



STUART INVESTMENT
MANAGEMENT LIMITED

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The Economy

Employment: At -247,000, job losses subsided somewhat less than expected, but still signal the economy is not yet recovering. The best indicators of an economic turnaround are hours-worked and temporary employment. Because employers want to wait until they are sure a recovery will be sustained, they tend to work their labor force harder and use temporary employees before hiring permanent workers. Thus, hours worked and temporary employment data are the best indicators of future trends. On that score the data were mixed. Hours worked increased by 0.1 to 33.1 but temporary employment fell by 10,000.

As is usually the case, the inventory cycle tends to drive employment at a turnaround. Thus most of the increase in hours worked was in the manufacturing sector. Although this sector continued to shed workers, new orders in this sector, as indicated by the latest monthly ISM data, finally rose above the breakeven line. And Ward's auto data suggest a huge ramp-up in car production as two of the three U.S. auto companies emerged from bankruptcy and as the "cash for clunkers" incentive is drawing down car inventories.

Although the rebound in auto production may be pulling production from the future, the temporary lift will likely result in manufacturing employment stabilizing in the third quarter. On the other hand, "spreading the work" has played a more important role in this downturn than typical. Thus, much of the increase in production in the economy as a whole will initially come from increasing hours of those already employed. Despite my forecast for 3% growth in the third quarter (see below), payrolls will likely decline by another 100,000-200,000 in coming months.

The 0.1% decline in the unemployment rate (from 9.5 to 9.4%) is an anomaly. It is based partly on statistical "noise" and partly on an actual reduction in those in the labor force. Some but not all of those leaving the labor force were discouraged, not a good sign. But the broader unemployment rate including part time and discouraged workers also declined from 16.5 to 16.3%. So part of the reduction in the labor force is likely due to demographic factors. In any event, the reduction in numbers working or looking for work does not bode well for household income in coming months.

I still expect the unemployment rate to top 10% by the first half of 2010.

The Consumer: Household indebtedness continues to contract, with consumer debt falling a greater-than-expected \$10.3 billion. The good news is that household balance sheets are better than they would be if credit were not contracting. The bad news is that consumer income is not likely to grow as job losses continue. Indeed, the approximately 4% drop in household debt since the peak in mid 2008, is more than matched by a 4.62% drop in household wages and nearly matched by the 3.45% drop in overall household income. Wages represent 52% of household income and 65% if benefits and bonuses are included. Part of the reason that household income is down less than wages is due to temporary and one-time-only income gains in the form of tax cuts, unemployment insurance and a social security bonus that are part of the stimulus program.

Because household income has been reduced by approximately the same percent as the consumer balance-sheets are being repaired, it is unlikely that consumer spending will lead the economy out of the current recession to the usual extent. There is some gain from the stimulus program and incentives such as the “cash for clunkers” that will lead to marginal debt creation that would otherwise not be the case. But such programs do more to stem the downturn than increase future income and spending.

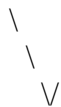
Growth: Forward economic indicators are indicating some recovery in the second half. Leading indicators have been up strongly for three months. At 55, the new orders index of the manufacturing ISM survey is a positive. And the increase in hours worked in the July employment report suggest that industrial production for July was up about a half a percent. Finally, the so-called “cash for clunkers” incentive is resulting in a sharp third quarter ramp-up in car production.

One of the biggest contributors to third quarter growth will be a smaller reduction in inventories. A reduction of \$34.5 billion in inventory liquidation results in a 1% contribution to growth. A huge \$156 billion in inventories were liquidated in the second quarter. So even if an additional \$100 billion are liquidated in the third quarter, this will contribute about 1.6% to growth. Further, it is not unusual at the turn in a business cycle to get growth above 5% if there is an outsized contribution from the cessation of inventory liquidation.

Not all signs point to a rebound in growth. July data suggest that while manufacturing and housing were small contributors to positive growth, the service sector was still flat to contracting a bit. The non-manufacturing ISM index came in just under 49. Further, retail store sales contracted although overall retail sales including auto sales were likely up about a half a percent. Still, by the end of the third quarter, growth should be solidly on the positive side. My forecast is for 2.5-3.5% growth in the third quarter.

Fourth quarter growth is also likely to be positive with some “spillover” effect from car incentives as auto company inventories “catch up” with the third quarter spike in demand. In addition, the full impact of the stimulus program will carry over into the fourth quarter. My preliminary forecast for fourth quarter growth is also 2.5-3.5%.

Beyond the “statistical” growth from the inventory liquidation, recovery prospects are more limited. As indicated above, consumers are likely to be tepid contributors for future growth. Export growth and the growth in government spending if, as I expect, government social spending (especially in health care) increases will have to carry more of the load for the recovery. But given the current huge fiscal deficit, the latter contribution is also likely to be tepid once the stimulus begins to wear off.

On balance, I expect what is called a “square root” recovery . That is, in

the early stages, it will look like a “V” as less inventory liquidation boosts growth disproportionately. Thereafter, however, I expect growth to flatten out, stopping the “V” in its tracks.

Fiscal Policy: The fiscal policy outlook is marginally improved from prior forecasts. At the height of the downward contraction, I thought there was risk of a \$2 trillion deficit this year and next, with little relief thereafter. These concerns have been lessened somewhat. It now appears the fiscal 2009 deficit will be closer to the \$1.600-1.700 trillion level, with some reduction in 2010 to, say, \$1.4 trillion. These are still huge numbers, near 10% of GDP.

Longer term, the budget outlook remains dire. Medicare and Social Security will begin to run huge deficits, as huge numbers of baby boomers begin to reach 65 years in 2011 (baby-boomers were born between 1946 and 1964). The necessity for older individuals to work beyond the normal retirement age will mitigate the Social Security deficit, but will only alleviate the Medicare deficit marginally. Workers will pay more into the funds than previously estimated and, in the case of Social Security, will delay collecting. However, Medicare will insure all qualified individuals whether or not they are working.

A big uncertainty for longer-term fiscal policy is whether the administration’s plans for health care will come to fruition and, if so, how much they will increase or decrease future federal obligations. Despite divergent views in Congress about health care reform, a broad consensus that something should be done exists. My best guess is that after much further debate health care legislation broadening coverage and capping some costs (the administration already has an agreement for a minimum of savings of \$80 billion for drug companies), will be passed by this Congress. It could pass this year, but I think a final bill is more likely to hold over until next year. It will almost certainly involve more government spending and, thus, further raise the prospect of tax increases once the economy recovers.

Regarding “cash for clunkers”, near term this expenditure is a much better fiscal stimulus than it is given credit for. Why? Because the program induces households to finance a sizable purchase that might not otherwise occur. Thus, the “multiplier” effect is much greater than for other programs. Of course the program is quite small (\$3 billion) relative

to other programs, but it comes at an opportune time for auto companies that are emerging from bankruptcy or otherwise struggling.

The downside of the program is that, for the clunkers, there is a premature scrapping and, the increase in demand now will come partly at the expense of future demand. But for a society that has always had a “throw-away” mentality, the program is one of the better “stop-gap” band-aids, especially when compared to the necessary, yet regretful mega-billions thrown at bankers during the crisis.

Monetary Policy: Since October, 2008 and for the foreseeable future monetary policy will focus on balance sheet issues rather than interest rates. The Fed will maintain the fed funds rate under 0.25% for several more quarters although, if growth is near three percent in the second half, pundits will revive the notion of a rate hike in the near future (recall the groundswell in June for a rate rise in September).

Regarding the balance sheet, the Fed will likely continue its outright purchases of securities at a rate that will offset the decline in loans that is taking place as banks and other entities pay down their emergency funds. Since October, the Fed balance sheet has remained close to \$2.1 trillion, up from \$800 billion prior to the crisis. A small decline over this period has more than been made up by an increase in foreign central bank holdings that have increased from \$2.5 trillion to over \$2.7 trillion. The Fed’s outright holdings have moved up steadily to over \$1.1 trillion from \$500 billion. Thus, the emergency portion of the balance sheet is declining rather rapidly, a good sign for private sector financing.

Many observers are concerned about the rapid rise in the Fed’s balance sheet. My interpretation is that the increase has only offset a portion of the decline in public sector asset values. Had this not been the case, I feel confident that the economic contraction would have been far worse. Further, until private sector balance sheets are repaired enough to support increased lending, the Fed’s outsized balance sheet will not be a problem. Moreover, the Fed is very aware of this relationship.

Many observers fear an inflationary consequence of the huge increase in money supply. But as long as velocity was declining at a rate that was faster than the increase in money supply, and as long as private debt reduction was faster than the increase in public debt, a deflationary outcome was the more likely result.

Recently the monetary base and M3, the broad measure of money has been contracting along with the monetary base. But M1 has been expanding, at about a 20% annualized rate in the past three months. This provides some evidence that, although the Fed asset base is becoming a bit more restrictive, transactions are beginning to improve. Combine these monetary developments with recent asset price developments, some indication that the housing price decline is lessening, selected commodity price increases, and the general rise in equity prices and my conclusion is that velocity is probably no longer decreasing. i.e. the risk of a systemic collapse has been all but eliminated.

In summary, monetary policy appears to support a recovery, and support for asset price increases is no longer increasing. As a final note, excess reserves, while easing, are still enormous, suggesting that the Fed has plenty of time to rein in liquidity.

A note on Inflation, Asset Appreciation and Commodity Prices: Many observers are concerned about inflation. And it is easy to cite rising food and gas prices to support this concern. However, note that in response to any economic downturn the Fed has to induce a reversal of the downward fall in asset prices before an upturn can begin. The reason has to do with the “real balance” effect. When workers are being thrown out of work and profits are falling, both consumption and investment will decline. The only way to offset this is to make household feel richer, i.e. to increase their asset prices.

Since the Fed has virtually no control over which asset prices will appreciate, it simply has to insure that, as a whole, assets appreciate. In this case, with housing price momentum quite negative, it is not surprising that equity and commodity prices began appreciating first. Thus, at least in the U.S., I regard the rise in commodity prices as a necessary prerequisite to a recovery. And the stock market rise, although I have been skeptical of the speed and extent of equity price increases, is also a prerequisite until growth in household income or from increased government expenditures and net exports stem the production decline.

Commodities, unlike equities, are both an asset and a good. In my previous monthly outlook, I stated that the rise in commodity prices is partly the result of asset price inflation rather than general goods inflation. It is premature to be concerned about inflation given that the recovery is in the very early stages, there is a reserve army of unemployed and excess industrial capacity, and an increase in household income is still not assured. Many critics of the Fed cite its contribution to asset price increases in the previous two business cycles. This criticism is without merit in the economic recovery stage, but becomes relevant when profit and earnings increases are sufficient to support sustained growth.

Markets

Interest Rates: Short-term rates will remain steady near zero, anchored by Fed policy. Near-term, however, longer-term Treasury yields will likely rise a bit further, with a test of the 4% level likely on the 10-year Treasury. \$75 billion in 3, 10 and 30 year notes and bonds will be offered the week of August 10, while \$109 billion in 2, 5, and 7 year notes will be offered at the end of August. Only \$14 of the \$75 billion quarterly refunding represents new money, but the “duration” effect is huge since all of replaced securities are maturing. \$85 billion of the end-of-month auctions represent new cash. Thus, both duration and size of Treasury debt will rise significantly and likely steepen the yield curve.

I think that 10-year note rates will likely peak in the second half of August, as investors look beyond the offerings. Excess bank reserves are over \$600 billion and the steepening yield curve will induce banks to increase their holdings of Treasuries in the middle to

short end of the curve, while investors will likely absorb the rest as some modest rebalancing of assets back to safety takes place.

My forecast for the 10-year note yield is 3.95-4.20% on the upside and 3.15%-3.4% on the downside for the balance of the year.

The dollar: Over the past 9 months, foreign central banks have increased their Treasury and other fixed income securities by approximately \$250 billion. Despite warnings from the Chinese and others about U.S. debt, foreign central bank increases are only slightly below the trend prevailing before the financial crisis. During this same period, the U.S. trade deficit has fallen by about half, from near \$700 billion annualized in 2008 to an estimated \$300-350 billion this year. U.S. net indebtedness mitigates the improvement somewhat as each year the cost of servicing our foreign debt potentially increases (although lower interest rates will lower the onus of debt servicing for the next few years).

The bottom line since the crisis is that foreign central banks are doing almost all of the net lending to cover the U.S. net export deficit. The fate of the dollar over the next few months hinges on whether

- the reduction in the trade deficit will continue,
- foreign central banks will continue to underwrite the current account deficit, and
- foreign investors will pour more money into the U.S. relative to the out-flowing funds of U.S. entities investing overseas.

I feel quite uncertain about the second-half direction of the dollar. Thus I would be a non-participant in dollar speculation. On one hand, a further rally in stocks (which I don't forecast near term), could draw private capital into the U.S. as foreign markets such as China look overdone. Structurally, however, U.S. investors will likely commit more of their funds overseas as longer-term growth prospects in Asia and supporting resource markets such as Brazil and Canada look better than those in the U.S.

Longer term, I see further downside for the dollar both because of relatively better investment opportunities overseas, and because, in order to service its net foreign debt, the U.S. will have to gain a better competitive edge. Faster growth overseas should result in greater exports, but to turn the still-huge trade deficit to a surplus will require dollar depreciation as well.

Equities Oops! As forecast in the previous months outlook, earnings came in better than expected and the outlook for the economy in the second half has improved. But I dramatically underestimated the market response to the better news, having assumed that the already powerful rally had capitalized the forthcoming good news.

During the month, Goldman Sachs raised its 2010 S&P earnings estimate to \$75, and its estimate for this year to \$50. Although I regard their next year's estimate as too optimistic, their 1060 target on the S&P, implying a PE ratio of 13.33 would, in my opinion, be fully justified by their earnings estimate. With inflation low, it would not be

unusual to have a PE ratio to be even higher. This has caused a number of more optimistic forecasters to target the S&P at levels of 1100-1200.

An 1130 level represents a 50% retracement of the bear market losses and is not out of the question, even in a bear market. Thus, over the next year I do not rule out a move to the 1100-1200 range if the Goldman Sachs earnings forecast is on the mark.

Near term, and despite the better economic background, I continue to think the market rally will give way to a correction. Default rates on many types of debt, including commercial real estate, both sub-prime and prime loans and revolving credit will continue to rise over the next few months. Housing prices for the wealthy will continue to fall, even as valuable home prices bottom out. Finally, while job losses in the 100,000-200,000 are far better than those in the 600,000 range, such losses will inhibit growth in household spending.

The bull case for equities remains the notions of “don’t fight the fed”, lots of money on the sidelines, and improving profits. While I don’t deny these factors, I think the market is now more vulnerable to a negative surprise in the fall. Admittedly after the fact, I am raising the top of my S&P range to 1050 from 920. But I continue to see a late Summer-Fall correction to the 810-876 level.

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