



Economic and Market Update: October 5, 2009

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The Economy

Employment: There were no redeeming features to the September employment report. Not only did job losses rise from August to September, but if 550,000 former job seekers had not opted out of the market, the jobless rate would have been 10%. Hours worked declined and 1700 temporary jobs were lost on balance. Both of these numbers have to improve before job losses end. I continue to look for the unemployment rate to rise to the mid-10% level.

Making matters worse, a revision of the “bias” adjustment (the so-called “birth/death” model of jobs created or lost by small business developments that are not effectively caught in the normal payroll changes) subtracted an additional 824,000 jobs over the past year. While such an adjustment is expected and normal in times of contraction, the revision highlights the fact that small businesses, which have been responsible for much of the job creation over the past few decades, are shedding jobs at an alarming rate. Moreover, such businesses are often affected with a lag. Thus, even as mass job layoffs abate, losses from small businesses will persist for some time. Thus, future downward revisions are likely.

My 3% GDP growth estimate for the second half (see below) should mitigate further job losses, but I see no prospect for job gains through year end. Given the normal increase in the labor force of say 100,000 jobs per month, I now feel that the jobless rate will top 10% by year end rather than in the first half of 2010 as I previously expected.

Growth: The second quarter decline in GDP was revised to just 0.7% from the previously reported 1%. While on the surface this is positive, recent employment trends and the makeup of the revisions do not bode well for the second half. Third quarter growth, the first estimate of which will be announced on October 29, is likely to be close to my forecasted 3%, but with a potential range of up just 2% to a gain of as much as 4.5%. However, as discussed in previous months, much of this gain will most likely be the result of slowing inventory liquidation and the temporary effects of the government stimulus, including the boost in auto sales from the “cash for clunkers” program. The rest of the gain is likely to come from a modest pickup in housing. Away from cars and housing, consumer demand continues to be quite weak.

My forecast is based on the following estimates for components of GDP. Residential housing will likely add 1% while other consumer demand, including auto sales will likely be near 1%. Some deterioration in net exports will likely subtract a half a percent and this will be offset by a similar gain in government spending (although continuing state and local budget problems give a downside risk to this estimate. Investment will likely be flat to down marginally as consumer construction subtracts more than increased technology spending adds to GDP. Finally, slower inventory liquidation will likely add 1 to 1.5% to GDP. It would have added more but for the fact that auto sales drew down inventories to below desired levels. Thus some of the positive from the clunkers program will show up in a more positive gain the inventory contribution in the fourth quarter than otherwise would have been the case.

A further inventory contribution from rebuilding auto inventories will allow slower inventory liquidation to add, say, 2% to 4th quarter growth. However, recent employment, confidence and retail sales data suggest end-use demand in the fourth quarter will be very sluggish, offsetting growth potential from slowing inventory liquidation. Thus, for now I am holding my fourth quarter GDP growth estimate at 3%. The risk is to the downside.

Monetary and Fiscal Policy: Although some of the temporary Federal Reserve programs such as Treasury purchases are winding down, the Fed will not boost the near zero funds rate for several more months. On the contrary, recent fears of resurging inflation are being replaced by concerns that, without further stimulus the economy may sink back into recession following a couple quarters or weak expansion.

A number of disturbing economic signs have emerged in recent weeks. UI claims remain high and do not appear to be declining. After a robust August, September auto sales fell back to pre-clunker levels. The spring-summer housing pickup, such as it was, is over. Loan defaults, both household and consumer, continue to increase.

Finally, there are anecdotal indications that small businesses are facing both weak demand and lack of credit. The small business sector tends to “fly under the radar” since developments are harder to follow. But increasing problems in the community and regional banking sector are starving small businesses in need of loans. Demand continues to weaken. And uncertainty concerning tax policy is also weighing on the sector.

The fall 2010 election, coupled with fears of a “double dip” recession will prompt Congress, both Republicans and Democrats, to call for additional stimulus. Although pundits debate the effect of previous stimulus programs, few in Congress will be able to withstand the pressure to “do something” in 2010. Moreover the tax situation will play a huge role in Congress in 2010. Members cannot afford to do nothing because, absent a change in the law, the tax cuts adopted during the 2001 recession will expire in 2011. This prospect will weigh increasingly on business confidence as 2010 unfolds.

Although a very vocal minority in the Republican Party has so far stymied the Administration’s health care package (as has differences among Democrats), the

Democrats would appear to have considerable leverage in tax and fiscal developments in 2010. To avoid a massive increase in taxes across the board, but especially on upper income households, Congress must do something. Thus, it is likely that further tax cuts for lower and middle income families will be adopted in exchange for reducing the rise in taxes that upper income families get.

While I doubt that further stimulus will be adopted yet this year (with a possible further extension of unemployment insurance benefits being an exception), I think that tax and fiscal policy developments will be the centerpiece of efforts to revive the economy in 2010. The tax changes are likely to be those discussed and the fiscal policy will likely be targeted to more help for states and local government, more infrastructure programs and possibly energy and education program spending, since in addition to health care, these are the priorities of the administration. On the energy front, my thinking is energy security will play a bigger role as opposed to global warming issues. This would increase the probability of getting broader bipartisan support in Congress and, I think, would “sell” better with the American public.

Health care remains the big “wild card” in the fiscal policy mix. If no reform package is passed this year, the overhang of this issue will conflict with efforts to deal with the acute need to revive the economy next year. Although a long shot, I do not rule out a “grand bargain” in which Republicans, forced over a barrel on the tax issue, agree to a bipartisan bill on health care reform in exchange for more favorable treatment on taxes for upper-income households and businesses. This would be a much preferable solution to one in which democrats “rammed through” health care reform and then let the tax cuts for upper income families expire completely. If such a grand bargain becomes a possibility, it is likely to take place in the spring of next year, so that it can be used by both Democratic and Republican incumbents in the fall Congressional election.

The downside to a grand bargain is the uncertainty for the markets and the economy during the next 6 months.

Markets

Interest Rates: Since March, when the stock market and commodity prices rallied strongly, market pundits and investors have consistently worried that inflation was just around the corner. And indeed there are disturbing developments that could lead policymakers to choose between chronic high unemployment and inflation. As a result, longer-term Treasury rates increased, with the 10-year note rising to 4% from their “panic” low of near 2%.

Although inflation fears are not likely to go away, they are likely to be more balanced by continued concerns over unemployment and sluggish growth. As the focus shifts toward economic concerns between now and year-end, I think the 10-year note range will test the 2.8-3.0% area. Thereafter, fears of rising deficits as Congress considers further stimulus and as a health plan is adopted will likely send Treasury rates higher again. Over the next

6-9 months, I look for the 10-year notes to range between 2.0-3.0% on the downside and 3.75-4.0% on the upside.

The dollar: I continue to think the yen is likely to be the strongest currency. This will put increasing pressure on China to revalue its currency upward, either by effecting a one-time-only upward revision or by managing the currency over a period of time, as was done in 2005-2007. In either event, I think the Chinese yuan will move up 5-8% over the next year with further gains almost certain after that.

The G7 appears to accept some further dollar depreciation as a partial means of managing down the huge external balance of payments imbalance between the U.S. and the rest of the world. The danger is that the dollar fall gains momentum and becomes disruptive. Thus eventually the G7, or more likely the broader G20 group that includes countries that have the largest trade surpluses with the U.S., will have to make a definitive policy statement on the dollar.

Despite my longer-term forecast of dollar depreciation, the near-term outlook for the dollar is mixed. The Canadian dollar will likely move above the parity level longer-term as investment flows continue to pour into Canada. But as a resource-rich country the Canadian dollar is correlated with commodity prices. Over the next few months, a correction in commodity prices coupled with Canada's proximity to the U.S., will likely result in some consolidation. My range through year-end is 88-90 cents on the downside and 95-96 cents on the upside.

I feel most uncertain about the euro. If the dollar continues to be under pressure, the euro is the obvious liquid currency of choice and could rally further. Alternatively, the euro could come under pressure if investors emphasize continuing financial problems facing a number of countries in Europe. With Germany, far and away the largest European country seemingly growing at a moderate pace, a case can be made for either side of the euro. With these conflicting factors in mind, I think the central tendency will be for the euro to trade between US\$ 1.44-1.48. But I have very little confidence that the euro will stay within this range.

The yen is likely to consolidate between the 87-92 yen/dollar over the next couple months but, as discussed in last month's report, I think the Asian currencies will remain in a long-term upward trend.

Equities: I continue to think the upside for the stock market is limited. The late summer correction I called a couple months ago was much shallower than I expected and, in effect, did not materialize. My current view is that a 10-15% correction will occur from present levels, although I do not rule out further rally attempts through the October-early November earnings season.

The positive for the market is that earnings comparisons for the third and fourth quarter are quite easy given the sharp decline in second half 2008 earnings. However, I think the rally we have already had in the market fully anticipates these better comparisons. Thus,

over the next couple months, emerging evidence that the economy is still on very tenuous footing will increasingly bring selling into the market. My range for the next 2-3 months is 910-970 on the downside and 1050-1075 on the upside.

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