



STUART INVESTMENT  
MANAGEMENT LIMITED

## Economic and Market Update: June 8, 2009

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### *The Economy*

***Growth and Employment:*** Although first quarter growth was revised to down 5.7% from the originally-reported 6.1%, the components of the revision do not bode well for the economy or second quarter growth. Specifically, consumer demand was revised down from growth of 2.2% to 1.5% while the “gain” in growth came primarily from lower inventory liquidation (0.45%). Essentially this means that, relative to the previous reading there is a bit more inventory liquidation to go than otherwise would have been the case. And this comes in the context of less demand.

The May ISM numbers reinforced the notion that the economy is still sliding. The manufacturing index, at 42.8, is still well below the breakeven 48-50 level. Historically, a number above 42 indicated growth because the service sector was “always” growing and thus manufacturing, a smaller fraction of the economy, could still be contracting as long as the growth in the service sector offset the manufacturing decline. However this is not at all an ordinary recession. The service sector index came in at 44, indicating that this larger sector is also contracting.

On balance, I see second quarter GDP as contracting between 1 and 2 percent, the same as my forecast of a month ago.

Despite its being a lagging indicator, employment is nevertheless an important determinate of growth. Labor’s input represents 65-70% of GDP. Despite an easing of monthly job losses, I find recent data discouraging. Previously, I thought second quarter job losses would ease faster and that the peak unemployment rate would be, say, 9.7%. I am now with the consensus that the unemployment rate will peak at 10% or a bit above, indicating that job losses in the second quarter will likely be in the 1.1 to 1.2 million areas versus the 2.0 million first quarter loss (the April and May losses, to be revised, were 504 and 345 respectively. With secondary and tertiary losses from the GM and Chrysler reorganizations likely to add to the totals, second half losses are likely to be another 0.9 to 1.2 million. This will leave the end of year rate between 10 and 10.2% (It is currently 9.4%). Absent a follow-on stimulus program late this year, the rate could climb a bit further.

Will there be growth in the second half? It looks less likely than previously but, for now, I am sticking with my forecast of second half growth from flat to up 2%. The full thrust of the stimulus program should be taking effect. In a positive sign, household personal income was up a higher-than-consensus 0.5% in April. Much of the rise was due to initial flows of stimulus-related tax reductions and increased unemployment insurance payments. Further, the 3 month rally in equities tends to mitigate the negative wealth effect from falling housing prices. However, households need to shore up their balance sheets in a context of still-rising unemployment. Thus the savings rate is likely to stay elevated relative to recent history and this is likely to hold back consumer demand. Fortunately for the U.S., and unfortunately for those countries that export to the U.S., a significant portion of the slowdown in consumer demand is borne by U.S. trading partners.

***A note on the “misery” index and “stagflation”***: Two concepts that were popular in the 1970’s when both unemployment and inflation were higher than trend were “the misery index” and “stagflation”. The former referred to the sum of the unemployment rate and inflation, which reached a level above 20 in 1982 when unemployment and inflation both temporarily rose above 10%. There were a number of causes including the introduction of the huge untrained “baby boom” into the labor force, the OPEC-supply induced oil price rise, and a monetary policy that did not adequately account for the increased “power” of money due to the emergence of new methods of money expansion (e.g. the growth in Eurodollar deposits in the 1970’s).

Stagflation referred to the inability to sustain real growth at previous levels without generating higher-than-trend inflation. Stagflation resulted from the first two of the above-cited three problems. Essentially it is a problem of low-potential growth. When the central bank tries to drive growth above potential or misjudges potential growth inflation results. Of course, inflation can also be a result from a central bank misjudging the impact of monetary expansion on credit creation.

From the late 1980’s to the early 2000’s the misery index and stagflation were relatively and, in my opinion, unsustainably low. Lower tax rates, maturation of the baby boomer work force, the peace dividend from the fall of the “iron curtain” and the discipline caused by globalization on U.S. production costs combined to keep inflation low at a time when potential growth was above its long-term trend. A speed up in the implementation of technology also likely contributed. Both the 1990 and 2001 recessions were mild. During the 1990’s, unemployment averaged below 5% and inflation was kept under 3% for much of the period. At one point in this period the misery index was below 6 and real growth was nearly 3/4ths of nominal growth (the tendency over the course of a cycle is for real growth to be near half of nominal growth).

Looking forward, I see the misery index as rising above the 6 to 10 level that is normal. Unemployment is likely to remain in the 9-10.5% range throughout 2010 and to fall to, say the 7.5-9% range in 2011. However, despite the very high level of unemployment, a combination of government policies that re-orient production from individual consumption to community consumption, increased international competition for

resources, and the increasing burden of transfer payments will lower the potential growth rate for an extended period. Thus, the return of growth and lower unemployment is likely to be accompanied by higher inflation than was the case in the 1990's and early 2000's. If I am correct, then, inflation will likely rise back to the 2-4% level during this period, leaving the misery index in the 11 to 13 range. This is not as onerous as the level in the early 1980's. However, my concern is that, as the burden of the aging baby boomers forces higher taxes, more of the older population attempts to stay in the work force to maintain income, and the international competition for resources becomes more intense, the misery index will stay persistently high.

The level of stagflation will depend on Fed policy. If the Fed decides to reduce the onus of the public debt that is currently accumulating at near a \$2 trillion a year rate, then inflation will rise more than my forecast and unemployment will likely be a bit lower. Alternatively if the Fed correctly anticipates the end of deleveraging and reigns the money supply in a timely fashion, inflation will be held in check, but real growth is likely to be held below potential for an extended period (my forecast). In either case, following the initial recovery growth spurt to bring the economy closer to its full resource utilization, real growth is likely to remain persistently between 1/3 to 1/2 of nominal growth.

### **The Markets**

**Interest Rates:** Longer-dated Treasury rates continued to rise in the past month, beyond the level that I anticipated. Although I was neutral at the time, I expected the 10-year note, which was then 3.2% but has subsequently risen to 3.86%, to trend back to the 2.80% level in the following few months. I continue to expect a Treasury rally, but it will have come from higher levels that I previously thought.

Several factors accounted for the continued rise in longer-dated yields:

- The fed did not step in to actively buy and jawbone at a time when supply was increasing rapidly. This raised concerns that, the U.S. might implicitly be supporting a “let the dollar decline” policy.
- Seasonal factors usually boost rates in the second quarter.
- After a sizeable rally in mortgage and corporate bonds, there appeared to be some reallocation toward equities from institutional managers who might have feared they missed the boat on an economic recovery.
- A rebirth of “bond vigilante” thinking as fears of ever-rising budget deficits with little Congressional appetite for reducing spending.

Although I do not rule out some further near-term rise in longer-dated Treasury rates, I expect 10-year Treasury yields to return to the 3.1-3.25% level over the course of the summer and early fall. Supply will remain high and onerous. However, I expect a combination of still-weak economic growth and geopolitical concerns will lead to buying Treasuries as a safe haven. Much below-potential growth should, within the next few months, lead to a reversal in the recent rise in mortgage rates. As banks increase their capital, they will move to take more advantage of the steep yield curve to increase

purchase of longer-dated maturities in their trust accounts as the reallocation toward stocks is reversed for a period.

Finally, my hunch is that, in the ebb and flow of world politics, an event, probably in the Middle East, will precipitate a flight to the dollar and Treasuries as a safe haven. Although the Obama administration is seeking closer cooperation with Europe and trying to build bridges to countries that were shunned by the previous administration, some active players, perhaps terrorists or nations such as Iran, North Korea or Israel, might view this as weakness and either see an opportunity for taking advantage of the situation or, alternatively, feel compelled to take unilateral actions. Although it is impossible to predict specific actions and timing, the situation reminds me of 1962, when Kennedy was tested by the Cuban (Turkish) missile crisis.

**The Dollar:** My view on the dollar and on equities (see below) interacts with my thinking on Treasuries. If I am correct, the U.S. will be favored for a period of time by unfolding economic and geopolitical events. This should temporarily reverse the recent dollar slide. I remain negative on the dollar longer term.

Over the next few months, continuing economic problems in Western Europe and both credit and economic problems in Eastern Europe will likely lead the Euro to retest the 1.28-1.32 level.

The Canadian dollar should retain much of its recent rise from the 77 to 93 cent level. However, a temporary setback in commodity prices, a general flight to the U.S. dollar, and sensitivity by the Canadian government to the recent speed of Canadian dollar appreciation and its potential negative impact on the manufacturing sector will likely lead to a retest of the 84-85 level over the next few months. Longer term, a world recovery should allow the Canadian to appreciate back to or above par against the U.S. dollar.

I also favor the Chinese yuan over the longer run. Near term it is not likely to weaken even if the dollar rallies. But at some point, when the dollar rally that I am forecasting is exhausted, I think the yuan will appreciate 5-10% over the course of 12-18 months. It should also appreciate over a longer period of time as growth in China outpaces growth in the industrialized countries.

**Equities:** In my May outlook I cited the primary reasons for the sharp rally in equity prices as:

- The near-term deeply oversold condition of the market in March,
- Optimism that the economic contraction is subsiding, and
- Liquidity looking for a home as the Fed floods the market at the same time credit demand is declining.

The continuing rally carried the S&P index to the very top of my 750-950 range. My dilemma now is whether or not to raise the range. Holding it steady is a strong statement that I think the market is headed down from here.

Although my analysis below still forecasts a correction back to the 800 level or below, holding the top of the range at 950 fails to recognize that the upside momentum is more powerful than I previously anticipated. Thus, I am, reluctantly, raising my 3-4 month range to 780-980.

My reasoning for expecting a sizeable correction is two-fold. First, just as the equity price decline overly discounted the negative factors, I think the current rally is overdone relative to my economic and earnings outlook, both for the balance of the year and for the longer term.

Second, I refer back to the notion that geopolitical developments could have a parallel effect on the stock market as was the case in the Cuban missile crisis (although the precipitating circumstances would be quite different). Then the stock market made a bear market low in the late winter of 1962 and the powerful subsequent rally was very much like the present one. However, as market participants correctly anticipated the November crisis, equity prices gave up most, not all, of their gains in the late summer and early fall.

Finally, could equity prices go much higher than my upper bound even if my cautious economic outlook is correct? Yes, from a technical perspective, given the liquidity in the market and assuming that the geopolitical background remains calm, there is a precedent in bear markets for the equities to recapture as much as 50% of its losses from the high. This would put the S&P at about 1120. Given an S&P earnings forecast of \$50-60 in 2010, this would put the forward PE ratio between 18.5 and 22, too high in my opinion. Credit card default business and commercial real estate credit problems continue to get worse. And the uncertainty of how and when the Fed and Administration will exit the current crisis mode, and how policy will affect employment, productivity and inflation calls for a more restrained assessment of the economy and earnings potential over the next few months and years. Thus, I see continuation of the current rally as a low probability bet.