to historical highs, which means there is no reason to become pessimistic at this stage. Corporate bonds are not cheap, but these spreads are still attractive. To illustrate, US investment grade bonds are currently trading at a 1.46 percentage point premium to the sovereign, while the spread of high yield over Treasuries is 4.92%. As corporate balance sheets are strong and economic growth continues at a moderate level, we believe the recent widening is not a prelude of a trend reversal. However, the potential for some weaker macro data in the near future and the risk of a swift debt restructuring for Greece are tempering our optimism, making us careful about the short-term outlook.

US INVESTMENT GRADE AND HIGH YIELD SPREADS

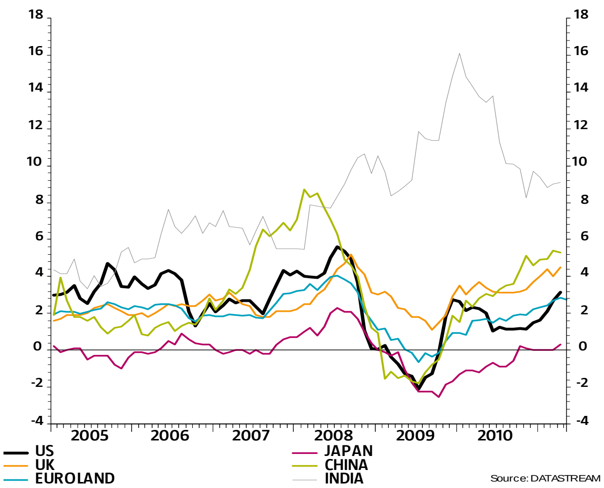


SOURCE: BARCLAYS, ROBECO

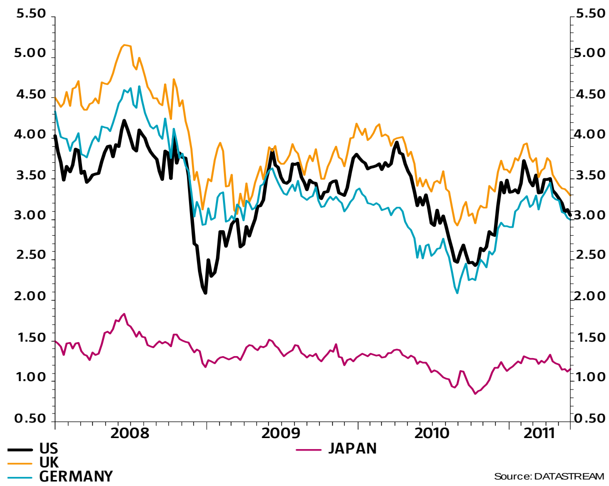
Government bonds

Returns for government bonds recently turned positive but the outlook, especially on a somewhat longer horizon, remains unattractive. Despite inflation rates creeping upwards, it is too early for long interest rates to move higher. Due to low core inflation rates and high unemployment, the short-term inflationary risks are low. But in the medium term, we forecast tight commodity markets, as the global middle class keeps growing, as does its demand for commodities. Supply will continue to have trouble in catching up. In addition, despite the ECB's early move, monetary policy can still—in general—be characterized as loose. This is increasing the inflation risks in the future.

INFLATION RATES



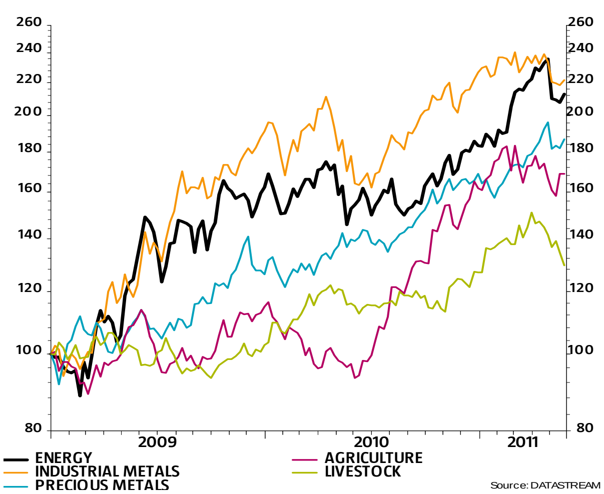
TEN YEAR INTEREST RATES



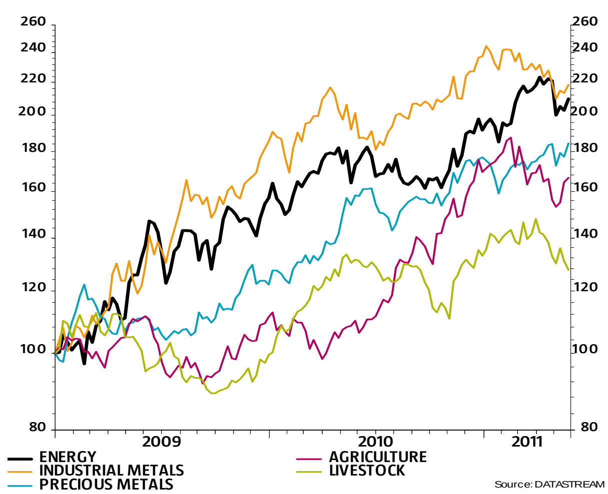
Commodities

The recent correction in commodity prices can be attributed to the decreasing risk that the oil production in Saudi Arabia will be affected by the social unrest in the Middle East. In addition, the market was apparently overbought, meaning that mass psychology also played a role. Recent macro data has tended to disappoint. That is not such a surprise after months of good economic news flow. As the current growth is driven by businesses and consumers, we expect the global economy to continue its recovery at a moderate pace. It might take a while before commodity prices set new highs. Even so, the outlook for commodity prices in the long run continues to be good. The long-term uptrend is a reflection of growing demand from the global middle class. Growth in demand will not change and it will take another few years for supply to catch up.

GSCI COMMODITY SPOT PRICES (USD)



GSCI COMMODITY SPOT PRICES (EUR)



Regional mix

PERFORMANCE OF REGIONS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)

	-1M	-3M	-6M	-12M	-3Y	-5Y
NORTH AMERICA (48%)	1.9%	-2.3%	4.2%	8.2%	11.4%	8.6%
EUROPE (26%)	0.0%	-0.1%	9.6%	18.2%	-3.5%	4.1%
PACIFIC (13%)	0.8%	-8.8%	-4.6%	1.6%	-2.1%	-8.3%
EMERGING MARKETS (13%)	0.5%	2.2%	-0.5%	10.3%	12.9%	57.7%
AC WORLD (100%)	1.1%	-2.1%	3.6%	9.9%	5.3%	8.8%

SOURCE: THOMSON FINANCIAL DATASTREAM

Within equities, emerging markets are still our favorite region. Inflation risks have declined now that growth is slowing. Nevertheless, some more tightening will be needed. Even so, the outlook is still for continuing growth. Moreover, sovereign-debt restructuring will not be an issue in these countries. With valuation at similar levels to developed markets (P/E and P/CF are below developed markets', P/B is a bit above), there is room for outperformance. Meanwhile, we prefer North America to Europe and the Pacific. Clearly, all developed regions have a sovereign-debt challenge to meet. At present, we prefer the US: it is a flexible economy that has no immediate aging problem, US consumer spending is in an upward trend and the dollar's weakness has improved the country's competitive position.

EARNINGS AND VALUATION DATA OF REGIONS (MSCI AC WORLD)

	EARNINGS GROWTH (%)			ST.DEV. ESTIMATES (%)		EARN. REV. INDEX		P/E ON 12M FWD EARN.	
	FY1	FY2	12M	CURRENT	10Y AVG.	3M	1M	CURRENT	10Y AVG.
NORTH AMERICA	18.0	13.7	15.8	6.3	5.3	25.2	20.1	12.8	15.5
EUROPE	12.9	12.5	12.3	14.5	12.7	-10.2	-14.4	10.3	13.5
PACIFIC	18.5	21.1	18.9	1.3	1.4	-37.3	-28.5	12.8	17.1
EMERGING MARKETS	16.8	13.3	15.3	14.2	9.6	-3.4	-19.1	10.4	10.8
AC WORLD	16.3	14.1	15.0	2.6	2.0	3.8	-4.6	11.7	14.6

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.
SOURCE: THOMSON FINANCIAL DATASTREAM

Sector mix

PERFORMANCE OF SECTORS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)

	-1M	-3M	-6M	-12M	-3Y	-5Y
ENERGY (12%)	-1.4%	-5.0%	10.3%	18.3%	-3.9%	24.1%
MATERIALS (9%)	-1.1%	-2.7%	2.9%	17.5%	0.6%	46.0%
INDUSTRIALS (11%)	-0.1%	-1.9%	4.5%	13.5%	5.6%	12.5%
CONSUMER DISCRETIONARY (10%)	2.6%	-0.7%	1.6%	13.3%	28.6%	13.6%
CONSUMER STAPLES (10%)	4.8%	5.5%	4.6%	11.8%	33.0%	48.8%
HEALTH CARE (9%)	5.8%	6.5%	9.4%	11.9%	30.4%	15.5%
FINANCIALS (20%)	-0.4%	-5.7%	1.8%	2.5%	-15.7%	-29.9%
IT (12%)	1.3%	-5.0%	-0.3%	3.2%	12.9%	16.2%
TELECOM SERVICES (5%)	2.1%	0.9%	3.0%	15.2%	9.1%	33.8%
UTILITIES (4%)	0.6%	-4.7%	-2.1%	0.0%	-11.1%	10.8%
AC WORLD (100%)	1.1%	-2.1%	3.6%	9.9%	5.3%	8.8%

SOURCE: THOMSON FINANCIAL DATASTREAM

We have a slight preference for defensive sectors over cyclicals or financials. Defensive sectors such as consumer staples and telecom—our favorites, with stable cash flow—have withstood a deteriorating market and continued to deliver positive returns. We anticipate mixed economic data in the months ahead, in line with developments over the last month. Sovereign-debt issues could well bring some volatility. Within cyclicals, industrials have a positive outlook due to the sector's late-cycle characteristics, although our conviction about this call is weakening, as recent earnings revisions and momentum data did not support this view. Financials are being hindered by ongoing downward earning revisions. A rapid Greek debt restructuring would affect the sector negatively, if only because of the attendant uncertainty.

EARNINGS AND VALUATION DATA OF SECTORS (MSCI AC WORLD)

	EARNINGS GROWTH (%)			ST.DEV. ESTIMATES (%)		EARN. REV. INDEX		P/E ON 12M FWD EARN.	
	FY1	FY2	12M	CURRENT	10Y AVG.	3M	1M	CURRENT	10Y AVG.
ENERGY	25.0	10.4	18.1	3.4	2.5	16.9	25.0	10.0	12.2
MATERIALS	39.8	13.7	24.9	3.9	2.5	2.9	-31.1	10.5	13.2
INDUSTRIALS	17.0	16.0	16.7	1.0	0.7	16.7	-20.7	12.8	15.5
CONSUMER DISCRETIONARY	16.5	22.3	17.7	1.0	0.7	-5.9	-7.4	13.6	17.0
CONSUMER STAPLES	8.5	11.2	10.0	0.4	0.3	-7.3	15.7	14.8	16.3
HEALTH CARE	5.6	5.9	5.9	0.4	0.3	17.2	-6.7	12.0	16.3
FINANCIALS	15.3	18.0	16.5	0.8	0.9	0.8	-29.6	10.3	12.0
IT	14.0	13.4	12.7	0.6	0.4	1.6	30.9	12.4	20.4
TELECOM SERVICES	5.0	8.4	6.4	0.5	0.5	-17.1	-4.5	11.9	19.8
UTILITIES	7.3	16.9	11.5	1.4	0.7	-20.8	-45.9	13.7	13.3
AC WORLD	16.3	14.1	15.0	2.6	2.0	3.8	-4.6	11.7	14.6

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.

SOURCE: THOMSON FINANCIAL DATASTREAM

Special: the structural outlook for the US consumer

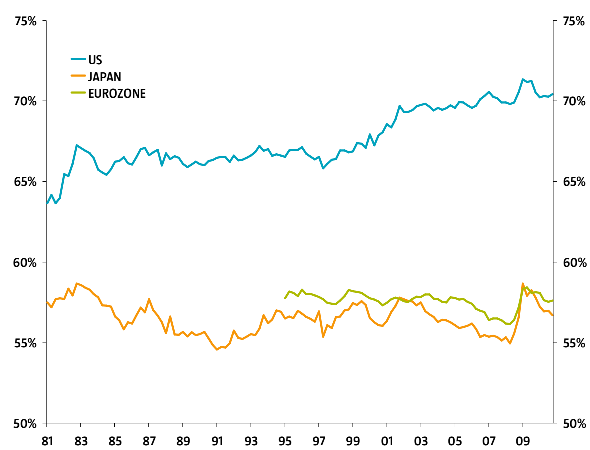
"Never underestimate the American consumer" has been sensible advice over the past 30 years when assessing the outlook for the US economy, as well as its global counterpart. The US consumer has been declared dead more often than Elvis has been spotted alive, only to surprise on the upside. Even today, following three years of weak economic performance, US consumer spending is still equal in size to the economies of the four BRIC countries put together. As such, the US is by far the most important consumer market in the world, both in absolute size, as well as in its trendsetting nature.

Over the decades, US consumer spending has steadily outperformed the broader US economy, acting as the main engine behind the US success story. As a consequence, the consumption ratio (consumer spending as a percentage of GDP) has risen steadily, a development not seen elsewhere in the developed world (see chart below left). Consumer spending in the US currently accounts for 70% of GDP, as against some 58% in both the eurozone and Japan. The general perception is that this high consumption ratio is a reflection of high levels of debt and the easy availability of credit, but it should be stressed that you cannot draw this conclusion simply by looking at the high consumption ratio. Differences in tax rates, the overall level of government spending and the presence of a sizeable current-account deficit (X-M) are all factors that contribute to the higher level of consumer spending versus total GDP.

Even if these variables were the same internationally, a rise in consumer spending relative to GDP does not necessarily have to be a bad thing. Nor must it be unsustainable. Although US debt as a percentage of GDP has steadily risen in line with the consumption ratio, it would be wrong to conclude that the consumer is heading for a prolonged period of below-average growth because of it. Debt alone is not the whole picture. As long as an increase in debt is offset by a rise in wealth and assets, the underlying financial position of households will not deteriorate. The question is therefore this: what happened to the net wealth position during the period of the rising consumption ratio?

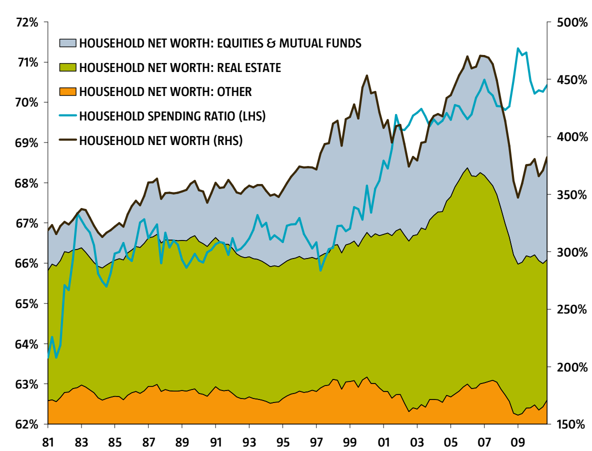
In the chart on the right, we have plotted the development of household net worth as a percentage of GDP, broken down into three components. Net worth is the sum of all household assets (from financial assets to durable consumer goods) minus all household debt (from credit cards to mortgages).

CONSUMER SPENDING RATES HAVE STEADILY DIVERGED OVER THE PAST 30 YEARS



SOURCE: BLOOMBERG, ROBECO

SPENDING INCREASES WITH WEALTH - BUT DOES NOT DECLINE AS MARKETS RETREAT

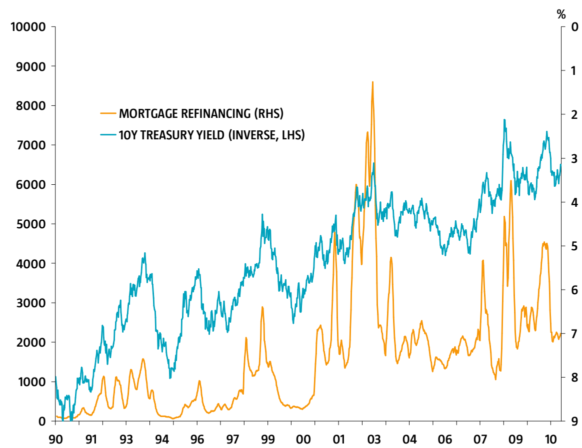


SOURCE: BLOOMBERG, ROBECO

The good news is that household net worth has been trending upwards over the past 30 years and is currently almost four times as big as US GDP (382% to be exact) as of Q4 2010. The not-so-good news is that this net worth has been far from stable, with much of the volatility linked to the recent bubbles in financial markets. As can be seen from the right hand chart above, most of this volatility is related to developments in equity markets (the 1997-2000 bull run, for example), as well as the housing market (the 2002-2007 bubble). With US house prices reaching a new post-bubble low at the end of Q1 (down by 4.3% versus Q4 2010), it is clear that the upside for net worth is likely to be limited for now.

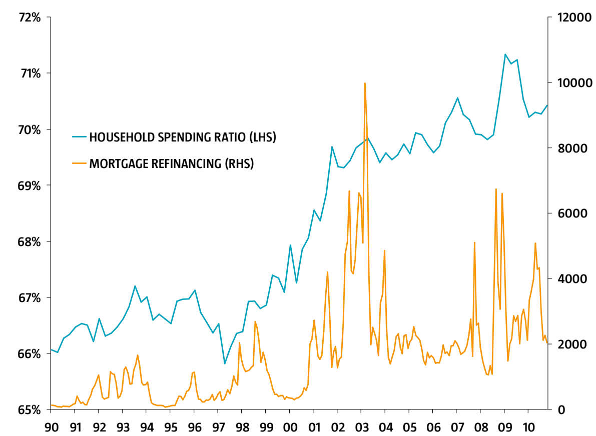
An interesting development highlighted by the chart is that the consumption ratio increased in line with the strong rise in net worth over the 1997-2000 period, but did not decline in the period when the stock markets retreated. This somewhat puzzling outcome can be explained by looking at the US housing sector, which has played a crucial role in consumer spending. Unlike in many countries in Europe, US house owners can refinance their mortgages without a penalty. With the Federal Reserve lowering interest rates to ever lower levels during the past decade and with bond markets generally following the Fed's lead, each crisis presented fresh opportunities to refinance mortgages (see chart below left). This has not only been beneficial in lowering interest payments, but was also coupled with home-equity withdrawal; households cashed in home equity to use for consumption purposes. Home equity has been referred to as the secret piggy bank for consumers, boosting consumption during each crisis that triggered the Fed to cut rates. With interest rates near zero, housing prices currently down by 34% from their 2006 peak and an estimated 25% of mortgage holders in negative equity, it is clear that this piggy bank will not be of much use in the near future.

CONSUMER SPENDING RATES HAVE STEADILY DIVERGED OVER THE PAST 30 YEARS



SOURCE: BLOOMBERG, ROBECO

CONSUMER SPENDING RATES HAVE STEADILY DIVERGED OVER THE PAST 30 YEARS



SOURCE: BLOOMBERG, ROBECO

Where does this leave us? For one thing, net wealth as a percentage of GDP is back to the levels seen in the mid-90s, while the US economy's dependence on consumption has increased by 4 percentage points over that period. With housing prices still in decline, the net wealth position is unlikely to improve substantially from here, even though US stock markets have been supportive. With the US government deficit firmly on track to breach the 10% of GDP level for the third year running, it is clear that the chances of a tax cut are non-existent; if it hadn't been for the anti-tax stance of the Republicans, a *hike* in taxes would be the logical working scenario. All in all, even though it is not impossible that the US consumer will find a new way to surprise on the upside, the odds against such an event are clearly increasing. As such, the US consumer appears to have surrendered his role as the engine of the global economy to the growth miracle of emerging markets. This does not mean that low growth is inevitable; rather, the US consumer will—on average—track growth and not lead it.

Closing date text and tables 01 June 2011.
In our text and data tables, we do not refer to calendar months but look back from this closing date.

Important information