

Research

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Peter Passing Andersen, Senior Analyst, +45 4513 70 19, pa@danskebank.dk

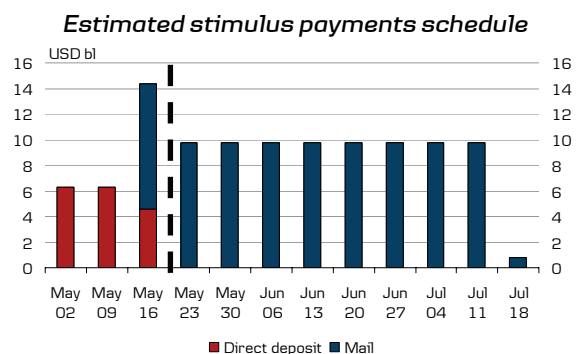
US: A rebate update

- A little more than three weeks ago, the Internal Revenue Service (IRS) began the transfer of USD 106bn in tax rebates to US consumers. Currently almost a quarter of the rebate payments have reached consumers; the remaining transfers should be completed by mid-July.
- With the rebates being paid from early May, some impact should be visible, if not in May, then in the June data. While there are major uncertainties around the timing and size of the impact of this stimulus package, we believe the most likely outcome is that the rebates will provide a significant boost to consumer spending over the coming three to four months.
- The reacceleration in consumer spending will have a spin-off effect on US industry. While industrial indicators are set to weaken further in the next couple of months, the scale-up in demand at a time when inventories are very lean is likely to spark a temporary rebound in the manufacturing sector during the autumn. Generally, the major bulk of the GDP effect from the rebates expected to arrive in Q3.
- However, around New Year 2009 the positive impact from the rebates is likely to peter out, resulting in renewed softness in consumer spending, as the underlying economy will remain relatively weak at that time. We do not expect consumers to be on track for a sustained recovery before somewhat into 2009.
- In the short term, though, it will be crucial to keep track of high-frequency indicators to watch the response among consumers. This is likely to be a determinant of market sentiment over the summer. If the stimulus package finds traction in the economy it could support some of the current optimism about the economic outlook in the markets. However, if the tax rebates fail to jumpstart consumption in the next few weeks and months this could potentially spark serious concerns.

Rebates being paid

Jumpstarting consumers

The stimulus package that was approved by Congress and signed off by the Bush administration in February is now finding its way into consumers' wallets. In the first week of May the Internal Revenue Service (IRS) started the transfer of the USD 106bn of tax rebates to the public.



According to the IRS payment schedule, 25% of the transfers reached consumers within the first three weeks of May. The entire transfer is scheduled to be completed by around 11 July. In the chart above, we estimate the amount of weekly transfers to consumers in the period to 11 July from the information available on the IRS homepage.

The payout schedule has been moved forward slight from the dates provided in the initial announcement, and anecdotal information suggests that the IRS may even be ahead of the *new* schedule. In turn this is likely to bring some of the response forward compared to the profile we estimated in our February report *Research US: Consumers under siege*

A résumé of the fiscal stimulus package

The stimulus package was approved by Congress and signed off by the Bush administration in February. The purpose of the stimulus package is to support the economy in the coming quarters thereby bridging the economic gap until monetary policy easing get traction during H2. Generally, the package includes the following initiatives:

Tax incentives:

(USD 152bn in 2008 and USD 16bn in 2009)

Personal tax rebates

(USD 105.7bn in 2008 and USD 9.7bn in 2009)

- *Tax paying individuals receive USD 600 per person
- *Non tax paying individuals with income above USD 3,000 receive USD 300 per person
- *Everyone eligible receives USD 300 per child
- *Rebates for recipients of social security and veterans.

Tax deductions for businesses

(USD 44.8bn in 2008 and USD 6.2bn in 2009)

- *Consists mainly of allowance of accelerated tax depreciation for investments

Temporary housing initiatives:

- *The conforming loan limit is increased for Fannie Mae and Freddie Mac
- *The loan limit for FHA-insured loans has been increased

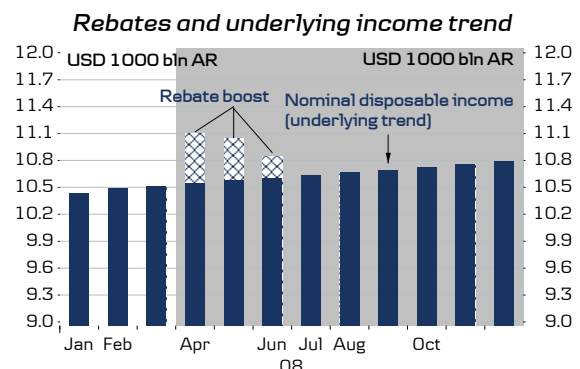
See [press release](#) and [fact sheet](#) on

<http://www.whitehouse.gov> and [Congress web](#)

How much bang for the buck?

The size and timing of the impact on personal spending of the economic stimulus package are both very uncertain. Studies of the 2001 rebates provide little specific guidance; estimates range from 20% to 60% of the tax rebates being spent within six to nine months of being received. Moreover, the situation is likely to be different this time around, as consumers seems to be in a much worse state, dealing with a combined energy, credit and housing shock. Back in 2001, none of these factors were present to the same extent as they are now. Finally, the 2001 rebates were a part of a more permanent tax relief, which from a theoretical consideration (the permanent income hypothesis) should have a substantially larger impact than a temporary tax relief. Hence, after all, 2001 may not be that good a guide to the current situation. In addition the 9/11 attack further complicates any comparison.

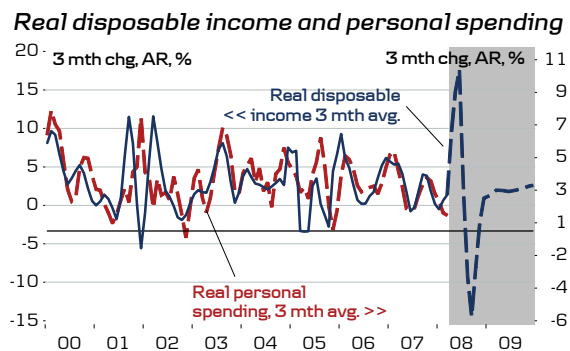
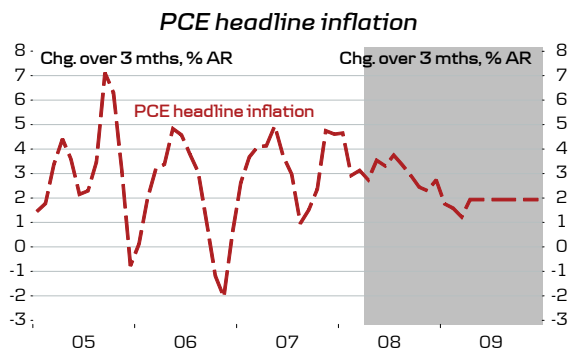
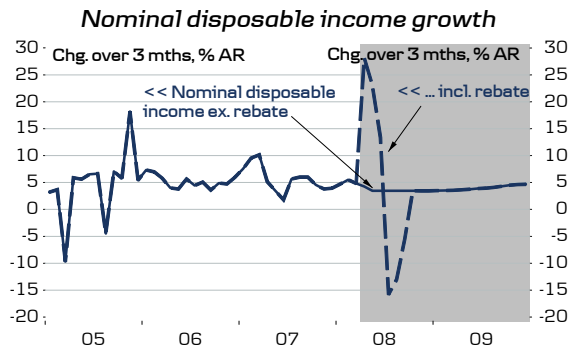
One starting point is to consider the impact of the stimulus payments on nominal disposable income growth. As the charts below show, real disposable income is set for a significant boost between May and July.



Source: IRS, Ecowin and Danske Bank calculations

The issue is, of course, how consumers will initially react to this real disposable income growth (see chart below) boom-bust pattern, and how this will affect consumer dynamics in the coming quarters. According to our fundamental based model for consumer spending (See *Research US: Consumers under siege*, February 2008) aggregate consumer spending usually reacts with a coefficient of one-third to changes in aggregate nominal disposable income growth on a quarterly basis. The idea behind this estimate is that one-third of the US households are hand-to-mouth consumers, while the other two-thirds have access to credit markets and therefore smooth consumption in accordance with the permanent income hypothesis.

Moreover, what usually matters (at least for the markets) is growth rates, not levels. As the charts below demonstrate, the rebate payments imply a significant jump in nominal disposable income growth in the payout period. The consequence of this jump is a sharp decline in the growth rate of nominal disposable income growth later this year.



Source: IRS, Ecowin and Danske Bank calculations

Note the charts above do not take into account dynamic effects arising from the tax rebates.

While it seems appealing to apply the 'standard' rule-of-thumb that aggregate consumption is responding with a coefficient of one-third to changes in aggregate nominal disposable income growth, this could also have several drawbacks. Consumers could react differently to tax rebate income than to ordinary income. They may save a different share or they may tend to smooth rebate-related spending more than normal usual spending.

To examine these possibilities we have drawn four alternative scenarios. In the simulations, consumers react as if rebate income is smoothed over *three, six, nine or 12 months*. Or they simply react in accordance with the standard model (ie, instantly). See the box on the next page for the results.

The simulations provide some useful insights into the rebate dynamics.

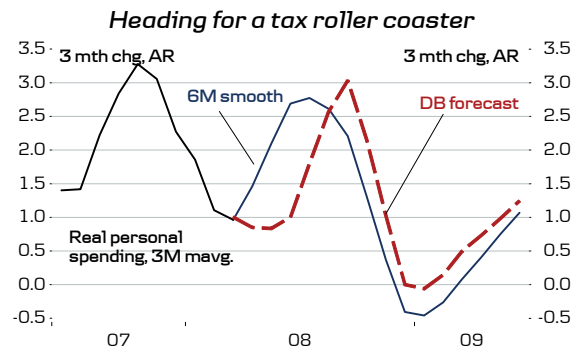
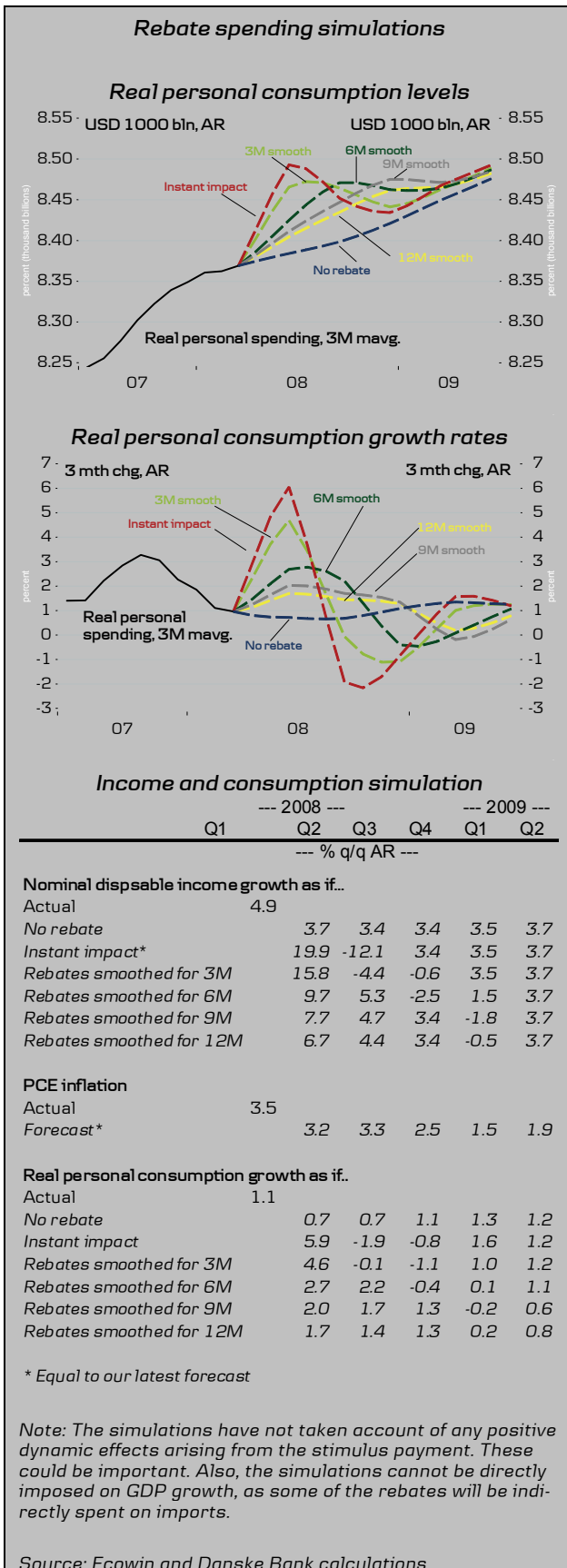
Rebates should provide a significant lift to the *level* of consumption during 2008. According to the simulations, USD 14.2-43.9bn (or 13.4%-41.4% of the rebates) will be spent within the first six to nine months.

The major positive impact on consumer spending *growth rates* should arrive in Q2 and Q3 for most scenarios.

The more consumers initially spend their rebates, the larger the negative 'growth gap' around New Year 2009 becomes (when disregarding any positive dynamics arising from the rebate payments).

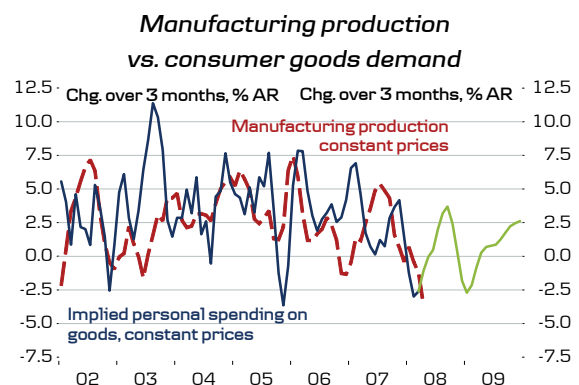
While these simulations provide some useful insights into the rebate dynamics, it remains very uncertain as to which of the scenarios is most likely. Moreover, one has to take into account the dynamic effects arising from the stimulus payments and the extent to which monetary easing will gain traction later this year, as this is likely to be important for the job market and income dynamics.

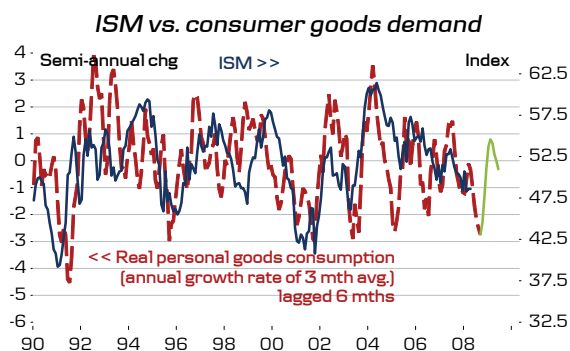
Generally, we favour the spending pattern seen when consumers react if rebate-related spending is smoothed over six months. However, as actual consumption is entering Q2 at a rather slow pace, the quarterly growth pattern is likely to be a little different from this simulation. Hence, Q3 personal spending growth is likely to borrow from Q2 compared to the simulation (see the chart at the top of next page in the right column).



Moreover, we find it less likely that real personal consumption growth will trend persistently into negative territory around New Year, as some positive dynamic effects are likely to arise (note this was not taken into account in the simulations). In fact the positive dynamics are likely to become more pronounced the sharper the rebates kick-in. The chart above shows our forecast for personal consumption growth.

As business inventories are likely to absorb some of the swings in consumer demand in the early phases of the reacceleration, the bulk of the GDP impact is also set to arrive in Q3 as businesses scale up production to keep on track with demand. Further, Q4 and Q1 GDP is set to turn out more positive than suggested by our forecast for consumer spending as businesses are likely to restock somewhat in this period following the spending spree. Generally, these considerations support the case that the manufacturing indicators (i.e. the ISM index) will rebound somewhere in the autumn.





What to watch

According to our simulations some positive effects of the rebates should be visible if not in May then in the June data. However, it will be important to monitor consumers' reaction during the next few weeks and months as this is likely to be an important factor for market sentiment during the summer.

If the stimulus package gains traction among households it could help maintain some of the cur-

rent optimism in the markets. On other hand, if the stimulus payments fail to jumpstart consumption within the next few months this could potentially spark serious concerns.

Below we have added a list of key indicators that we recommend watching to keep track of consumer reactions in the coming months.

- Weekly indicators
 - o ICSC retail sales
 - o Redbook retail sales
 - o ABC consumer confidence

- Monthly indicators
 - o Michigan consumer confidence
 - o Conference Board consumer confidence
 - o Retail sales
 - o Personal spending

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First date of publication

Please see the front page of this research report.

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