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Global economy set to grow at more sustainable pace

The global economy grew at a rapid rate in early 2010 with the International Monetary Fund (IMF) calculating that GDP output increased at a faster than 5% annualized pace in the first quarter of the year. Trade volumes and global industrial production surged, and the global purchasing managers' and OECD leading indicators indices returned to pre-recession levels. Not surprisingly, the pace of increase in the global leading indicators slowed in the second quarter, which was consistent with the world economy growing at a more sustainable pace.

'Unusually uncertain' outlook

While the base case is for the recovery to continue, Fed Chairman Bernanke's statement that the outlook is "unusually uncertain" raised the possibility of the Fed implementing a further easing in monetary policy. In early August, the Fed downgraded the forecast for the economy further and announced they will be reinvesting the principal payments from agency debt and MBS in longer-term US Treasuries and will roll over their existing holdings of Treasury securities in order to support the economic recovery by keeping market interest rates low. The Fed's actions highlight their intention to do whatever is necessary to ensure that the recovery stays on course. Policymakers stopped short of putting any conditions or timetable around the "extended period" language although kept the door open to further steps to ease policy by committing to "employ its policy tools as necessary to promote economic recovery and price stability."

U.S. economy slows

To be sure, the U.S. economy geared down in the second quarter of 2010 following strong gains in the prior six-month period. Consumers are spending at a moderate pace as they rebuild savings. A broad-based increase in business investment in the second quarter and inventory rebuilding provided support for the 2.4% annualized increase in real GDP. A factor acting to restrain the growth rate was some of the strength in domestic spending was met by imports. Revisions going back to 2007 showed a generally softer profile for growth and a peak-to-trough decline during the recession of 4.1%, higher than previously estimated. Much of the anxiety about the outlook for the second half of the year is due to the pace of job growth, which has picked up but remains lacklustre. Private-sector employment (excluding the effect of census hiring and firing) accelerated from the first quarter's 79,000 average monthly gain to 108,000/month in the second quarter mainly due to a surge in April. In July, private payrolls increased by 71,000. Our view that the pace of job growth will rise is consistent with the economy staying on its moderate recovery path in the near term and accelerating in 2011. This forecast implies limited progress in eliminating the large output gap this year meaning the unemployment rate will remain elevated and inflation benign. Faster growth in 2011 will support a more substantive improvement in the labour market and sustained downward pressure on the unemployment rate.

What's next?

The Fed's decision to provide additional insurance against another downturn in the economy in early August and the possibility of additional measures being implemented will keep government bond yields low. We have modestly cut our near term interest rate forecast although still expect rates be higher in 2011 as we are maintaining our view that the economy will emerge from its current slower growth path late this year. This sets up for the Fed to be in position to reverse some of these extraordinary measures in 2011. Importantly for the economy, residual concerns about the spillover effects from fiscal consolidation, the benign inflation environment and Fed's action will keep interest rates in the lower end of this year's trading range. The stimulus from the low level of rates combined with a steady improvement in supply and demand of credit will mitigate downward pressure on the economy as fiscal stimulus diminishes.