STUART INVESTMENT
MANAGEMENT LIMITED

Economic and Market Update: January 11, 2010

David Horner
Economist

The Economy

Summary: I am raising my growth forecast for the first quarter, 2010 to 3-4% from 2-3%. My forecast for 4th quarter, 2009, to be reported on Friday January 29, remains 4%. Based on probable 2010 S&P profits of $73-80, I am raising my yearly, 2010 forecast for the S&P to 980-1300 from 880-1250. Although the December jobs report (released on Friday, January 8) was disappointing, there is no change in my employment and inflation forecast. Monetary policy will remain supportive of the economy and equity prices, while fiscal policy will be a mild negative for equities. The yield curve, which has already steepened sharply, will remain steep. However, longer-term Treasury rates are not likely move as high as some of the more pessimistic forecasts as inflation remains relatively tame.

Regarding equities, I am less confident about a significant correction early in the year. The Fed will continue to provide liquidity as unemployment remains high - despite decent growth. Thus, monetary policy will continue to underpin equities.

Growth: I expect 4th quarter, 2009 to be near 4%. Holiday sales were somewhat better than I (and the consensus) estimated and, as a result, household consumption will add about ½% more to growth than I previously expected. However, this will come out of inventories, subtracting about 1/2 from the 3% "statistical" growth I see coming from slower inventory liquidation.

First quarter growth is likely to be 3-4%, a percent higher than my previous estimate. Although employment losses will continue to put a damper on household spending in the first half of 2010, cessation of inventory liquidation in some industries and limited rebuilding of inventories in consumer-oriented industries that experienced better-than-expected holiday sales will likely contribute 2.5-3% to business spending in the first quarter.

I expect household consumption will contribute 1.5-2% to growth in the first quarter. However, the 18% November drop in consumer revolving credit, while perhaps an outlier, underscores the sluggishness of household spending. Further, the disproportionately high propensity to import consumption goods will limit growth, as a portion of the inventory rebuilding will likely boost the trade deficit, subtracting a percent from growth in the first quarter. Thus, there is some downside risk to the 4% 4th quarter GDP forecast. On the other hand, the faster the households repair their balance sheets, the better will be their contribution to future growth.

Government stimulus will continue to contribute to demand in the first half. And given the absence of robust employment gains, more stimulus is likely to be enacted (see the fiscal policy section below) in an election year. However, deficits at the state and local levels will limit the contribution to growth from the government sector. Thus growth in the first half will be well below the level needed to narrow the gap between potential and actual growth. For now, I am keeping my 2nd quarter growth forecast at 1.5-2.5%. However, the risk is to the upside.

Employment: The 85,000 loss in jobs in December was disappointing, despite a small upward revision that boosted the November payrolls to a small positive. Adverse weather probably accounted for some of the loss. Hours worked were unchanged Still, the number was worse than expected. More problematic was the data from the household survey. Among the 661,000 workers that left the work force, many were discouraged. Had this not been the case, the unemployment rate would have risen to a new high rather than coming in steady at 10%. The household survey is more sensitive to small business employment and likely signals continued closing of small businesses even as larger multi-national businesses begin to pick up. Construction and manufacturing companies continue to lay off workers, with the latter able, so far, to increase production without hiring.

Despite the worse-than-expected December report, the employment situation continues to be less negative. Temporary workers increased for the third month in a row, usually a sign of a pickup. Both the manufacturing and non-manufacturing ISM's improved, although the employment components were still not signaling an overall pickup in jobs. The trend in the 3-month payrolls average also continues to improve. My best guess is that there will be a net job gain in the second quarter with the first quarter showing at least one monthly gain as well.

Despite some improvement in the outlook, anecdotal data suggests that employment gains will be tepid. For example, UPS indicated that, although its business is picking up, it will furlough 1500 management and administrative workers. This recovery is likely to be similar to that following the 2001 recession except that the unemployment rate will start at a much higher rate. Accordingly, wage gains will be meager and workers will be hard-pressed to keep up with inflation.

Even as jobs are being created, it will be difficult to bring down the unemployment rate. Discouraged and new workers will enter the market at a rate that will offset the payroll increase. Thus, I expect the unemployment rate to stay above 10% for most of the year. There is a strong possibility that further fiscal stimulus will be adopted in an attempt to bring the rate under 10% by the November election. In particular, the government may try to retain a million-plus census workers into September, the last month to be reported before the election.

Inflation: Despite wide-spread concerns among institutional investors, I do not see inflation picking up to a disturbing level (above 3%). Aside from the admittedly-fast rise in commodities, the bulk of production resources, labor, equipment and plant, is in near-extreme excess. Moreover, as companies invest in technology to maintain their competitiveness, productivity is increasing at a rate well above trend.

Those citing the potential for inflation due to the increase in the money supply simply do not understand the monetary backdrop. To date, the increase in liquidity has not kept pace with the destruction caused by declining leverage in credit and velocity in the money supply. The concern about the increase in the Fed's balance sheet, from $800 billion to $2.2 trillion is unfounded. Indeed, the pre-2009 $800 billion only supported the growth in the economy because of the willingness and ability of banks to circumvent reserve requirements by building up their off-balance sheet portfolios. When will banks, under the increasing scrutiny of the Fed and Congress, rebuild their off-balance sheet assets? Not soon.

Another argument used by those fearing inflation is that the fiscal deficit will somehow lead to inflation. To date, the increase in the budget deficit is swamped by the reduction in private debt, much of it for consumption purposes. I have often argued that public debt is not inherently inflationary, but rather, for the most part, affects income distribution. More important is how the government spends the non-transfer component of the debt, specifically whether it supports investment, or is used to support public consumption.

While I do not share the concern that inflation will soar out of control, neither core nor overall inflation is likely to be as tame as in the past two recoveries. Ultimately, if taxes are levied to finance the deficit in a way that reduces production incentives rather than curbs consumption, this will hurt productivity and reduce potential real growth relative to inflation. In addition, I share the concern that the government, aided by the Fed, will choose to lower the onus of the public debt by inducing a controlled inflation. However, this would be a conscious policy. The Fed has, and knows how to use, measures to limit and combat inflation.

Inflation will likely creep up a bit in 2010 (my forecast is for overall inflation to rise 2.2% in 2010 and core inflation to rise 2.1%. Because of the excess labor and plant and equipment capacity, inflation will not get out of hand.

Monetary Policy: The Fed has made it clear that it will not hike the funds rate for several more meetings. Even the 4% growth that I envision for the most recent and the present quarters should not change this outcome. Neither will an upward revision of asset prices. Indeed, the latter is needed to promote demand in the absence of a solid earnings increase. It is only when the Fed can be assured that excess labor and capacity are being reemployed at a robust level that the Fed will hike rates. Look for several increases of 150,000 or more jobs before the Fed signals a rise in rates.

As indicted in my previous monthly report, the argument that the Fed is currently creating an asset bubble is questionable. This problem holds only when the economy is already operating near capacity and when asset price increases, such as in housing earlier in the decade, are threatening to create excess demand and, hence, inflationary pressures. Indeed, asset price appreciation is a necessity in the early stages of a recovery until the expansion is self-sustained by increasing household income, coupled with a repair of consumer balance sheets.

As discussed in the inflation section, I am not concerned with the sharp increase in the Fed's balance sheet. This increase is needed to offset the contraction in money velocity caused by banks bringing their off-balance sheet items back into the reserve-required asset pool. The greater danger will be if the balance sheet were reduced more quickly than a rebound in velocity (the power of money). With credit still contracting and considerable excess labor and plant capacity, it will be several quarters before the Fed can or will consider shrinking its balance sheet. Indeed, given the timidity of banks, I think the Fed may have to increase its balance sheet further to accommodate a return to growth. Households are still being forced to reduce credit. Household balance sheets will not be repaired until either an increase in asset prices occurs, or household earnings increase. If either is sufficient to allow them to satisfy their desire to save and still have an ability to spend, that should be sufficient to grow the economy at a rate that will absorb the unused resources.

Fiscal Policy and Regulation: Despite concern in the financial media over administration policies regarding businesses and Wall Street, the popular press suggests the public is more concerned with jobs and the budget deficit. Indeed, the administration is being criticized that it has been too easy on financial entities. As I see it, the administration and Congress have to steer a fine line that allows and encourages banks to finance growth and create jobs and, at the same time, reregulates the banks in a rational way to prevent the possibility of another systemic collapse.

Near term, there is almost no chance the banks will engage in the type of risky policies that led to the implosion of credit in 2009. There are, however, further losses to be realized from past banking practices, both in housing and commercial real estate. Thus, the Fed and Treasury must be vigilant to insure that past decisions do not undermine an economic recovery. While banking regulation will be a much-discussed item in Washington and on Wall Street, it will have little effect on the economy and markets in 2010.

Fiscal policy will continue to be extremely important for the markets in 2010. Prospects for health reform have already affected equities in the health sector and perceptions in the Treasury bond market. Expectations have moved from anticipating an "anti-business" government takeover of the health care system to a program that will not cut costs but will expand coverage by the private system. As a result, prospects for higher budget deficits have risen but health stocks have rallied as it appears that passage of a bill will benefit 'for-profit' health care businesses.

Away from health care, the jobs situation will be the primary stimulus for fiscal policy. Congress and the administration have already put into place much of the policy that will maintain demand in 2010. The housing incentive has been broadened to cover almost all buyers of homes, unemployment insurance benefits have been extended and money is being shifted to state and local governments to preserve jobs and build infrastructure.

Although there are some who deny the importance of fiscal policy in creating demand and jobs, I am confident that, although they are hard to quantify, the number of jobs preserved and the demand created is huge. While they are not-at-all the preferred ways of boosting the economy, deficit spending and asset appreciation are the "only games in town" until the private sector is capable of sustaining an economic expansion. Thus, Congress is likely to spend more on job creation and to relieve state budgets in the coming year. The November election gives them an incentive to do so.

The Markets

Interest rates: The Fed will keep policy rates near zero well into 2010. But if I am correct that the dollar weakens in the first quarter, the yield curve will stay quite wide. The 2-10 year spread widened rapidly to 290 basis points at the end of 2009 and will likely stay in the 275 to 310 basis point range. Offsetting the negative impact of dollar weakness is the likelihood that stocks will no longer react positively to a dollar drop, resulting in a moderate flight to Treasuries.

I expect the 2-year note yield to remain under 1%. My 2-3 month range on the 10-year note is 3.50-4.20%, considerably higher than my previous range of 3.1-3.8%. I would raise my range further, but I think that the drop in the dollar that I envision could be supportive of Treasuries. Many observers fear that Treasuries would suffer if the dollar falls. However, if private investors begin to divest dollars, the central banks of those countries that want to preserve the stability of the dollar, e.g. China, will buy additional Treasuries to offset the potential decline in the dollar. Thus it is stocks and more risky assets that the central banks do not buy that will experience price declines. Risk premiums are thus likely to rise in the first quarter.

The dollar: Despite year-end strength in the dollar, I continue to think the dollar will weaken in the first quarter. The strong rally in gold, since its recent correction, is a strong indication that investors remain concerned about the value of the dollar. But they are also concerned about the euro and yen as well. Thus the first quarter ranges for the euro and yen are likely to be lower than in my 2010 forecast.

I am not as positive on the euro as previously. Credit problems, both sovereign and in the banks, remain negatives for the euro. Further, the euro has appreciated to the level that likely exceeds its value against the dollar. Thus, the dollar's weakness is the only remaining reason for a euro rally. I think it will retest the 1.50 level in the first quarter.

The yen is also likely to gain from dollar weakness. My first quarter target is a return to the 88-90 level, below my previous forecast of a move to the low 80's. The new Japanese administration is concerned that the strong yen will undermine the economic recovery that remains quite tentative.

The Canadian dollar is likely to be the strongest currency in the first quarter. Although it corrected a bit more than I forecast in the fourth quarter, I am sticking with my 0.94-1.04 range in the first quarter. It continues to be supported by the longer-term growth prospects in Asia and the positive implications of that growth for Canadian resource exports and foreign investment flows into Canada. In addition, the fiscal policy and debt situation in Canada remains the most favorable among the G7 countries.

I continue to expect that, near the end of the first quarter, the Chinese will revalue their currency up by 2-3% and allow a further 12-13% gradual appreciation over the next two years. This will be similar to their 1995-1997 policy of revaluation. If I am correct, this policy will reverse the negative pressure on the dollar against the euro and yen, and the dollar could then experience a more sustained rally followed by more sustained stability against other major currencies.

Equities: As indicated in the summary I have raise my 2010 forecast range for the S&P to 980-1300 based on the positive outlook for earnings (S&P earnings are likely to come in between $73 and $80. The willingness of companies to reduce employment has resulted in a sizable gain in productivity, increasing margins and profits. As was the case following the 2001 recession, I expect companies will be reluctant to hire workers. Although they may miss sales in the recovery, margins will hold up well in the initial stages of the recovery.

Longer term, margins will again come under pressure as tax rates are likely to be raised. But in the coming year, Congress and the administration will be reluctant to hike taxes until after the election and until the recovery is sustainable without fiscal support. And the money the Fed is providing to the economy is also supportive given that the yield on other liquid assets has fallen dramatically.

The dollar will likely be a key to equity prices in the first quarter. To date a weaker dollar has been a positive because it increases the competiveness of U.S. businesses and also increases the dollar value of overseas earnings. In my opinion this will change with further weakness in the dollar, limiting stock price gains as investors begin to fear a reallocation away from dollar investments to non-dollar investments. My adjusted S&P range is 1020-1160.

Third Party Research Disclosure

this publication is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities.

Stuart Investment Management Limited, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities of issuers mentioned in this publication, related securities, or options, futures or other derivative instruments based thereon.