



STUART INVESTMENT  
MANAGEMENT LIMITED

## Economic and Market Update: February 8, 2010

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### The Economy

**Summary:** Fourth quarter growth surged to 5.7% as inventory liquidation slowed markedly and consumer spending and exports and investment in capital equipment each made moderate contributions. First quarter growth is also likely to grow 3-4% as inventory liquidation turns to a small accumulation and other domestic components add small contributions. Further employment losses should be more than offset by gains, keeping the unemployment rate from rising too far above the 10% level.

The dollar continued to find support, but I remain skeptical. I continue to expect China to allow 2-3% appreciation in the yuan near the end of the quarter. Stocks have entered the first quarter setback I forecast, but further losses in the S&P should be limited to an 8-12% drop from the 1145 top. The main downside risk is if sovereign debt problems in several European countries and U.S. states induce a significant shift away from risky assets. As regards equity prices, the negative “macro” backdrop is trumping the positive business and earnings developments.

Generally, I stay focused on what is happening and how it affects the markets rather than what “should” happen. However, I am increasingly concerned that we are facing a crisis that could soon (within a couple years) undermine what, in any event, could be a delicate economic recovery. To support my pessimistic intermediate to longer-term market and economic outlook, I summarize what I think is the biggest problems the U.S. faces, growing external debt and political paralysis. I outline what needs to be done to solve the external debt problem, namely focus incentives on investment over consumption. And while I outline the problem with gridlock, I am pessimistic on the outlook.

**Growth:** At 5.7%, fourth quarter growth was a percent higher than the consensus. Although encouraging, more than half, 3.4%, of the growth was from slower inventory liquidation. Domestic consumer demand, at 2%, was moderate. More positive was a further narrowing of the net real trade deficit, contributing 0.5% to growth. Residential construction and investment in software and equipment also contributed, as buying incentives are helping the housing market. Commercial building remains a negative.

The profit picture continues to be quite favorable. In their concern and, in some cases, panic, many businesses were able to hike margins in the face of declining sales and slow or negative growth in revenues. Productivity has skyrocketed the last three quarters of 2009, rising more than 6% in each quarter. Productivity generally increases at the onset of an economic recovery as managements utilize their labor more intensively prior to increasing hiring. But the early onset, extent, and persistence of the 2009 productivity gains is much greater than in recent recoveries.

First quarter growth should again be reasonably strong. I estimate 4%, as the larger-than-needed, somewhat panicky liquidation is replaced by moderate inventory rebuilding. Consumer spending growth is likely to remain near 2%. However, as indicated in my note on trade, I think net trade will not contribute much to growth in the next couple quarters and its 0.5% contribution in the fourth quarter was my biggest “miss”. I had expected a 1% subtraction from growth as imports revived.

**Employment:** The January employment report was a bit of a “head-scratcher”. Benchmark revisions subtracted an additional 1.4 million jobs in 2009, vs. the 800,000 additional job loss forecast in the October preliminary estimate. Payrolls were estimated to drop another 20,000 in January. Yet the unemployment rate, generated by a household survey that is not connected with the payroll estimate, fell from 10% to 9.7%, inconsistent with the payroll data. At the same time, the household survey did not, as has happened previously, show a further drop in those in the labor force. So the drop in the unemployment rate suggests a significant number of unemployed people found work.

The resolution of the inconsistency is likely to be an upward revision in January payrolls and positive job creation in February. Payrolls of many firms take time to update and may lag the household survey. Moreover, temporary jobs continued to increase and there was a small increase in hours worked. These statistics are likely a leading indicator of job creation. Additionally, January ISM data indicate an increasing demand for workers as do the 5.7% 4<sup>th</sup> quarter growth rate and prospects for another 4% growth in the first quarter. Alternatively, it is unlikely that there really was a 0.3% drop in the unemployment rate. Looking beyond the early year data, hiring of more than a million census workers, while temporary, should insure that employment improves in the first half, likely keeping the unemployment rate near 10%.

**A note on trade:** Although a fourth quarter 18% increase in exports allowed net trade to add a half percent to growth, the nominal trade deficit likely widened, as the quarterly increase in the price of oil and other imports will offset the narrowing in the real deficit. Thus, the financial implication is a continuation of the rise in the U.S. external debt.

The reduction in the trade deficit in the past year is welcome. However, I am not optimistic about the next year. Some of the reduction can be attributed to a weaker dollar and the robust rise in U.S. exports, but the bulk of the reduction stems from weak consumer demand. U.S. households disproportionately import consumption goods and, as measures are adopted to stimulate demand, imports will rise more rapidly than exports, raising the average monthly trade deficits. Although the percentage increases in exports

remain robust, imports are approximately 26% higher than exports and will likely expand on an absolute basis faster than exports.

The rise in the U.S. nominal external debt is my biggest long-term economic concern, one that swamps my concern for the rise in government debt. In a “closed” economy, where the debt is financed domestically, the budget deficit represents a debt that we owe ourselves and only affects the distribution of income. But the rise in the external debt results in an ever increasing debt servicing burden that saps our national income. That debt is becoming increasingly onerous and, unless slowed or stopped, will eventually impoverish the nation, both by lowering the value of the dollar and by increasing the debt service payments to unsustainable levels.

As stated in previous monthlies, the solution to the external debt is more investment and less consumption, accompanied by increasing exports relative to imports. Given the propensity to consume foreign products, it is unlikely that a focus on tax cuts to households will help. Rather, two policy measures should be adopted on a bipartisan basis:

- Tax cuts used to add stimulus in the economic recovery should be directed to business and, in particular, to subsidizing products that the U.S. exports and taxing consumption goods that the U.S. disproportionately imports.
- A bipartisan energy bill should focus on aggressively reducing energy imports and doing it quickly.

Recent political history (see the policy discussion below) is discouraging on dealing with the external debt problem quickly. Unfortunately in the U.S. a crisis is necessary before the government deals with the problem. And a crisis will come!

***The danger of gridlock:*** Many economic observers suggest that gridlock is good for the economy and the markets. I strongly disagree. Rather I think gridlock is both a reinforcing mechanism, and a negative for solving longer-run policies. Thus, in the late 1990s, when the peace dividend, the benefits of globalization and favorable demographics and the mix of monetary and fiscal policy were combining to boost the economy and household income, gridlock appeared favorable by adhering to the physician’s mantra “do no harm”, while allowing us to ignore the potential future imbalances that the situation was promoting.

In the past decade, gridlock and the unwillingness to pay attention to longer-term problems exacerbated the longer-term problems, in particular, allowing the rising external balance to go unchecked. The benefits of the tax cuts continued to boost consumption even as the distribution of household income worsened and budget deficits were allowed to persist in a period in which surpluses should have been generated.

In the current situation, gridlock will be “lethal”. The imbalances we have accumulated over the past several decades are quickly mounting to a crisis level. If the same solutions, tax cuts and spending increases are used to keep the economy running without targeting the tax incentives and spending to those areas that will solve rather than exacerbate the

problem, what has been an impending crisis will become a current crisis. Gridlock in the period preceding a crisis insure that the imbalances will become overwhelming.

What needs to be done? First and foremost, we should shift the debate away from “evils” of government vs. private spending and focus on the importance of providing investment vs. consumption incentives. The government clearly has a huge role in promoting the appropriate incentives, whether it does so by creating private tax incentives or through its spending policies: Specifically,

- Tax cuts should be focused on providing incentives to businesses, especially targeted to exports (this conflicts with world trade policy, but belatedly realizes that continued globalization has to rely on a better balance). Thus the spending should be focused on specific industries that are export driven and not to promoting exports directly. For example, subsidies to, say, Boeing should be to lower the cost of planes, not to finance exports, a subtle, but important distinction.
- Spending to promote investment and job creation should be targeted to ***quickly*** reduce energy dependence. All means should be adopted, using a broad brush approach, natural gas, clean coal investment, nuclear power, conversion of shale and coal to oil, wind and solar power etc.
- Spending on infrastructure in transportation and information technology should be increased.
- A health care bill is vitally needed for its own sake. But in addition to expanding coverage and bending the cost curve, a reform package needs to transfer the burden of health care away from business and onto the consumer. The rhetoric in the U.S. focuses on the inefficiency and danger of public health care. Meanwhile our trading partners almost all have programs that have removed the burden of such care from the businesses that produce and create jobs.

The focus on investment and productivity would lower the inflation potential in an economy that will increasingly be forced to service its public and external debt. However, the current level of unused resources is such that, despite the fact that it increases public debt, spending and tax cuts should not yet be offset with an attempt to slow consumer demand growth. However, once the economy reaches full potential, some sort of consumption tax should be adopted to offset the targeted tax and investment spending incentives and to reign in debt growth.

An unintended benefit of a consumption tax, if put in place well before the inception date, would be so stimulate near-term consumption vs. future consumption, thus helping to bring the economy back to its potential. Moreover, although the rise in public debt is a concern, the overall level of debt to GDP is contracting as deleveraging reduces private debt. The current rise in public debt is thus needed to offset the further damaging effects of rationalizing the level of gross debt and avoiding a further disruptive decline in gross spending. **The essential debt problem is not whether the debt is public or private. Rather it is whether an increase in debt is being used to finance consumption or investment.**

***The size vs. the distribution of the pie:*** Unfortunately, most of those advocating tax cuts over spending to stimulate the economy are ideologically motivated rather than educated on the importance of the issue. Both tax cuts and government spending will stimulate demand and create jobs. Obama clearly has the high ground on the issue of stimulus and jobs. Unfortunately however, rather than create jobs, the program saved jobs that would have been lost, since the downward momentum from the 2008 credit crisis insured that millions of jobs would be lost in 2009. It was a matter of stemming the tide. As indicated in the previous section, the problem with the stimulus program is not whether it saved jobs – it did – but rather that it was not targeted enough to investment vs. consumption.

Legitimate supply-side economics is concerned with increasing the size of the economic pie in the best most efficient way. It is a tool that does not address distributional, quality, or normative questions. It does not determine the appropriate:

- Distribution of income unless the distribution itself is a barrier to efficiency.
- Balance between private and community consumption, i.e. it does not weigh in on whether more should be spent on museums, national parks and public education etc. vs. household consumption of vehicles, housing, jewelry etc.
- Policies needed to control environmental damage.

Several years in the most recent expansion were the first in which the median income went down as the mean income went up. This is a warning that the policies adopted, while stimulating growth without regard to promoting investment also resulted in a more rapid rise in inequality in the distribution of income. In the 1980's past policies had resulted in a distribution of income and penalties to entrepreneurship that were inhibiting the size of the pie. However, the ideological pursuit of tax policies have now resulted in a level of inequality that will also inhibit incentives by alienating the working population that sees itself slipping out of a comfortable middle class existence.

***Why I am pessimistic:*** Unfortunately, the result seems to be that, out of frustration, voters are electing many ideologues to Congress who offer solutions that appeal, but do not address the joint problem of boosting the size of the pie while maintaining a balance of distributional considerations. While there are some shining lights in Congress, the level of debate in Congressional hearings and the ideological spin of the news on much of TV attest to the ignorance of both the voters and many of those whom they have elected. The situation appears to be getting worse.

***What needs to be done:*** In my opinion, three political developments are needed to get the U.S. back on track:

- In order to achieve their goals of efficiency and appropriate incentives, the Republican center, while a minority within the party, needs to reject the dominant right and make necessary concessions on distributional and public vs. public consumption issues to the party in power.
- The left wing of the Democratic Party needs to compromise in a way that achieves a move in the direction of addressing distributional problems but preserves incentives that ensure investment and growth in the “pie”.

- Both the rational Republicans and Democrats should focus on leading the electorate by communicating to them what they need to hear rather than insuring their re-election by telling them what they want to hear.

## **The Markets**

**Interest rates:** The Fed will keep policy rates near zero well into 2010 and probably throughout 2010 as sovereign debt problems threaten to derail the recovery. Moreover the rise in the dollar is an effective tightening, one that, if it continues, may be unwanted by both the Fed and administration. Even the withdrawal of the Fed from buying mortgage debt may be delayed if monetary leverage continues to contract and asset prices continue to decline. The Fed's balance sheet will likely have to expand further to offset these negative factors.

In last month's report, I assumed a further dollar fall would steepen an already wide Treasury yield curve. Instead, dollar strength and some "safe haven" buying have allowed the curve to flatten slightly. At 2.82%, the 2-10 year spread remains within my 2.75% to 3.10% forecast range, but the widening pressure from a falling dollar has not occurred.

I continue to expect the 2-year note yield to remain under 1%. My revised 2-3 month range on the 10-year note is 3.35-4.00%, a bit lower than my previous range of 3.50-4.2%. The growth in the U.S. economy will probably not send Treasury rates higher until the domestic and foreign credit problems recede and investors become more confident that the economic recovery will be sustained at a rate that will absorb unused capacity and labor.

**The dollar:** Last month I became less bullish on currencies and lowered my forecast ranges, especially for the euro. But I vastly underestimated the extent of dollar strength early in the year. The main impetus for dollar strength appears to be the unwinding of carry trades. Both the Japanese yen and the U.S. dollar have benefitted from the increase in sovereign risk, as investors pull back from their investments in higher-risk investments in countries with shaky finances.

In addition to heightened concern over sovereign risk, the moves in Asian countries, especially China, to slow growth have resulted in some commodity liquidation. This in turn has also favored the U.S. dollar and Japanese yen as funds from liquidation are repatriated from resource-based countries such as Australia to funding countries.

Concerns over debt in Greece, Lithuania, Portugal, Spain and Italy will likely keep pressure on the euro for some time to come. Whether or not one or more of these countries ultimately default (I don't think they will), or are bailed out in some fashion, the negative impact of the austerity measures needed to rectify the situation will limit investment opportunities and growth. I am lowering my 2-3 month euro range significantly to \$1.28-1.42 with a downside target of at least \$1.3250.

The yen has traded in line with the revised 88-90 per dollar target in last month's report. With interest rates having been so low for so long, many investors and speculators have funded their operations in yen. Thus, the recent unwinding of risk and commodity trades has benefitted the yen as much or more than the dollar. Despite the moderate rise in the dollar, the yen remains a much stronger currency. The Japanese administration is concerned about this strength but there is little they can do to reverse it given the present world financial situation. Thus I expect the yen to keep pace with the U.S. dollar until the uncertainty about credit problems ebbs and the Chinese currency is allowed to appreciate.

The Canadian dollar has been a bit weaker than I forecast, as Asian moves to slow growth and limit inflation resulted in commodity liquidation. I am lowering my 2-3 month range to 92-98 U.S. from 94-104 U.S. based on what is likely to be a near-term continuation of commodity liquidation. However, unlike the situation with sovereign debt, which will drag out over the intermediate term, commodity prices are likely to rebound in the intermediate term, as the Chinese currency is allowed to appreciate and as growth in Asian continues. I remain very positive on Canada and the Canadian dollar. The financial situation remains favorable and its position as a dependable resource supplier will support its currency. The pullback in the Canadian dollar will be a buying opportunity.

In my opinion, gold, the "other" currency is correcting from an overbought position and the general liquidation of commodities. Yet the primary reasons for owning gold remain.

- The economic, credit and debt problems in Europe, Japan and the U.S. are not going away and gold will maintain its value as an alternative currency.
- As Asian countries, especially India and China, continue to grow, the demand for gold will increase.

At current prices, the supply of gold will increase. So I am not as wildly bullish as are the prominent gold bugs. But my forecast is that gold will hold above the \$950-1000 per ounce range and, at a minimum, retest the \$1200 within the next few months.

I continue to expect the Chinese will allow a small (2-5%) appreciation of their currency in March or April, following a key party meeting. The recent public pressure for the Chinese to revalue the currency may be counterproductive, but the Chinese are well aware that if they don't soon revalue their currency, their trading partners will begin to effect counter measures that will inhibit free trade. Moreover, there are benefits to the Chinese, namely that revaluation would help the Chinese to hold down inflation and would reduce the price of key commodity imports.

If I am correct, after a moderate upward revaluation, the Chinese will allow additional appreciation to occur gradually. The model is similar to that adopted by the Chinese in the mid-2000s when they made an initial revaluation of 2.5% and allowed an additional 12% over the ensuing 18 months.

We are currently in a period of dollar strength. As discussed in the section on trade, my concerns about the U.S. external debt and its potential impact on the dollar remain. Ultimately, although it is not the only or preferred situation, I think a further dollar drop

in inevitable. But for the time being, the focus on sovereign debt in several euro-based countries, the correction in commodity prices and even the economic problems in Japan will likely keep the dollar well bid.

**Equities:** Last month I raised my 2010 forecast range for the S&P to 980 on the downside and 1300 on the upside. I also suggested that, near term, a further dollar fall would cease to be a positive factor for stocks as investors began to fear that an uncontrolled dollar fall would heighten fears that foreign investors would exit the U.S. market. My notion was that the S&P would top out at or below the 1060 area followed by a correction to the 1020 area. The correction is indeed occurring but my erroneous dollar call did not play a part in the correction.

The fall in equity prices is mostly the result of

- raised fears that the political climate is worsening and does not support a rational, healthy business climate, and
- a rise in credit concerns focused on sovereign and commercial real estate debt.

The motivation for the correction is in direct contrast with the near-term economic and business outlook. Fourth quarter profits came in better than expected and the economic growth inertia almost insures that corporate profits will continue to improve in the first half. As the economy expands jobs will be created. This will reinforce the economic recovery. As a result, I view the current fall in equity prices as a correction, not a new bear market.

My cautiously optimistic near-term forecast is that, once the current correction is over, stocks will move back toward their highs. But I am more pessimistic about the longer-term outlook than previously. Credit problems will ebb and flow and the risk is that, as in 2008, investors and policymakers alike may underestimate the gravity of the problem. Moreover the interconnectedness of world credit markets increases the potential for a systemic contraction. Residential spending dropped 18.5% in 2007 and the mortgage credit risk was well known by the end of the first quarter of 2008. The S&P first corrected in July, 2007 and after resuming its rally did not top out until early October 2007, well after the collapse of residential investment, but before the credit crisis.

If history is a guide, investors are already wary of the potential for further credit problems in sovereign debt, both at home (California) and abroad (Dubai, parts of Europe and Latin America). At the same time, there is still the consensus that states in the U.S. and countries abroad will not be allowed to default. Recall, however, that after several investment and commercial banks failed or were threatened with collapse, the G20 stemmed the systemic collapse in October/November 2008. But, aside from China, which took early fiscal action to maintain growth, the world equity markets did not bottom until March of 2009. The message is that a bailout of sovereign entities does not ensure that equity prices will not fall further for a period.

The risk to my call is that the sovereign debt crisis escalates immediately and the market heads below my near-term support without a recovery rally. However, my base case is

that the positive near-term business and economic conditions will allow a partial recovery in the S&P. A move above the previous high near 1150 would, in my opinion, be a bull trap. More likely is a recovery to the 1120 area which would be a selling opportunity.

Based on the pessimistic policy outlook expressed earlier in the report, I am reevaluating my 2010 equity range. I do not look for a double dip in the economy and, I think companies will continue to maintain margins despite further credit shocks. So profits will likely hold up this year. But if the political gridlock and uncertainty persist beyond the normal “jockeying” period of winter posturing and extend beyond the spring thaw, prospects that electioneering will completely dominate discussion will send equity prices lower than my moderately optimistic forecast for the second half of 2010.

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