



2010 Forecast

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Background

In an idealized business cycle, the onset of an economic recovery is followed by a multiyear expansion that absorbs unused labor and capital and then continues to employ new labor market entrants as they enter the labor force. Incomes rise as do asset prices, ideally at a sustainable pace. Interest rates go up as below-trend rates are no longer needed to help jump-start the economy. Fiscal deficits incurred during a recession to help boost demand are reduced and eliminated and eventually become surpluses to bring public debt back to a level that is easily financed and allows for additional debt to be taken on if and when the next downturn occurs.

Many forecasters, especially on Wall Street rely heavily on past experience to predict the future. Alternatively, one can identify the factors that are peculiar to a given cycle and hope to divine how they will affect the future. The first method one of “persistence” assumes that the structure of the economy has not changed. The second identifies the change, but has the disadvantage of not being able to utilize historical data to predict the outcome.

My view is that, while the characteristics of the current cycle are much the same as in the past, the relative importance of various factors is quite different. I will first describe what I think are the salient differences in the current cycle and then give my forecast based on how these “atypical” factors condition my outlook for 2010 and beyond.

Comparison of the current and past cycles

The main characteristics of the current recession that differ from the norm in previous recessions are the following negatives:

- Private debt, credit quality and leverage were much higher than at the onset of previous recessions
- Although public debt was not particularly high, debt creation (the budget deficit) remained high at the onset of the recession. In contrast to the end of the 1990’s expansion when surpluses were created by lowered defense spending and the coordinated effort between the Clinton administration and the Greenspan Fed to reduce spending in exchange for lower rates, the 2003-

2007 expansion was characterized by increased defense spending and a fall in tax revenues relative to discretionary spending.

- As a result of the implosion in credit availability and the decline in asset prices (both housing and equities), jobs were lost at a much more rapid rate than in previous recessions and household spending was impacted to a greater extent
- The budget deficit due to the revenue losses and “pump-priming” policy added much more than normal to the already high deficit at the recession’s onset.

One positive is that Asian growth has held up much better than might have been expected. Still, although the Asian economies, especially that of China, are expanding robustly, they are not, by themselves, large enough to offset the negatives.

While I don’t characterize it as a positive or negative, one other critical difference is demographic. The aging of the baby boomers has had an impact on all business cycles, but has been most pronounced in the 1970’s, when the boomers were entering the labor force, the 1990’s when boomers were moving into their peak productivity years, and in the current cycle when, had household balance sheets not been so negatively impacted, they would be moving into “unforced” retirement. The huge number of young members needing employment in the 1970’s likely contributed to inflation as their productivity was relatively low. Of course the oil embargo and increasing “straight-jacketing” of the economy by regulations and higher tax takes also were contributors as was the increasing power of money, caused by the development of instruments that expanded money velocity but were not yet understood by the central banks. In contrast, the maturing job experience of the baby boomers was one of several contributors to productivity that, along with the peace dividend from the fall in the “iron curtain” and globalization, that allowed for higher growth and lower inflation in the 1990s.

Lower taxes contributed heavily to increasing incentives during the 1980s and 1990s, helping to promote growth. Unfortunately, however, too many of the benefits of these positive factors were used to foster private consumption, at the expense of both private and public investment needed to keep the U.S. as competitive as otherwise would have been the case. The relative allocation of resources to private consumption and the willingness of the U.S. to finance that consumption externally also left us with huge capital account liability vis.-a-vis. the rest of the world, especially China. The coming years, will see the reverse of this positive development, as households are forced to save more, taxes (both explicit and/or implicit – inflation) rise, and the resources needed to service external debt rise.

As a result of the above differences in the current cycle when compared with previous cycles, the economy, while recovering, faces a much bigger headwind than is typical coming out of a recession. The cessation of rapid inventory liquidation in 2009 will mask the difficulty of the current economic environment by accounting for more than half of the growth in the early stages of recovery. However, high unemployment, too-high-levels of debt and the necessary repair of both private and public balance sheets will hold growth below the level that is required to quickly repair these deficits and to create the jobs needed to bring down unemployment.

Overseas growth will help to narrow the trade deficit, but that process will be painfully slow until the dollar bottoms. Once it does however, the subsequent stability or, more likely, a rebound on the dollar

will allow net exports to contribute to a more sustained expansion. I expect this to happen in the second half of 2010, but not before an early year crisis in which the dollar, in contrast to the current situation, results in a correction in U.S. equity prices.

Finally, in contrast to previous milder recessions, businesses went into “survival mode”, aggressively laying off workers and restructuring. This, coupled with reduced competition from businesses that failed, has left those remaining much leaner, putting them in a much better competitive footing and maintaining profit margins much higher than had been forecast a year ago, when the economy looked like it would spiral down into a depression. In part this accounts for the rapid rebound in stocks which began in March of 2009.

Forecast

Growth: Following what I think will be 3.5% growth in the second half of 2009, growth in the first half of 2010 should stay in the 2-3% level. Consumer demand and, thus, investment will be sluggish as consumers try to repair their balance sheets and businesses spend only on what will make them more competitive, but not on expansion. Unused capacity is likely to remain well above the 15-20% level that would begin to foster plant and equipment expansion. Unemployment will stay above 10% peaking in the 10.4-10.8% range. Were it not for the fact that too many employees were laid off in some industries when things looked their worst, there would be little reemployment.

Because I forecast that dollar weakness may threaten to become disruptive, business confidence may suffer a bit although I expect consumer confidence to remain historically low, but stable. Growth in the sluggish second quarter will likely slow, as the positive impact of reduced inventory liquidation that contributed to growth in the second half of 2009 and first quarter of 2010 declines.

In response to higher unemployment and the November election, Congress will probably pass additional stimulus programs, probably pointed to building infrastructure, stimulating consumption via further tax breaks and transferring more money to states to preserve jobs. These programs will help to boost growth in the second half. The weaker dollar, followed by a somewhat stronger dollar following a first quarter dollar bottom will also stimulate exports, helping growth in the second half. Thus I expect some rebound in second half growth to the 2.5-3.5% level.

The following tables summarize my forecast for 2010.

Table 1: Economic Forecast 2010

	1 st qtr.	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	2.0-3.0%	1.5-2.5%	2.5-3.5%	2.5-3.5%
Unemployment (%)	10.2-10.6%	10.4-10.8%	10.2-10.6%	10-10.5%
Inflation (qtrly %)	1.5	2.0%	2.5%	3.0%
Core Inflation (%)	2.0%	1.8%	2.0%	2.4%

accounts for 65-70% of the cost of production, and unit labor costs are falling. Most industries have an excess of capital and many others are investing in technology to lower costs. Productivity has been increasing rapidly.

Inflation typically falls well into a recovery as production picks up faster than hiring. However, the extreme layoffs that have occurred in this recession have brought forward many of the cost reductions that normally accompany the transition to recovery. Moreover, solid growth in Asia is holding up commodity prices more than usual. Thus, I do not expect inflation to subside as much as usual. Inflation will likely be higher at the end of 2010 than at the onset.

My forecast is for overall inflation to be 1.5% in the first quarter. It will then gradually rise to 3% by the fourth quarter of 2010. Core inflation will likely ease a bit in the first half declining from 2.0% in the first quarter to 1.8% in second quarter. My forecast for the second half is a gradual increase to 2.4% in the fourth quarter.

Although cyclical forces are continuing to exert downward pressure on inflation, structural changes as the allocation of resources moves to support a stronger safety net and broader health care will likely put some upward pressure on inflation. So, too, will the need for the U.S. to support both its external and internal deficit. Higher prices will be needed to help curb private consumption so as not to crowd out the inevitable tax “bite” and increase in public spending, and to pave the way for both higher private and public investment needed to support the servicing of the U.S. external and public debt.

Finally, I do not see the recent sharp rise in gold prices as a harbinger of inflation. Rather I see it as part of the asset price increase that is generally needed to boost wealth and contribute to a demand recovery. The inordinate rise in gold relative to other asset prices is likely to result of the lack of confidence investors have in paper currencies and also the understandable growth in demand as the Chinese and Indian economies grow rapidly.

Fed policy and interest rates: To insure that the recovery becomes self-sustaining, and to foster a recovery in employment, the Fed will likely hold the fed funds rate near zero for most of 2010. Some observers are already calling for a tighter monetary policy to counter the increase in inflation that some see in 2010. And while I too see a moderate rise in inflation, the Fed will bend over backward to avoid the possibility that the economy will slip back into recession.

The Fed has already taken steps to end the quantitative easing that is complementing low interest rates. It has ended market-based purchases of Treasuries and will end or sharply reduce purchases of agency and mortgage-backed securities by the end of the first quarter of 2010. Although the increase in the the Fed’s balance sheet worries some observers, the increase is necessary to counter the fall in leverage as lenders reduce overall credit. This increase is needed as long as the MxV (money times velocity) continues to fall. Money supply increases alone are not worrisome until velocity stabilizes and the Fed is well aware of this, even if some critics are not.

Anticipating the increase in inflation and continuing low policy rates, investors are increasingly concerned about rising longer-term rates. Thus, the yield curve has gradually become steeper. If I am

correct that the Fed holds rates down even as inflation begins to increase in 2010, the yield curve will steepen further. And if, as I think likely, the Fed holds off raising rates until the fall, the 10-year note will likely rise back to 4% with a risk of the rate moving even higher until the Fed acts to increase the fed funds rate. I expect the Fed to begin hiking rates in the fourth quarter 2010 with the rate at year end near 50 basis points.

The Dollar: Although the dollar has fallen in 2009, the fall has been quite controlled and not disruptive. As 2009 ends the dollar remains 5 percent above its 2008 low (although it is about 18% below the safe-haven high it achieved during the credit crisis. If, as I expect, the dollar continues to erode in the first quarter of 2010, the fall will threaten to become disruptive, especially as it nears and moves through the 2008 low (70.70 on the dollar index future).

Specifically, I expect the dollar index (futures) to fall below the 2008 low. It is highly speculative to say just how far it will fall once it moves to a new low. I have assumed a level of 68, but this is a “wild” guess relative to already-speculative attempts to forecast market levels in general.

As the potential for a dollar crisis increases, I expect the G20, led by the U.S., will move to stabilize the dollar. A number of factors will contribute to this process, including intervention and the possibility of other financial measures to make “bets” against the dollar costly. One thing that is unlikely, however, is a Fed rate increase. While this would help in the short run, the consequences of risking a double dip recession would undermine the dollar in the longer run.

One of the most important developments that is necessary for a reversal of the dollar is for the Chinese to participate in the dollar support operation by allowing the yuan to appreciate. This will take the pressure off some of its export competitors in Asia and allow the Chinese to purchase additional dollars at cheaper rates, thus helping to support the dollar against other currencies such as the yen and euro. Indeed, I think the U.S. will be reluctant to agree to support the dollar until such a revaluation takes place.

Once the dollar bottoms, the recovery should bring the dollar back to a level between its present value and the 2008 safe-haven induced high. My forecast is for a return to the 76-82 level in the second quarter and topping out in the mid 80s in the third quarter. The lagged effects of the dollar drop and a mini- “rush” to buy U.S. goods once the dollar bottoms will likely act to narrow the trade deficit considerably by the end of 2010. I also expect domestic demand in Asia to grow rapidly enough to sustain an improving level of U.S. export to Asia, although not enough to reverse the trade deficit with China.

If my general dollar forecast is correct, the euro should rise early in 2010 to the \$1.55-1.58 level (below the \$1.60 2008 high), and the yen to move to the 82-85 per dollar level. Both currencies will then lose value against the dollar for the balance of the year, with the euro moving back to the \$1.28-1.36 level by the end of the year and the yen moving to the 90-69 per dollar level.

The Canadian dollar continues to benefit from a much better mix of monetary and fiscal policy than other G7 nations and from its key position as a stable provider of much-needed basic commodity resources. Although the recession in North America and Europe has dampened the sharp growth in the use of oil and other commodities, the economic recovery in the industrial countries and the robust growth in Asia assures continued growth in oil and other natural resource and agricultural staples that Canada exports.

Thus the Canadian dollar should hold its gains more easily than the euro or yen.

My forecast for the Canadian dollar is for it to top out in the \$1.02-1.04 range. Once the U.S. dollar recovery begins, the Canadian dollar will likely fall back, but should remain well above the mid seventy cent value hit during the worst period of U.S. economic contraction. In the second half of 2010, I expect it to trade in the 88 to 98 (U.S.) cent range.

Unlike the previous multi-year rallies in the mid 1980s and the late 1990s, I do not expect the dollar index to do more than recover the 2009 losses. Thus, I do not expect the 2008 US dollar high to be breached. I expect trade deficit to narrow appreciably in the second half of 2010. Further, the level of the external debt, coupled with the longer-term secular tendency for Asia to grow relatively faster and the emergence of the Euro as an alternative currency of choice, will limit future US dollar gains. Indeed, the best the U.S. can hope for is that the dollar holds its value once it bottoms 2010.

Equities: The equity price rally over the past 9 months has been primarily driven by the interaction of Fed-provided liquidity coupled with a sharp upward revision in earnings expectation. In addition, because there was an inordinate fear that the fall 2008 credit panic would lead to a depression, stocks were deeply oversold.

The upward revisions in earnings are the result of several factors. The swift reduction in workers allowed businesses to maintain margins despite lower sales. In a typical recession, many companies hoard labor anticipating a demand revival. By contrast this recession drove many businesses into a survival mode and, in some cases, they downsized more than necessary. Another factor is the benefit multi-national companies get from a falling dollar. Profits earned overseas can be translated into more dollars than would otherwise be the case. A third, unfortunate factor that has benefitted high-profile larger corporations is the demise of many smaller companies that have been unable to garner the credit needed to survive. Over ten percent of the storefronts in many cities are now vacant. The larger, surviving businesses gain market share in these process.

Much of the equity rise is resulting from a rise in PE ratios as investors anticipate a rise in profits as an economic recovery unfolds. It is typical that PE ratios decline once the profit improvement occurs and further expectations for earnings are more restrained. Thus, any further boost in stock prices in 2010 will depend heavily on the economy and earnings performing better than current expectations.

My view is that the stock market rally correctly anticipates a recovery, but that there is little reason to think that the recovery will continue to exceed expectations beyond the first quarter of 2010. Further, if the dollar decline that I anticipate gains momentum in the first quarter, the benefit from improved foreign profits translation could be swamped by selling of U.S. stocks by both foreign and domestic investors to avoid the negative impact of a depreciating dollar. As a result, I expect a sharp correction in stock prices from current levels before a resumption of the equity rally.

I expect the S&P to peak in the 1115-1130 area and then correct to the 870 to 920 level in the first quarter. However, once the dollar drop is contained, equities should recover their losses. However, given the tepid recovery I expect, and the unfortunate, but inevitable hike in future taxes to reign in the deficit, I

do not look for a return to the 2008 highs (1585 for the S&P for several years). My forecast is for the S&P to end 2010 near 1250, approximately 10 to 12% higher than its current level.

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