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This month we are deviating from our usual Market Commentary as we believe that the enclosed "Economic and Market Update" written by our economist, David Horner, makes for rather interesting reading.

Economic and Market Update: July 6, 2009

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The Economy

Employment: The June employment report was a shocker! Not only was the payroll job loss approximately 100,000 more than expected but the supporting statistics added to the negative nature of the report. Hourly wages were flat, unusual even in a recession, and hours worked continued to decline. Losses were widespread.

Although one should not put too much emphasis on a single month's performance, the setback suggests that the "second derivative", i.e. the rate of slowing in job losses, has a lot less momentum than previously thought, even if one looks at the three-month rolling average. Had the household survey not shown a decline in those looking for work, the unemployment would have been higher than 9.5%. This reinforces my notion that the unemployment rate will peak above 10%, probably close to 10.5%. It also underscores the overly rosy nature of the administration's forecast used in the bank stress tests, something I discussed in a previous outlook.

Job losses will very likely moderate in the second half. My forecast is that another 500,000 will be lost in the third quarter and 350,000 in the fourth quarter. The job losses will probably reverse next year, but I doubt any gains will offset additions to the labor force. Thus, once the unemployment rate goes above 10%, it will stay there through most of 2010.

Growth: Second quarter growth will be reported on July 31 and is likely to show a decline of 2-3%, much less than the near 6% drop in the previous two quarters. Additional inventory liquidation, lackluster consumer spending (probably flat to up a percent) and a further drop in business investment will offset some stabilization (at a lower production level) of the housing market, some further small improvement in the trade deficit, and the initial effects of the stimulus package. Both the manufacturing and non-manufacturing indexes also indicate a further decline in production.

Despite my pessimistic view on employment, I continue to think the economy will likely see limited growth in the second half. However, the growth will be mostly "statistical" in nature and not signal a robust recovery. First, inventory liquidation in the first half should be followed by a period of stable inventories or possibly a small build. The absence of liquidation sometimes adds as much as 2% to growth in any given quarter near the trough of a recession. Although it is difficult to gauge whether such a gain will be realized and in which quarter it will come, my best guess is that a contribution will be included in the third quarter.

Second, the effect of the stimulus will add to third and fourth quarter growth. Despite continued job losses, personal income has been rising as direct payments to households and reduced taxes have more than offset the income loss from earnings. To date, households have been rebuilding their balance sheets, raising the savings rate. However, I expect household spending to improve a bit in the third quarter. Further, although housing foreclosures will continue to exact a toll on households, the impact of this is beginning to moderate.

My best guess as to third and fourth quarter growth is 1-2% in each quarter. In the absence of a further fiscal stimulus, growth in 2010 will likely be well below potential.

Fiscal and Monetary Policy: If my forecast of moderate growth in the second half is borne out, it is unlikely that another stimulus package will be adopted this year. However, talk of such a package will increase, adding uncertainty to the market. In particular, I think the administration will try to portray their health and energy programs as additional stimulus and job creators since both proposed policies involve initial costs of a magnitude equal to the current stimulus program. Both the uncertainty surrounding passage of these programs and, more importantly, the form of the health program will also increase investment risks. Not only will the overall economic effect be in doubt, but also the outcome as it involves specific market sectors. Thus the outcome of the health debate and the form of any health reform and expansion will have a disproportionately big impact on both the economy and market in the next year.

Inflation vs. Asset Expansion: In the near to intermediate term, concerns about inflation are both premature and overblown. The dire nature of banking developments, the economic and market downturn, and the magnitude of the monetary and fiscal response all raise the near term risk of deflation. Betting on the "inevitability" of inflation is, in my opinion, not warranted in the present situation. Employment and capacity utilization will remain so low over the next 12-24 months, that the risk remains one of deflation. Further, recent wage trends suggest that household earnings may fall over the next couple years.

Many observers confuse asset inflation with goods inflation. They are very different entities. The recent rise in commodity price best illustrates why the two can be confused. In our "modern" financial system, commodities have become an important asset class. However, commodities also represent an important input (from 6-9% of the input to all consumption goods) into goods production. Swamping commodities in goods production are labor and capital, which are responsible for the other 91-94% of the goods input. In my opinion, the rise in commodity prices is **not** a sign of inflation. Rather, coupled with the rapid rise in stock prices, it is a sign of the potential for asset inflation. Recall that Fed policy following the 2000 recession, resulted in the housing bubble, just as policy in the late 1990's resulted in the NASDAQ bubble. In this case, however, housing prices, a huge portion of U.S. household assets and a driving force in household spending, are still falling. Thus, the rise in commodity prices is, in part, the result of a speculative search for the next asset bubble. And, to date, it is a relative, not a general rise in asset prices. Another candidate for the next asset bubble is emerging markets stock prices, discussed below in the market section on equities.

Goods inflation is likely to stay under control much longer than the naysayers suggest. The prices of labor and capital are currently steady to falling. I expect this to be the case for some time to come as unemployment rises to and stays above 10%. And at 67% and falling, capital utilization is likely to stay far below the mid-80% level that is associated with incipient inflation through 2010.

Longer-term, over the next 5-10 years, I am concerned that goods inflation will increase at an average rate exceeding that of the 1990's and early 2000's. The competition for world resources will get more intense, public obligations will balloon and compete with private demand, and the less "evil" method of depreciating government debt may be a higher inflation rate. Policymakers will be hard pressed to pursue a policy of stable prices. Still, they have the means and expertise (in the U.S. and Europe) to keep prices stable if they choose. So even longer-term price increases are not as assured as the inflation hawks tout.

The Markets

Interest Rates: I expect Short-term Treasury rates will continue to hover near zero well into 2010. Despite evidence that the economic slowdown is ebbing, the unexpected rise in job losses at the end of the second quarter has quashed talk of a Fed tightening later this year.

After widening rather sharply into the main June Treasury offerings, the Treasury yield curve reversed course as the 10-year note yield peaked at 4%. Over the near term, the yield curve will likely narrow further, as the "green shoots" optimism fades. However, a return to growth, however slow, the continued rise in the budget deficit, fears of the cost and nature of health reform and concern over the long-term fate of the dollar as foreign buyers look to diversify their purchases will keep a lid on a Treasury rally at the long end of the curve. Thus, I no longer think the 10-year yield will fall below 3%. My range over the next 3-4 months is 3.0 to 3.5%.

The Dollar: As indicated in last month's update, I think continuing economic problems in Western Europe and both credit and economic problems in Eastern Europe will lead the Euro to retest the 1.28-1.32 level. Over the past 4 weeks these problems have become more apparent and the ECB has effectively introduced quantitative easing (by giving unlimited funding to banks at a low rate) although it continues to hold policy rates higher than most observers, including myself, think is justified. Europe does have more automatic economic stabilizers than the U.S., so the economy is not showing the same depth of recession as in the U.S. However, the export market is lagging and there is little chance that Eurozone growth will be enough to create the jobs needed to reverse the rise in the unemployment level.

In the past month, the Canadian dollar has fallen back toward my 84-85 target range faster than I anticipated. Both the rise in the commodity and stock markets of the past few months rose faster than can be supported by the fundamentals. Likewise the Canadian dollar rose too quickly and, as a result, is correcting. While anticipation of better Chinese growth was a huge factor in the commodity and Canadian price rise, recent U.S. economic data and European financial data are now mitigating this optimism. Canadian economic data have been disappointing as well. Thus, the Canadian dollar is likely to stay in a range near present levels for the next 2-3 months. My range is 82-88.

Over the longer term, I expect the Canadian dollar will perform well against the U.S. dollar, probably moving back to parity or higher. The Canadian debt situation is much more favorable than in the U.S. The fiscal, monetary and regulatory policy is more rational than in the U.S. and the private sector will continue to outperform that in the U.S. because resources represent a greater fraction of the economy than is the case in the U.S.

I continue to 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 current dollar rally is exhausted, I think the yuan will resume its appreciation.

Equities: As earnings season gets underway, it is tempting to delay my call for a significant correction. Second quarter earnings were likely down year-over-year, but this is already factored in the market. Indeed, it is almost always the case that, by the time earnings season approaches, analysts have already made their estimates so conservative that actual earnings are better than expected. This will very likely be the case this quarter as well.

Despite prospects for better-than-forecast earnings and continued liquidity available to the market, I think that rising unemployment, coupled with the prospect of another 2-3% GDP contraction in the second quarter (to be announced July 31), will result in a further equity correction in July. My 6-8 week S&P range is 810-920.

Emerging markets have performed much better than the U.S. market so far in 2009. As with the commodity price increase, I think the more rapid rise in emerging market indexes is partly the result of speculators looking for the next asset bubble. And, as is usually the case, there is almost always a solid fundamental basis for a price rise. The problem is that when liquidity is readily available, the price rises that are experienced are quite excessive relative to what is justified.

The fundamental basis for second quarter rise in some key commodity and emerging market equity prices is the prospect for continued robust growth in China and India. The Chinese were first to adopt a significant stimulus package (November, 2008) and the size of their package was greater relative to Chinese GDP than the U.S. package. The Indian election appears very positive for maintaining good growth there, and protecting the role of the private sector in achieving growth.

It is probably the case that the Chinese and Indian markets, and the markets of developing countries that are resource-rich such as Brazil, will outperform the U.S. market over the next decade. However, because world markets tend to correct together, I expect a temporary setback in the Chinese and other emerging markets over the next few months.

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