The Royal Bank of Scotland Group

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The US economy returned to growth in Q3 thanks to the extraordinary policy stimulus. The hope is that the recovery will gain its own momentum before these economic steroids lose their potency.

The recession in the US ended in Q3. The economy expanded in the three months to September, after four consecutive quarterly contractions. Overall activity grew by 3.5% on a quarter-on-quarter annualised basis, above expectations, leading to a surge in stock prices. Consumer spending contributed 2.4 percentage points to growth, though an important part of this was due to the boost from the government's cash for clunkers program. The upturn was also fairly broad-based. For example, housing construction posted its first increase since 2005.

Other US releases contained further signs that the recovery is being sustained in Q4. The S&P Case-Shiller house price index rose for the forth consecutive month, suggesting house prices in the 20 largest metropolitan areas have bottomed out. In addition, the Chicago survey of activity in the Midwest made its first trip into expansion territory for thirteen months in October.

The revelation that the UK remained mired in recession in Q3, together with the Monetary Policy Committee's (MPC) desire to pull out all the stops in sparking a recovery suggest that policymakers will opt for a further extension to the asset purchase scheme on Thursday. Ironically, the forecasts presented at this meeting will probably include a *higher* near-term inflation projection, given the continued weakness of sterling and energy price rises. Nevertheless, a weaker growth trajectory means a bigger gap between what the economy is producing and could produce (the so-called output gap) which will ultimately bear down on price pressures further out.

The case for more stimulus in the UK will be strengthened by signs that the £175bn of asset purchases are still not getting much "bang for the buck" when it comes to credit growth or the money supply more generally. Money and credit data remain fundamentally weak - the MPC's preferred measure of money growth fell to -1.7% q/q in Q3, down from 3.5% in Q2. This doesn't mean QE has had no effect. Whilst immeasurable, money growth would have fallen a lot more without it.

UK house prices rose by 0.4% m/m in October, according to the Nationwide index. This represents a slowdown from the summer surge that saw prices increase by 6% between April and September. But the health of the market cannot be measured by values alone. Many fewer properties are being bought and sold than in "normal" market conditions. The first nine months of this year have registered just over half a million transactions, an annualised turnover rate of only 3.6% of the housing stock, well below the 20-year average of 8.5%. In September mortgage approvals for house purchase were 56K, up 68% on a year earlier, but still below the 10-year average of 100k. The housing market is recovering but still has some way to go.

Inflation in the euro area remained negative in October at -0.1%. But the pace of deflation looks to be easing since the -0.3% outturn the previous month. Either way, inflation is not likely to become a problem for a long time to come. The recovery is expected to remain fairly lacklustre and there is still plenty of slack in the economy. This is most evident in labour markets - regional unemployment increased to 9.7% in September from 9.6% in August, and has now reached double figures in France.

Money supply indicators reinforce the case for keeping European rates on hold. The European Central Bank (ECB) closely monitors money supply growth as a leading indicator of longer-term inflation trends. These indicators are blinking red about potential deflation further out. M3 money growth fell to its slowest rate since 1981, and loan growth to households and businesses recorded its first contraction on record in September. This reinforces our view that the ECB will keep rates on hold at 1.0% this month and for a long time to come.

The rebound in output In Japan appears assured as industrial production rose for a seventh month on the trot. Output in September increased by 1.4% m/m, as demand from China, Japan's largest export market, helped pull production up 22% from its February low. Whilst this will provide a strong boost to growth in Q3, production is still 20% below pre-crisis levels and the Japanese economy remains incredibly reliant on overseas demand to keep it ticking over. Lower unemployment, down to 5.3% from 5.6% in August, will help the recovery and, if continued, provide support to consumer spending growth.

Japan's fledging recovery may find its germination into fully sustainable growth cut off if falling prices encourage households and firms to defer spending. Consumer prices fell 2.2% in September - the deepest period of deflation the country has seen so far.

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