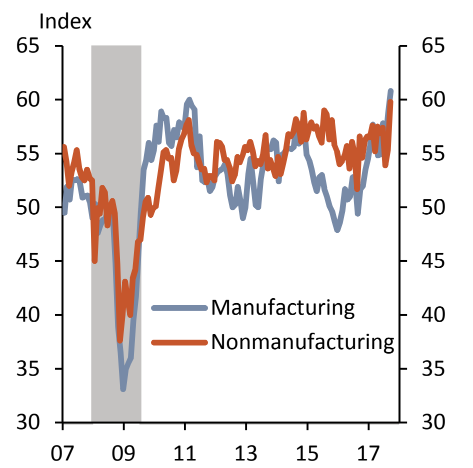
U.S. confidence points toward sustained momentum

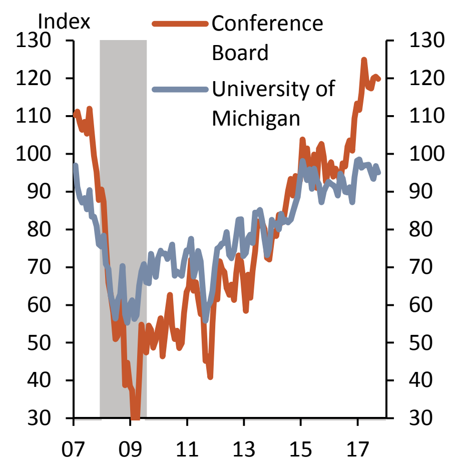
- The elevated readings of business and consumer surveys —despite dysfunctional Washington, DC and delays in tax and fiscal reforms — are predicting significant growth momentum in real business fixed investment and consumption growth through year-end 2017 and into 2018.
- So far in 2017, the heightened confidence indicators have fed through and lifted actual consumer spending and business investment. This is consistent with our prior empirical research that showed that when survey indicators are at very high levels, they are reliable predictors of consumption and investment (see "US: "soft" data and "hard" outcomes," March 9, 2017).
- Most current readings of business and consumer confidence surveys are in the highest 90 percentile of all historical readings. This is quite striking and, according to our models, should not be ignored.
- Besides stronger confidence, the overall economy is firm, supported by favorable cyclical economic fundamentals and financial market conditions. The probability of recession is low. Further progress on tax/fiscal reform would add to momentum in both the sentiment surveys and actual investment and spending.

Chart 1: ISM business confidence indexes



Source: Institute for Supply Management and Berenberg Capital Markets

Chart 2: Consumer confidence indexes



Source: The Conference Board, University of Michigan and Berenberg Capital Markets

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Current trends in sentiment

Optimism among U.S. manufacturers and non-manufacturers has surged, with some sentiment indicators surpassing their post-election highs. ***It is striking that the current readings of the key regional and national manufacturing, non-manufacturing, and small business sentiment indicators are all over the 85th percentile of their historical values*** (see Table 1). Confidence of consumers is also elevated. The Conference Board consumer confidence index is in the 90th percentile of all historical readings and the University of Michigan survey has lagged somewhat but is in the 78th percentile. Home builder sentiment has bucked the trend, coming down slightly in recent months due to idiosyncratic factors including shortage of land and labor, higher material costs, and hurricanes.

Table 1: Key business and consumer sentiment indexes

(Index)	Sep-17	Sep-17 Percentile*	Change from Oct-16	Change from Jan-Aug-17 avg.
Texas mfg	55.6	*86*	5.8	2.2
Empire State mfg	57.3	*93*	10.2	3.3
Philly Fed mfg	57.9	*96*	7.8	1.1
Richmond Fed mfg	19	*96*	18.0	5.6
Kansas City Fed mfg	59.2	*97*	8.1	3.4
ISM mfg	60.8	*89*	8.8	4.1
ISM non-mfg	59.8	*99*	5.2	3.5
NFIB Small Business Optimisim+	105.3	*98*	10.4	0.4
Home Builders housing market index	64	*81*	1.0	-3.1
U Mich consumer	95.1	*78*	7.9	-1.3
Conference Board consumer	119.8	*90*	19.0	1.4

*Note: *Percentile of the September value of indicators relative to history of each respective series. +As of August 2017. Source: Institute for Supply Management, Federal Reserve Banks of Philadelphia, New York, Kansas City, Richmond and Dallas, National Federation of Independent Business, National Association of Home Builders, University of Michigan, The Conference Board, and Berenberg Capital Markets*

The strength of the business and consumer surveys, despite the lack of significant progress on fiscal and healthcare reform and a politically dysfunctional environment, is encouraging. It provides a clear indication of improving underlying economic fundamentals and points to building momentum. Presumably, these high readings reflect rising employment and low unemployment, rising incomes and product demand, and the strong stock market. Importantly, anecdotal evidence suggests that business confidence has been lifted by the improving regulatory environment.

Note that most of these sentiment indicators were measured before the release of the Trump Administration's tax reform framework in late September and the Senate Budget Committee's proposed Budget Resolution for the Fiscal Year 2018. Signs of progress on the fiscal policy front would boost confidence.

Survey data: Predictors of actual outcomes?

The improved sentiment this year has fed through to the "hard data," consistent with our empirical models (see "US: "soft" data and "hard" outcomes," March 9, 2017). ***Our analysis showed that, in the long run, consumer and business sentiment indicators provide little value-added above other indicators such as real disposable incomes, product demand, and profits to predicting consumption and investment, but whenever the survey indicators are near historical highs (in the highest one-quarter of all historical readings),***

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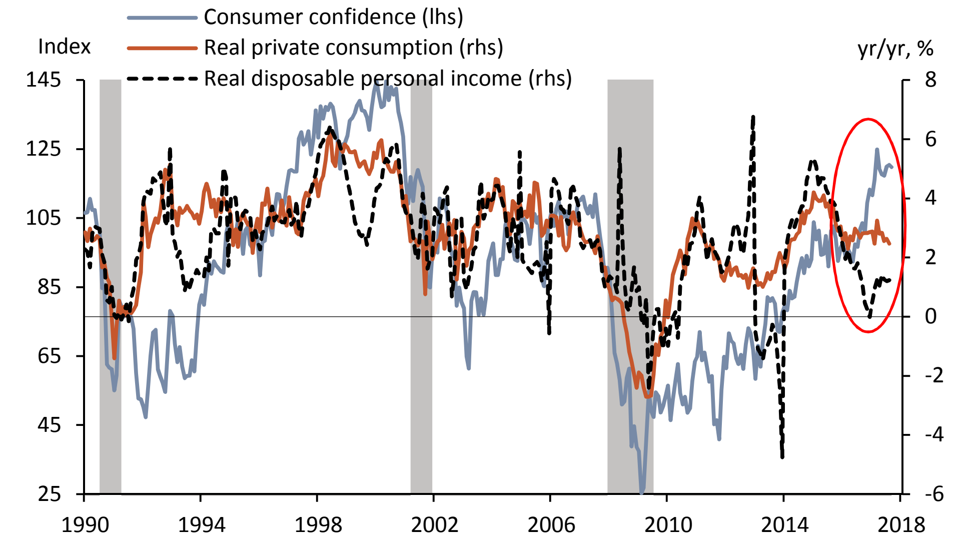
they are reliable predictors of consumption and business investment. In our March 2017 report, the elevated ISM manufacturing and The Conference Board surveys predicted significant momentum. Our model proved correct: since then, real consumption has exceeded real disposable personal income as consumers reduced their rate of personal saving and business fixed investment strengthened.

Consumption

Heightened consumer confidence has helped to sustain solid real consumption despite relatively weak gains in real disposable personal income. This was made readily apparent when the Bureau of Economic Analysis' (BEA) benchmark revisions lowered personal income and raised consumption in 2016, which resulted in a significant (0.8 percentage point) downward revision in the rate of personal saving. As of August 2017, the personal saving rate was 3.6%, near its mid-2000 levels. This suggests that consumers have grown significantly more confident in finances and the rising household net worth has boosted the propensity to spend (see "US Consumers Saving Less than Previously Thought," August 2, 2017).

As shown in Chart 3, real consumption has grown significantly faster than real disposable personal income. Real consumption increased 2.5% yoy in August, while real disposable personal income increased by only 1.2%. The solid gains in actual consumption growth in Q217 and Q317 fell shy of our model predictions, but the pace of growth far exceeding real disposable income has reflected the boost from confidence.

Chart 3: Real private consumption and disposable income growth and Conference Board consumer confidence index



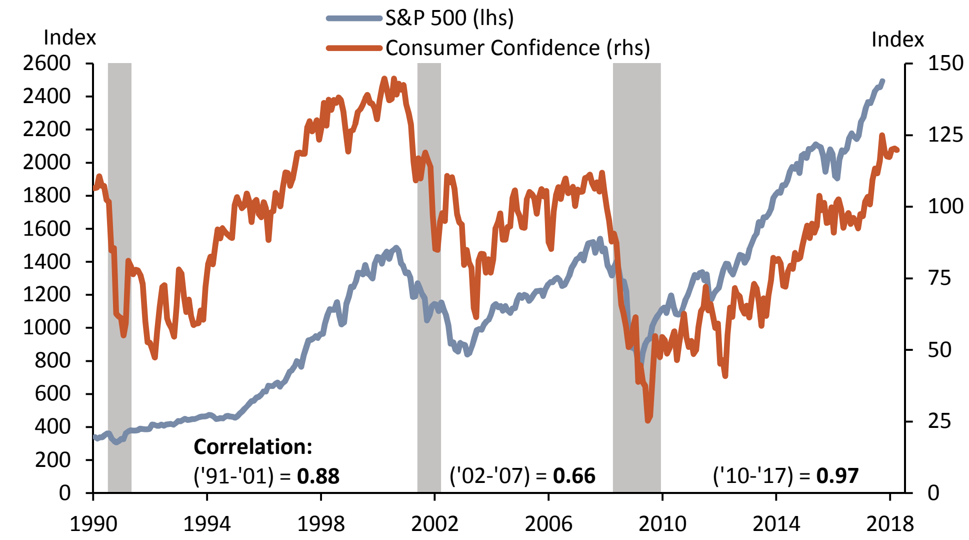
Source: The Conference Board, Bureau of Economic Analysis, and Berenberg Capital Markets

The combination of rising employment and improving labor markets, plus further increases in household net worth, is driving confidence and spending. Rising employment and wages and tightening labor markets build confidence that there is job mobility and lifts expectations of future income.

The S&P500 is up 14% year-to-date and home prices continue to rise, lifting household net worth to an all-time high. Note the strengthening in the relationship between consumer confidence and equity prices over the last seven years (see Chart 4).

While the resulting solid gains in consumption have been favorable, we are concerned with the soft growth in real disposable personal income — it has risen 1.2% in the last year. Eventually, either real disposable personal income growth will pick up to the pace of consumption or consumers will temper their spending growth. Moreover, the low rate of personal saving provides little cushion if an economic speed bump were to occur.

Chart 4: The S&P 500 index and Conference Board consumer confidence index



Source: The Conference Board, Standard & Poor's, and Berenberg Capital Markets

Business investment

Based on the elevated ISM manufacturing index in early 2017, in March our model predicted a rebound in business investment. That rebound occurred: after declining in 2016, actual real business investment grew 4% annualized in H117. This was moderately slower than the 7% our model had predicted. To be sure, the decline in investment in 2016 had set a low bar for 2017. The headwinds of prior years — a strong dollar, low oil prices that had suppressed oil patch investments, and sluggish global growth — turned more favorable, firms better adjusted to remaining headwinds (e.g., increased efficiencies for oil and gas firms), corporate profits picked up, and costs of capital remained low despite monetary policy normalization. Nevertheless, the turnaround in business fixed investment in 2017 was consistent with what the survey indicators had predicted.

What are current survey indicators predicting?

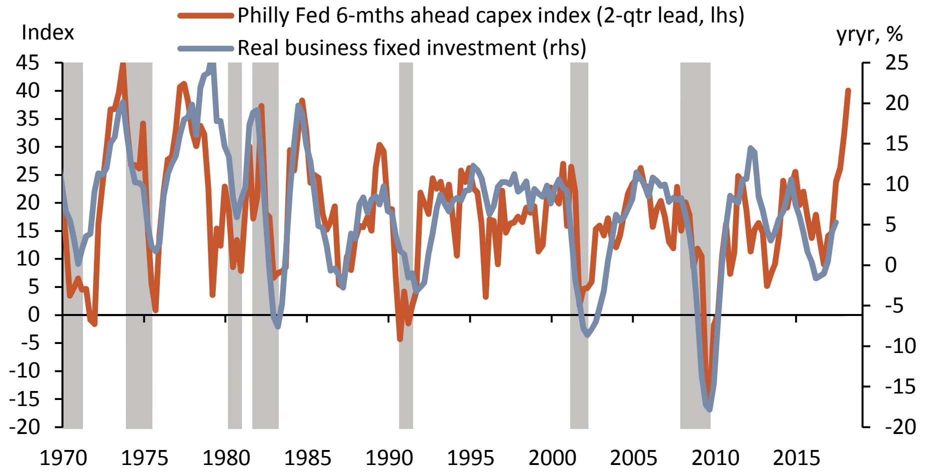
Based on our empirical models, the current elevated business surveys predict that business fixed investment should grow near 8% yoy annualized in the second half of 2017 and continue to rise solidly in 2018, while the consumer confidence surveys point to 4% growth in real consumption in the second half of 2017 and extend gains into 2018. While the models are over-estimating the growth in consumption and investment, the underlying fundamentals suggest building economic momentum.

Regarding business investment, it is noteworthy that the Philly Fed manufacturing survey of six-month ahead capital spending, a very reliable indicator of business fixed investment, is at a 41-year high (see Chart 5). Durable goods orders and shipments are rising solidly. The unfilled orders indexes within manufacturing surveys remain near recovery-highs, suggesting that factory activity will have to continue to expand robustly to reduce backlogs. Moreover, surveys suggest that the inventory rebuild will continue in coming months as inventory stock remains low relative to sales.

A note on the prospects for tax/fiscal legislation

The latest readings available on the confidence indicators and actual consumer spending and business investment occurred before the recent news that the Trump Administration has jump started the initiative to reform the corporate tax system and cut taxes for the middle class. Perceived progress toward fiscal legislation would boost confidence and support momentum in spending and investment.

Chart 5: Real business fixed investment growth and Philly Fed 6-mth ahead capex index



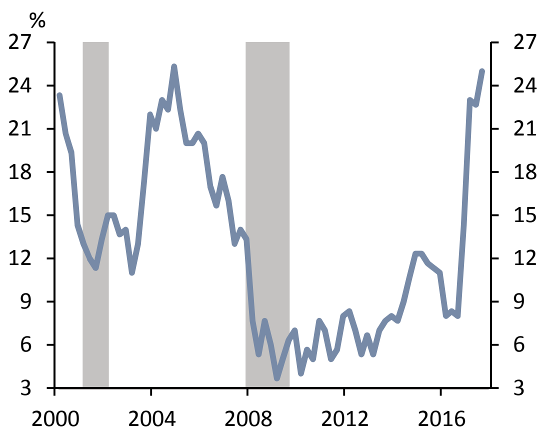
Source: Federal Reserve Bank of Philadelphia, Bureau of Economic Analysis, and Berenberg Capital Markets

In late September, the Trump Administration released its tax reform proposal followed by the Senate Budget Committee's proposed Budget Resolution for the Fiscal Year 2018 budget and the House passing its version of the budget — necessary steps in the fiscal policy deliberations. While these are necessary steps, we fully recognize that the fiscal policy deliberations will be contentious. We continue to believe fiscal legislation will be enacted in spring 2018. We expect that progress in this direction will lift confidence indicators and likely support improving economic activity even before enactment.

On the business side, companies are eyeing the benefits of lower tax rates on C corporations and pass-through businesses, and the proposed provision that would allow expensing of new investment. It is noteworthy that the Administration proposes to allow expensing of all new investment retroactive to September 27, 2017 (the date that the reform framework was proposed). If progress on the legislation proceeds and this provision remains intact, business investment is likely to rise before the legislation is enacted.

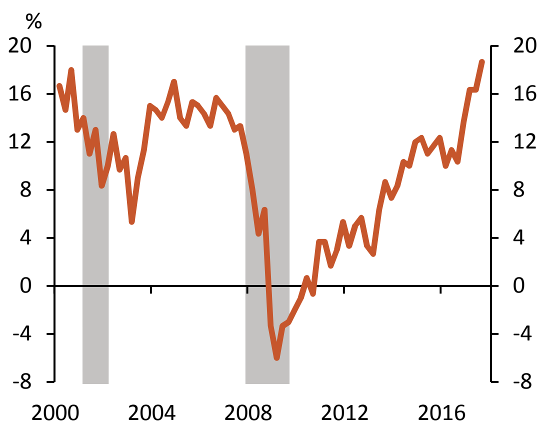
The proposed lower rate (25%) on pass-through businesses (sole proprietorships, partnerships, and S corporations) likely will support continued optimism for small businesses. They have been the most optimistic group since the U.S. elections and have given very high ratings to the current business environment (see Chart 6). These businesses, which account for a significant portion of job creation, also seem to have aggressive hiring plans (see Chart 7).

Chart 6: NFIB – net percent of small firms reporting that now is a good time to expand



Source: National Federation of Independent Business and Berenberg Capital Markets

Chart 7: NFIB – net percent of small firms planning to increase employment

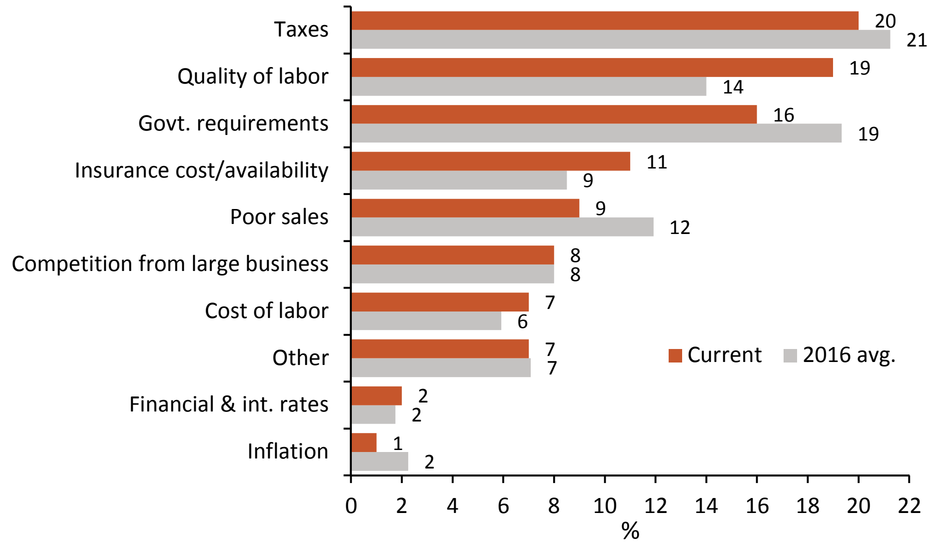


Source: National Federation of Independent Business and Berenberg Capital Markets

Despite the Trump Administration's absolute failure to enact healthcare reform and its stumbling attempt for sweeping fiscal reform to date, significant changes are underway in the regulatory environment that are affecting a wide array of industries and businesses. To date, this seems to be lifting confidence in a pro-business environment. The NFIB's member survey shows that fewer small businesses view regulations as their single most important problem (see Chart 8).

The impact of the tax proposal on consumer sentiment is unclear, as it lacks detail on many consumer tax provisions and deductions. But the continued rally in equity prices and gradual labor market improvement should keep private consumption growth on track.

Chart 8: NFIB - Single most important problem for small businesses, %



Source: National Federation of Independent Business and Berenberg Capital Markets

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