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US at fork in the road for 2016 growth prospects

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- Two scenarios in which growth could defy forecasts
- Consumers could exceed expectations and growth booms
- But the credit cycle could end, triggering a recession

Who is the second-largest economic group in the world? It's not China, it's the US consumer, and they may hold the key to prospects for GDP growth in 2016, says Lukas Daalder.

In a greatly overlooked statistic, US shoppers account for 15% of global GDP, above China's 13% and the relative puny 6% for Japan and 5% for Germany. The US as a whole is 22%. The spending power of this vast group of 322 million people has the potential to make or break US growth forecasts for 2016, says Daalder, Chief Investment Officer for Robeco Investment Solutions.

These forecasts made by major banks diverge, ranging from as high as 2.7% to as low as 1.7%, due to uncertainty over what will actually happen after the expected rate rise by the US Federal Reserve (Fed) later this month. And it could go either way, says Daalder, who foresees two potential outcomes in which the banks' growth forecasts could be proved wrong.

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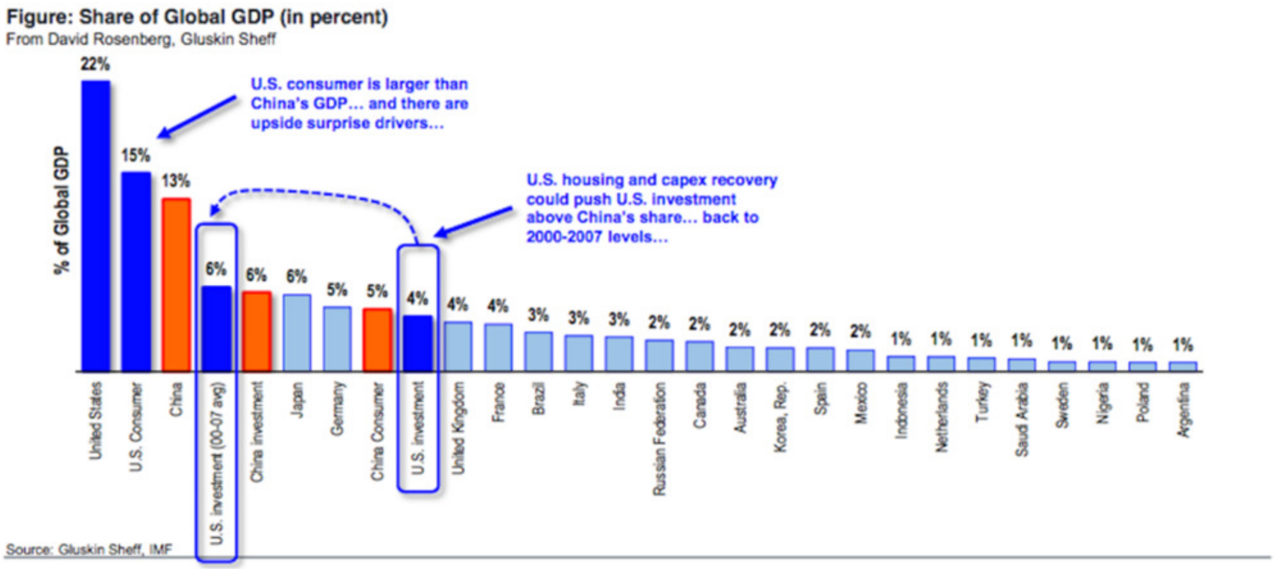
In an end-of-year challenge to the consensus, he says: "We find it quite easy to make a strong case for either a much stronger or a much weaker growth outlook. And we are not talking fantasy here: we really do feel that the US economy could be at a fork in the road."

All hail the consumer

In the first scenario, Daalder presents an optimistic case in which American shoppers drive growth above expectations. "Let's end the year on a high note, because we see quite a good chance of a scenario in which the US consumer takes center stage," he says. "Whereas the US corporate sector has been re-leveraging in recent years, the US consumer has been steadily improving its balance sheet, with both the absolute level of debt, as well as the absolute level of net wealth, steadily on the rise."

"Added to this is the fact that the labor market has steadily improved, with unemployment now down to 5%. And wages are on the rise in absolute terms. The growth rate is low compared to what we have seen in the past, but if we add zero inflation into the picture thanks to cheap oil, it is clear that there is plenty of room for improvement here."



The mighty US consumer - ranks above everyone except the wider US itself.

"So we would like to remind investors just how important this particular group has been for the world economy in the past. It almost seems unthinkable that we are heading for a recession given the clear structural improvements we have seen in recent years. US consumers will start to spend again, with growth rates of 3%-plus certainly possible, thereby boosting sales and earnings and reducing the risks of a negative credit cycle."

Credit cycle risk

However, there is a far gloomier potential outlook caused by the potential end of the credit cycle, Daalder says. If the US goes down this fork in the road, a credit tightening following a rate hike could cause a domino effect which leads to a recession.

"We have already flagged corporate debt as a risk factor in our previous outlooks, but none of the major banks have pushed it forward as a real problem for 2016, although some have mentioned it as a risk for 2017," says Daalder.

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"The risk of a self-sustaining downward cycle is certainly here. High debt that needs to be refinanced at increased spreads amid tightened conditions can push more companies into default, thereby triggering a further tightening of credit standards in the market. Added to this is the technical issue of reduced liquidity in the bond market itself, an issue that has been flagged by a number of people in recent months."

"Regulatory changes have led to a decline in dealer inventories at banks, which could mean that shocks in the markets will result in bigger swings in prices compared to what we have seen in the past. This in turn can act as a trigger for investors to withdraw funding, exactly at the time that more funding is needed. In other words, a classic credit cycle could get underway, which could potentially push the US in a recession. The elements are all there - high debt, rising spreads and the potential risk of lower liquidity - so all we need is a spark to set this thing on fire."

Fed could start spiral

What could be the spark? "There are a number of credible options: China, a meltdown in emerging markets, a further decline in the price of oil, the escalation of a political situation of some sort: there are plenty of candidates out there," Daalder says. "Even the Fed's first rate hike could act as a show stopper, as the current corporate debt situation is quite different from the last two times the Fed started to hike rates."

So which of these two scenarios is going to be more likely? "Both are pretty plausible, which makes it difficult to make the call on this one," Daalder says. "Much like the rest of the banks, we therefore stick to the middle ground and keep a close eye on how the markets will develop further. One thing is clear though: the credit markets should be closely watched, as that's the place where the risks will appear the clearest."