STUART INVESTMENT
MANAGEMENT LIMITED

Economic and Market Update: September 8, 2009

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The Economy

Employment: Job losses (-216,000) were again experienced in August but continued to subside somewhat. However, past losses continued to be revised up. The unemployment rate, 9.7%, continued to rise, confirming that the 0.1% drop to 9.4% in July was indeed an aberration. One commentator that I respect argued that downward trend of job losses per month suggests that losses will evaporate by year end. While I agree, I also note that the data is erratic enough that a move to job growth is still very uncertain, especially since there is a credible case to be made that 2nd half growth will be temporary (see the growth section below).

Several factors concerning the job market are disturbing. Despite the notion that the stimulus effect and the probable end to the inventory correction should prompt growth in the second half, both the manufacturing and non-manufacturing ISM indexes indicate that increased production will not lead to net hiring. Temporary workers are still declining, albeit at a slower rate, while the work week appears to have stabilized, but is not yet expanding. An increase in temp workers and the work week precede permanent hiring. Third, despite the 0.3% rise in August hourly earnings that was accounted for by the one-time-only effect of the minimum wage rise, compensation is in a flat to downward trend. Finally, if current job loss trends are normalized to the average loss over previous post war recessions, more than a million job losses are still expected before the job market turns up.

By my estimate, at least 100,000 per month in job gains are needed to stop the rise in the unemployment rate. I continue to expect the unemployment rate to top 10% by the first half of 2010. There is an increasing chance that, absent a further stimulus program, the rate will hit 10.5% or more by mid 2010.

Growth: Forward economic indicators continue to indicate moderate growth in the second half. Leading indicators have been up strongly now for four months. New orders index of the manufacturing ISM survey continued positive, and the production index (52) also crossed to the positive side. Housing will stop subtracting from growth and may make a small positive contribution in the second half. Finally, inventories will likely be

liquidated at a much slower pace in the third and fourth quarters adding as much as 2% to growth in the third and fourth quarters.

To see the potential impact of inventory liquidation on growth, consider the following. In the first two quarters of 2009, inventory liquidation went from $37.4 billion in the fourth quarter of 2008, to $113.9 billion in the first quarter, 2009, to $159.2 billion in the second quarter. This subtracted 2.36% and 1.39% from growth in the first two quarters respectively. If, in the second half, the inventory liquidation returns to the more moderate $37.4 billion level of the fourth quarter, 2008 then, despite continued inventory liquidation, growth in the second half would be boosted by just under 2% per quarter. If liquidation simply ceased, the contribution would be about 2.5% per quarter.

As indicated last month, not all signs point to a rebound in growth. July and August data for the non-manufacturing sector appears to be flat to contracting. To the extent that consumer demand improves, some of the improvement may be siphoned off by some limited deterioration in net exports. Further, the impact of the deterioration in state and local finances on the contribution of government will likely offset a small contribution from the federal government. Thus, a rebound in the manufacturing sector and slowing inventory liquidation will have to carry the brunt of return to growth.

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%, the same as last month. However, outside of an improvement in housing, most of what I learned in the past month shades my bias to the downside of my forecast.

I continue to expect what I called a "square root" recovery (\ _______) in last
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month's report. Once the contribution of slower inventory liquidation works into the system, there is little to promote growth. My employment forecast, lower employment and flat to declining wages, will dampen the contribution from household consumption. In past business contractions, the household income losses have been much more muted. Further, the negative begins to be offset by rising asset prices, both in housing and equities as well as fixed income holdings. In the present situation, any asset gains from appreciation in high grade fixed income holdings and the rise in stock prices is offset and perhaps swamped by both the loss in wealth associated with the fall in house prices.

Another negative is continuing credit problems. Foreclosures in housing related to prime loans are now being added to those associated with sub-prime loans. Defaults in commercial real estate, especially for condo and mall builders will put continued pressure on local and regional banks. 2010 will see a significant resetting of adjustable mortgages, although, with rates as low as they are, the resets may be negotiated to more manageable levels than would otherwise have been the case. Combine the ongoing problems with

credit and the demand factors cited in the previous paragraph and one can understand why many economists expect a return to recession in 2010.

My forecast is for 2010 to be a year of slow (2-2.5%) growth. My tentative forecast is for 1.5-2% growth in the first half, and 2.5-3% growth in the second half. My second half forecast is dependent on Congress passing an additional stimulus program early in 2010 as incumbents, desperate to improve the employment situation, pass additional incentives to boost housing and consumption, boost investment, and build infrastructure.

World Economic Developments: The September 4-5 G20 finance ministers meeting in Pittsburgh contained little to move the markets. The group acknowledged that it is premature to remove fiscal and monetary stimulus. The process of unwinding bad debts and too-high leverage, while past the critical stage, is still unfolding.

Over the next few months, I expect moderate growth in Europe and the U.S., and continued robust growth in China and India. Brazil, Malaysia, Indonesia, Canada and other resource-rich countries will continue to benefit from Asian growth.

In the case of Canada, an offsetting factor is the negative impact of the rise in the Canadian dollar and continuing problems in manufacturing. Historically Canada has enjoyed a trade surplus that allowed it to easily service its external obligations resulting from the net investment in Canada and its resources. However, in a disturbing development, Canada experienced its first monthly trade deficit.

A note on Japan: The election in Japan has introduced a good deal of uncertainty and debate over the course of domestic and foreign policy in Japan. Those concerned with the potential for Japan to loosen its ties to the U.S., especially with regard to military cooperation, cite the platform of the newly elected Democrats. This platform is perceived to call for an end to using the U.S. as a military shield and to reject the excessive "free market" ideology of the U.S.

Those who are less concerned about the direction of Japanese policy cite the new leader's (Yokio Hatoyama) Stanford education and his personal fondness for the U.S. Moreover, the extreme "free market" policies of the U.S. are more an artifact of the right-wing ideology of the U.S. Republican party, rather than U.S. policy. Indeed, the current administration has much in common with the new Japanese administration preferring to institute more balance between the benefits of free markets and the need to consider income distribution in making policy.

A major concern is that the new government in Japan, in order to foster domestic growth, will further increase deficit spending, leading to a public debt to GDP ratio that is untenable. While I share this concern, the Japanese with their higher savings rate and vast overseas investments are in a better position to support their debt load, which already exceeds the GDP, than is the U.S. with its much smaller (60% of GDP) public debt load.

The most important efficiency-producing policy that the new administration could undertake would be to begin to dismantle the bureaucratic excesses present in both the government and the domestic private goods delivery system in Japan. But in a time when unemployment is at an unacceptably high level, the government will be wary of taking on this task.

Finally, the biggest "wild card" is Hatoyama's personality and leadership potential. Most observers, myself included, regard the Democratic party victory as the result of frustration with the current economic situation and the long-standing inability of the rejected Liberal Democrats to reverse the domestic economic malaise. Hatoyama, himself only came to lead the party after a scandal resulted in the resignation of the previous leader.

My conclusion is that, although there is a lot of uncertainty, I do not expect a monumental change, either in domestic policy or in the relationship with the U.S. I do agree with observers who say that the deficit will rise as the new party passes budget-boosted legislation to reinforce the public safety net. Further, Japan will continue to build its relationship with its Asian neighbors, both symbolically (by further repudiating Japan's WWII policies) and by further increasing its already considerable investments in China, Vietnam and other emerging Asian markets.

Deflation or inflation?: Recent developments in employment will lead to a fall in real wages in the coming year. At the same time, both price indicators in the manufacturing and non-manufacturing ISM indexes underscored a significant increase. What gives?

Near-term, I expect inflation to remain subdued. There appears to be some rebound from prices that were particularly depressed as inventories are being liquidated. However, once extreme discounts are eliminated, the combination of unused capacity and labor availability will mitigate price appreciation.

The jury is out on longer-run inflation although I continue to see political and financial reasons to think the Fed will ultimately "allow" a moderate inflation rate in the 2-4% range. Both the need to favor employment growth and to lessen the burden of debt will lead to this response. At the same time, the Fed will be certain to contain the inflation rate in order to manage the decline in the dollar. Thus, I think the notion of hyperinflation that "scare-mongers" like Marc Faber are promoting is a very low-probability outcome.

A note on Gold: In my opinion, the recent rise in gold prices has nothing to do with inflation and everything to do with risk and a retreat from national currencies. There is a perception that the struggle to limit Iran's ability to produce nuclear weapons may come to a head this fall, leading to another period of conflict and greater uncertainty in the Middle-East. Further, the propensity of central banks to continue to foster liquidity appears to be undermining the value of paper assets relative to real assets. Thus, although some investors and traders are quite negative on the dollar, they are fearful that the alternatives, the euro and yen are also vulnerable.

As indicated in the monetary policy section below, the demand for liquidity coupled with continuing deleveraging make it mandatory that central banks continue to accommodate and reinforce fiscal measures to maintain demand and curb further job losses. Thus, the case for gold has to be made on its value as a currency and is related more to the demand for a safe asset than to any threat of emerging inflation.

Technically, it appears that gold is finally ready to move above $1000 per ounce, perhaps to the $1100 level as traders and speculators ride momentum. The potential near-term dangers in the Middle-East would support such a move.

Monetary Policy: In a recent interview, the head of the New York Federal Reserve Bank, William Dudley, suggested the Fed's balance sheet would gradually increase to the $2.5 trillion level. This is up from the pre-crisis level of $800 billion and the current level near $2.0 billion. Increasingly the balance sheet is made up of "permanent" investments, rather than the temporary "Maiden Lane" type investments, necessitated by the crisis.

The rise in the balance sheet worries many that the Fed is oblivious to the potential for increased liquidity to have inflationary consequences. In my opinion, the Fed has failed to explain adequately why it needs the bigger balance sheet. And even if it did, it is unlikely that many of the financial world's inflation advocates would accept the explanation. In my opinion, however, the need for an increase in the balance sheet is fully justified.

I have often made the case that concern over increasing money supply is not warranted. Huge excess reserves support the notion of a continued "liquidity trap", a high demand for cash equivalents despite zero interest. Continued deleveraging as investors continue to work off toxic assets is also reigning in velocity. This reduces the potential to support aggregated demand in a credit-driven economy. Thus money supply has to increase in kind to support and hopefully all for growth in aggregate demand.

The case for a higher Federal Reserve balance sheet is based on changes in the "power" of money caused by the deleveraging and the re-imposition of "off-balance-sheet" assets to the balance sheet in the banking system. Over the course of the 1980's to 2008, the Fed's reserve requirements affected less and less of the loanable credit. Thus, in order to hold down nominal growth and thus inflation, the Fed's balance sheet grew far less than the underlying global asset base and transaction needs growth. Indeed, if there were no shadow banking system and off-balance sheet banking assets, the Fed's balance sheet would, of necessity, already been above $2 trillion. I assume the lending availability and willingness of the shadow banking system of equity financiers and other non-regulated entities will remain well below the 2008 level. Thus, assuming the banks do not rebuild their off-balance sheet portfolios, then the balance sheet required by the Fed will remain above $2 trillion indefinitely. Most important, this is needed to support aggregate demand because of the greatly reduced power of money. Hence the greater balance sheet is a

necessary condition for recovery and future growth. 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 and from increased government expenditures and net exports stem the production decline.

Markets

Interest Rates: Short-term rates will continue to remain steady near zero probably well into 2010. Treasury yields, which are likely headed higher over the longer-run, are likely to remain in a range near present levels for the balance of 2009. My range for the 10-year note is 3.00%-4.00% for the balance of the year. If, as I expect, the equity market corrects and geopolitical developments in the near term result in a moderate safe-haven flight, and ongoing credit problems in commercial real estate receive more attention, the 10-year note should test the lower end of my yield range.

While I do not usually forecast foreign interest rates, the impact of the recent Japanese election coupled with the ongoing 20-year economic stagnation is worth a comment. The 10-year Japanese Treasury yield has long been mired at a level, mostly under 1.5%. Prospective policy associated with the new administration could, in my opinion, result in a change in the long-term trend. More so than is the case in the U.S., I think there is a high probability that Japanese Treasury rates will move higher. Spot rates for the 10-year note are currently near 1.3%. I think these rates are unlikely to revisit a level below, say, 1.1%. Further, if I am correct, the rate could move up to near the 2% rate over the next year. Note, however, that Japanese rates are highly correlated with U.S. rates, so a return to the 3% level in the10-year note rate in the U.S. could present a selling opportunity if the 10-year Japanese note rate returns to the 1.15-1.20% range.

The dollar: I continue to feel quite uncertain about the second-half direction of the dollar. Thus I would be a non-participant in dollar speculation. The near-term bullish case for the dollar is a potential "safe haven" flight if, as I expect, Middle-East problems escalate. Further, the case for a high euro from present levels is weak. Conversely, the bearish case is that, ultimately, the dollar will have to weaken as part of a solution to the U.S. current account deficit problem. This deficit must continue to be reduced if the U.S. is to be able to service its rapidly growing external balance-sheet deficit. Growth in U.S. exports to Asia over time should also help, but, in my opinion cannot alone reverse the deficit.

On balance, then, while the dollar may receive some support in the near-term, the longer-term prospect is for a weaker dollar, especially against Asian currencies. And the risk remains that, if the central banks do not carefully control the dollar, a faster more disruptive fall in the dollar is possible.

Over time, I expect the Chinese currency to appreciate. However, given that the yuan is not a free currency, other more market-oriented currencies will likely lead the way. In particular, the yen's future is interesting. Near-term, Japan policymakers would like to see the yen weaken against the dollar. However, while it is in the U.S. interest to see a stable dollar, over the longer term, the yen is likely to strengthen against the dollar as

Japan reorients its trade policy to increasing ties to other Asian countries. Both the U.S. and Japan will likely work closely behind the scenes to manage the yen. Over time I think that market forces will dictate further appreciation in the yen. Thus, I do not expect dollar/yen to rise back above the 100 level even if, near term, the dollar enjoys a period of limited strength.

The Canadian dollar continues to hold its recent strength as assets continue to pour into the country. Foreign investments in Canada are expanding beyond resource-garnering purchases to real estate and other assets. The government would like to see the Canadian retreat a bit, as the speed of the appreciation has made it difficult for Canadian manufacturing to stay competitive. The recent emergence of a trade deficit is in large part the result of adverse terms of trade in a period of economic contraction.

Although the long-term prospects for the Canadian dollar remain quite positive, near term, I think the Canadian dollar, at 93 cents, is at the top of its likely range against the U.S. dollar. My 3-month range is 86-88 cents on the downside and 93-94 cents on the upside.

Equities: Over the past month, stock prices have remained in a moderate range, with the S&P ranging from 980-1040. Technically, a bear could argue that S&P is exhibiting the early stages of a "rolling top" and is facing two of the worst-performing months. Bulls argue that the index continues to trade above its key moving averages with higher lows and higher highs. Until that pattern is violated, the burden of proof will remain with the bears to show why the trend has changed.

I agree with the bullish case technically. And the market has already gone higher than I expected given the underlying economic fundamentals. Still the S&P has not violated the top of my range, 1050, and I continue to think that a combination of geopolitical problems and valuation concerns will lead to at least an 8-12% correction. This would take the S&P down to the 915-955 level, higher than my previous forecast that the S&P would correct more deeply to the 810-876 level. At the same time, I hold out the prospect of a deeper correction if a Middle-East conflict develops.

In the previous two months I cited that Federal Reserve policy is supportive of the market. In particular, the Fed's objective in stimulating domestic demand is to make households feel richer by boosting asset prices. Since housing prices are not likely to rise, this leaves fixed income, commodity and equity prices shouldering the burden of improving household net worth.

I now add to the positive case, the fact that businesses appear to have been very aggressive in controlling costs by downsizing their work force. This greatly boosted productivity in the second quarter and reduced unit labor costs. This is in large part responsible for the better-than-expected earnings and also part of what caused forecasters such as Goldman Sachs to raise their 2010 earnings forecasts.

Despite the above positives, I am concerned that by improving profits at the expense of labor, household incomes will be less robust and the tendency to boost savings will increase. While this allows for investments to be more pointed toward becoming a more competitive exporter, the huge unused capacity of both equipment and labor is reducing potential longer-term productivity enhancing investments. Further, the administration and Congress will not sit by idly while unemployment continues to rise.

On balance, I continue to think that the 53% rise in the S&P since the bottom fully corrects the oversold condition of the bear market and will limit further appreciation. I also think that extrapolation of the recent earning forecast improvements overstate the case for future profits.

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