

Market View – Outlook for the US

October 2008

The successful 1992 presidential campaign of Bill Clinton is said to have centred around the maxim, “It’s the economy, stupid!” This US election on November 4 is no different, although the economic mood is far bleaker. The extraordinary machinations in the credit markets and near paralysis of the banking system have left many feeling helpless. Ultimately, once the new president takes office, it is what happens to the economy that will count for most people.

The increasingly frantic policy responses to the financial crisis may at last be having an effect and it will be an enormous relief for many to see liquidity start to flow again. The key question is how much the credit crunch will affect the man in the street and the real economy. It is already too late to prevent real economic damage, as the latest reports are indicating. Asset values, whether shares or houses, are significantly lower than last year, not something that can be said for most people’s borrowings. Although some in America are choosing to return their debt, with their house, to their lenders, as much of the lending is non-recourse.

Most recent figures show a sharp deterioration indicating the crisis is starting to take its toll. Retail sales have now fallen for the last three months, something not seen since 1992, and that means the outlook for consumer spending in the third quarter is unpromising. Since consumption accounts for around 70% of GDP, the first official 3Q GDP estimate to be released at the end of October is likely to be worse than most had been expecting.

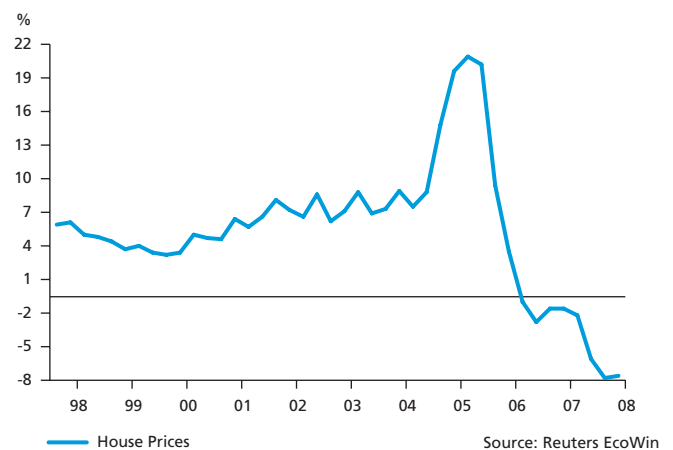
Consumers are feeling the effects in other ways. They are seeing just how quickly lenders are taking back credit allowances. Many are seeing their credit limits on credit cards being slashed as soon as they pay off their bills. Likewise, companies are drawing down available credit lines even when they may not need them, to have a cushion of cash.

Classic defensive sectors face their own problems because of the credit crunch. Levels of debt are under scrutiny making companies such as utilities, which usually do well in a crisis, struggling to deal with this when credit lines are jammed and interest rates high.

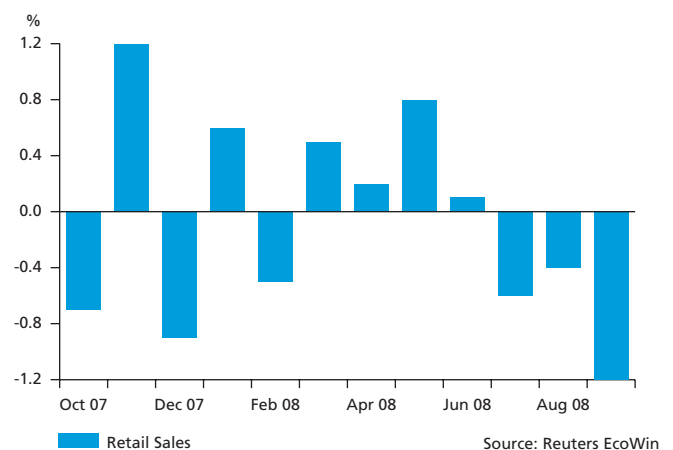
Part of the problem is what is called ‘the CNBC effect’. Since the news of the crunch went mainstream in September, it has rarely left the headlines. The media focus is undermining confidence among consumers making the downturn a self-fulfilling prophecy.

This seeping through of the crisis into slowdown leaves the next US President – and at this juncture it looks odds on to be Barack Obama – with something of a poisoned chalice. Although either candidate can pin the blame on the previous administration, it still leaves them with a bitter cocktail of rising unemployment, a growing fiscal deficit and the problem of how to pay for all the rescue packages put in place.

**US House Price Growth (YoY)
(National Association of Realtors)**



US Retail Sales (MoM)



The next president is already limited by the existing huge budget deficit and this may get even larger. Plans are currently underway for a further fiscal stimulus package that could help homeowners and businesses. Meanwhile, one difference between Democrat Obama and Republican John McCain during the campaign has been Obama's greater emphasis on carrying out large infrastructure projects, which would further ramp up the deficit. The problem, further down the line, will be how to pay this off. Classically there are two ways of paying, either increasing the tax burden or inflating away the real value of the debt. Neither is particularly palatable and the latter is currently difficult to engineer.

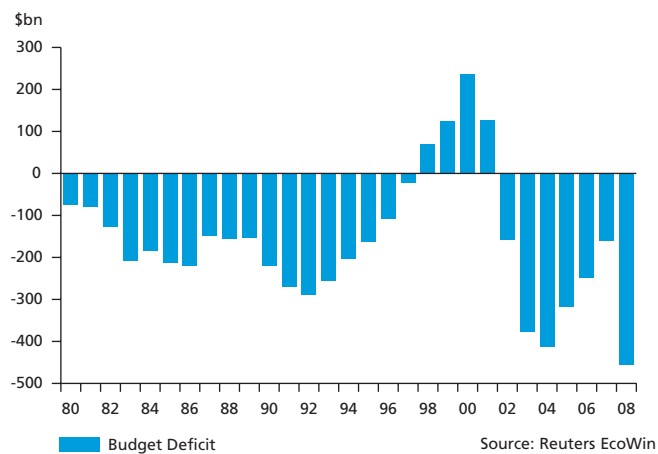
There is another spoke in the wheels: the economic order of events in this recession is unusual. Normally an economy would slow and unemployment rise before the credit cycle turns negative. This time we got a credit crunch first. This means the US has still to work its way through a deterioration in credit quality engendered by an economic cooling. Meanwhile consumers will be trying to repair their own balance sheets. None of this bodes well for strong economic recovery. America's economic flexibility, dynamism and powers of recovery are unsurpassed, with its labour laws helping companies, but this time recovery will not be fast.

All of this can be contrasted with America's northerly neighbours, Canada. Although they are experiencing a chill wind from America's economic downdraught, they have the benefit of lower levels of borrowing in the economy, particularly at the government level. They have also just had a, little reported, general election where the vote was in favour of the status quo, a Conservative minority government under the leadership of economist Stephen Harper. Any recession there will hopefully be mild and with capacity for fiscal stimulus and a consumer likely to benefit from any reduction in rates, their economic recovery should be much more marked.

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US Fiscal Deficit



US Unemployment Rate



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