



STUART INVESTMENT
MANAGEMENT LIMITED

Economic and Market Update: December 6, 2009

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The Economy

An update on Employment: Several pessimistic economists have forecast an unemployment rate above 11% and as high as 13%, higher than my own forecast of a high in the 10.5-10.8% range. The smaller 11,000 job loss and 10.0% unemployment rate in December, following a 0.4% rise to 10.2% in November was encouraging. So was the 52,000 increase in temporary employment and the 0.2 increase in hours worked which are precursors of a reversal in job losses. While it is also encouraging that new unemployment claims are falling, recent anecdotal data on employment remains mixed. The loss of manufacturing jobs is abating, but the non-manufacturing ISM dispersion index for employment suggests further job losses. Moreover, jobs for small businesses will likely continue to fall long after jobs for larger companies stabilize, suggesting downward adjustments in the numbers employed as benchmark adjustments are made in the future. Thus, despite the December unemployment rate drop, the risk is for a further increase in the rate in the first half of 2010.

I expect policy measures such as further stimulus and the cessation of inventory liquidation to stop job losses within the next 3-4 months. Unfortunately, however, net job creation will be harder to achieve. Thus my notion is that although the unemployment rate will not rise above 11%, it will remain “sticky” above 10% through 2010 (see my companion 2010 forecast).

Growth: As expected third quarter growth was revised down, to 2.8%. Higher net imports and somewhat lower consumer spending accounted for much of the revision while somewhat lower inventory liquidation offset what otherwise would have been a more significant downward revision.

The revisions to third quarter do not change my expectation for fourth quarter growth. More of domestic demand will be satisfied by imports. The contribution of lower inventory liquidation in the fourth quarter will likely contribute about 3% to growth. However, consumer demand continues to look sluggish and will not contribute more than a percent to growth. With other components likely to offset each other, my estimate for fourth quarter growth is 4% with equal risk that the number will be lower or higher.

As indicated in my forecast (companion) report, I look for growth in the first half of 2010 to be 2-2.5% and in the second half of 2010 to increase to the 2.5-3.5% level, still too sluggish to make much of a dent in the unemployment rate.

Sources of growth: Recently there has been a debate as to whether Federal Reserve policy is fostering an asset bubble and whether the Fed should be raising rates or lowering rather than hiking the size of its balance sheet.. The answer is discussed in the next section. But to lay the groundwork for the analysis it is useful to review the components of GDP and the potential sources of growth. While the following may seem a bit simplistic, the absence of understanding the basics on the part of many of the pundits on Wall Street and the media seems widespread.

Recall from the basic course in economics that all GDP is contained in household consumption (C), Investment (I), Government Spending (G) and net exports (X: exports minus imports). Thus $GDP = C+I+G+X$. This is a “tautology”, i.e.. GDP is defined as such. To understand both monetary and fiscal policy, it is useful to examine the forces that produce growth.

- C: Household consumption accounts for approximately 71% of GDP, 74% if the residential portion of the investment (I) component is included. The primary driver of consumption is earnings, which account for 65% of household income. In the past year compensation has fallen three percent (in real terms). With rising unemployment and pressure on wages, it is unlikely that the traditional source of growth, rising earnings will drive growth and bring the economy out of recession.

A number of other sources also contribute to household spending, but in an environment when households are concerned with future earnings, the best ways to restart growth by boosting consumer spending are (1) direct transfers to households (such as UI benefits or tax decreases), direct job creation (public expenditures in infrastructure and public services), or making households feel richer (an increase in net household asset values).

- I: Investment can vary quite a bit as a proportion of total GDP, rising in the later stages of a business expansion and falling sharply in a contraction. From its peak of 12% in 2008, private investment (excluding residential housing and inventory changes) is currently running just under 10%. While lower interest rates make investment more attractive on the margin, domestic and foreign demand for goods and services is far and away the biggest determinant of private investment. Thus, without a boost in household demand or for exports, investment is unlikely to contribute much to growth.
- G: Government spending, (Federal State and Local) represent about 20% of total GDP and stays pretty constant. Because most states operate with little ability to run deficits over time, state and local spending tends to rise and fall with GDP. Thus, growth in GDP that is related to government is dependent on the Federal government and represents just 8% of total GDP (much less than what most

individuals would estimate because money spent on transfers is not part of GDP). The Federal government can contribute to growth in two ways. By running additional deficits, the government can raise demand directly by purchasing goods. Alternatively it can transfer money to households (extended UI benefits or lower taxes) or State and Local governments (as it has in the previous recession to preserve state jobs in teaching, police and fire or for infrastructure spending).

- X: As with investment, net exports vary with the business cycle. At the cycle peak net exports subtracted a bit more than 5% from GDP since we imported far more than we exported. Because a disproportionate amount of our imports go to supporting household consumption, net exports are currently subtracting only 3% from GDP. The main drivers of net exports growth are (1) an increase in foreign demand and (2) substitution of goods produced in the U.S. to replace imports. Because of trade restrictions and the fact that the U.S. recession is accompanied by recessions and slower growth in many parts of the world (China excepted), the U.S. cannot count on spontaneous foreign demand as a source of growth. The primary method to produce net export growth is to depreciate the dollar. But dollar depreciation does not work quickly. Moreover as the dollar depreciates, foreign demand may even decrease as potential buyers hold off purchases waiting for the dollar to fall further. Moreover, dollar depreciation is considered “beggar thy neighbor” policy because ultimately our gain comes at the expense of nations whose currencies rise and make their goods less competitive.

I have excluded inventory building (or contraction) in the above since inventories, both desired and undesired, are almost completely driven by the above components. As indicated above I am simply laying the groundwork for analyzing monetary and fiscal policy debates discussed in the next section.

Fiscal and Monetary Policy: Several arguments have recently been debated concerning appropriate monetary policy. The most important of these with regard to the future course of the economy are:

- Is the Fed promoting another asset bubble and, as a result should it hike rates?
- Will the “easy” money that is one of the factors boosting gold prices and undermining the dollar result in inflation? If so, how soon?
- Should the Fed or Treasury take measures to boost the dollar? If so, how?
- Is further fiscal stimulus needed?

The analysis of what can cause growth helps to answer both the question regarding Fed policy and asset prices and policy regarding the dollar. As indicated in the previous section, investment is highly dependent on end use household demand or foreign demand for U.S. goods. Without demand, low interest rates are useless for promoting investment. While government stimulus can be a temporary help, ultimately, both an increase in household and foreign demand are necessary. And household demand is about 70% of the economy.

The two ways to stimulate household demand are to increase income and to make households feel wealthier. When earned income is faltering because of rising unemployment then, other than fiscal stimulus to transfer income to households, the **only** way to boost household demand is to boost their asset prices in order to make them feel richer. Thus, while the Fed may have erred when it did not act to curb the abnormal asset price increases during the dot-com stock bubble and more recently, the housing bubble, it is totally appropriate for the Fed to boost asset prices now until rising employment hikes household income is sufficient to boost demand.

The bottom line is that Fed should “blow against the wind”, i.e. boost asset prices to help jump start an economy when such a policy is needed and act to curb asset price rises in times when household consumption needs to be curbed in order to avoid artificially lowering the savings rate when the economy is functioning well at creating jobs.

The Fed and Treasury’s acceptance of the dollar’s decline is, unfortunately also warranted. The conditions for a lower dollar have been developing for the past 3 decades. Prematurely acting to stop the dollar’s controlled decline would not only act slow the recovery, but also set the dollar up for a further bigger decline. There is a danger that the decline in the dollar will accelerate, in which case it would be appropriate for the Fed and Treasury to act to stem the speed of the decline. But the consequence of keeping the dollar from achieving a defensible longer-term level is to lower its future level.

Regarding monetary policy then, it is entirely appropriate for the Fed to maintain low rates despite the rise in gold prices and the weakness in the dollar. While both can be harbingers of future inflation, they can also be manifestations of the healing process as gold in the recovery stage should be viewed as an “asset” whose price is rising and not a “good” that is inflating. With unused labor and capital at their lowest level in decades, inflation is not a **current** threat.

Finally, on the issue of whether more stimulus is needed, the recent trend to less layoffs, coupled with the fact that the previous stimulus is still operative suggests caution. However, given that 2010 is an election year and that, despite recent better news on the employment front, unemployment is still rising, more stimulus will likely be forthcoming. Thus, Congress will likely adopt further stimulus in coming months.

Looking into the future, the appropriate method for responding to the economic cycle is to stimulate now with low interest rates, but once economic growth is self-sustaining, raise rates and begin to reign in the budget deficit by allowing the stimulus-boosting spending to roll off and then hike taxes and curb spending. Despite fears to the contrary, there is nothing wrong with current monetary and fiscal policy. The problem we are facing currently is not the fault of current policy. Rather it is the result of not curbing excesses through better regulation and regulation enforcement, and not reigning in the deficit more aggressively during the expansion years (2004-2008) as was done in the prior expansion (1992-2000) when budget surpluses were generated.

The Markets

Interest rates: The Fed will keep policy rates near zero well into 2010. But if I am correct that the dollar continues to weaken in the first quarter, the yield curve will likely continue to widen. My 2-3 month range on the 10-year note is 3.1-3.8%, the high should be hit as the dollar weakens, but then treasuries should rally as fear raises the risk premium and stocks correct.

Trade and the dollar: The dollar may be the key to market moves in the first quarter. Recent data indicating growth in the economy is good for the dollar and could temper a further move down. Moreover, some analysts view the dollar as very oversold and expect strength from current levels. My own view is that, based on my analysis of what it will take to get sustained growth in the U.S., the dollar may still have to move lower before a corrective upside rally.

Specifically, I expect the dollar to fall further in the first quarter, perhaps culminating in an accelerated declines as investor fears rise when the dollar threatens to fall below the 70.70 2008 low in the futures dollar index. If I am correct, then, the major currencies will rally in the first quarter with the Euro moving to the \$1.55-1.58 level, the yen to the 82-85 per dollar level and the Canadian to at least the 98 level and possibly through parity to the \$1.02-1.04 level. The dollar fall will likely end when the G20 led by the U.S. moves to support the dollar in part with intervention and the Chinese allow their currency to appreciate.

A lower dollar allows U.S. goods to be more competitive against goods of our trading partners. However, if the dollar is threatening to fall further, potential buyers may choose to delay their purchases, hoping for still better prices. Conversely, once the dollar bottoms and begins to rebound, purchases in dollars can accelerate, reducing the trade deficit and reinforcing the upside dollar move. This effect will also help the U.S. economy as it speeds up the decline in the net trade deficit. This phenomena is built into my forecast for growth (see my 2010 forecast report).

Equities: In last month's report, I did not expect a big equity correction in the near term, But neither did I the market to go much higher. My preferred strategy was to emphasize dividend paying stocks and, for those who could do so, to write covered calls to enhance yield. I continue to think that dividend stocks will outperform other stocks in the current market. However, I am now more concerned that the market could take a tumble in the first quarter. Thus, consistent with the Will Rogers admonishment to "favor the return of capital over the return on capital", I suggest accepting a lowered blended yield by raising cash. For that proportion that remains in stocks I am heavily weighted to income producing stocks covered with 3-6 month calls with an "at the money" strike price.

A number of bullish, mostly sell side, analysts cite similarities to 1982, when a powerful 18 year bull market ensued. I don't see it that way. The following summarizes why I am so cautious.

	<u>1982</u>	<u>2009</u>
Dividend Yields	6%	below 2%

Book Value	Discount to Book	2X Premium
Monetary Policy	Reducing money growth and inflation	Creating money growth to avoid deflation
Inflation	Beginning a sustained down move	Hovering between deflation and inflation
Deficits	Peaking and coming down relative to GDP	High relative to GDP
Global Trade Barriers	Declining	Static
Regulation	Deregulation	Re-regulation
US Dollar	Plaza Accord bull market	Bear market
Household Credit	Balance sheets expanding	Balance sheets contracting
Tax rates	Income, capital gains and dividend taxes declining	Taxes set to rise

If I am correct, the first quarter of next year could be a “mini” repeat of last year. Moreover, I don’t expect December to be as strong as last year. I already see signs technical that the market is struggling to move higher despite encouraging news on growth. My 2-3 month range on the S&P is 870-920 on the downside after the S&P tops out in the 1115-1130 range. On a relative basis, I continue to expect dividend-paying stocks to perform better.

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