



Economic and Market Update: March 8, 2010

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Summary

The impact of a revised 5.9% growth rate in the fourth quarter is spilling over into the first quarter which I estimate to be growing at 3-4%, despite the negative impact of February snow storms in the East. A move to inventory accumulation is likely to add 1-2% to first quarter growth while consumer spending should also add 1.5 to 2%. Housing and net exports are likely to subtract a bit. The “square root” recovery (tepid growth after a couple good quarters) looks more and more likely as state budget problems dog the economy and households continue to repair their balance sheets.

Net job creation should begin in March and continue at a 200,000+ per month rate in the second quarter as Census jobs ramp up and the decline in manufacturing jobs ends. However, the unemployment rate will likely remain stubbornly high as a significant move out of the labor force reverses.

I am lowering my 2010 core inflation forecast to 1.8% from 2.1%. Substantial increases in productivity and a decline in unit labor costs affecting 70% of the economy should swamp the increase in basic material price increases which account for less than 10% of the inputs into production.

Short term rates will remain near zero and longer term rates are likely to remain in a range near present levels through the first half. Longer-term I remain negative on the dollar, but gains are likely to be concentrated in the Asian, the resource exporting and the emerging market currencies.

There is a significant divergence between economic performance and equity prices that has generally prompted economists, including myself, to underestimate the strength of the stock market rally. The over-reaction of stocks to the downside, coupled with better-than-expected productivity gains from sharp labor force reductions, has allowed corporate earnings to rebound sharply. And equities remain the “only game in town” domestically as housing prices remain moribund, short term interest rates remain historically low and the rise in debt and inflation fears make investors wary of longer-dated fixed income securities. Recently a pickup in M&A activity is also contributing marginally to stock price increases.

The Economy

Growth: Fourth quarter growth was revised up 0.2%, to 5.9%. Inventory liquidation slowed more quickly than previously anticipated, contributing 3.88% (2/3rds) of the growth, and investment was a bit higher. However the net export gain was revised down slightly and household spending growth that is needed to sustain a recovery once the “kick” from the inventory swing is dissipated remained tepid, contributing just 1.23% to the growth. The household spending contribution was down from 1.96% in the third quarter.

First quarter growth is likely to be in the 3-4% range. The swing to a small inventory accumulation from a \$17 billion liquidation to a \$15-45 billion build will contribute 1-2% to growth. Consumer demand appears to be holding up, even in weather-affected February, and will probably contribute 1.5 to 2% to growth. Investment will also contribute a percent. Net exports, government expenditures and commercial and residential structures will likely subtract a percent.

Second quarter growth will be sustained by the reinforcing effects of the return to goods production growth and income gains from rising employment. Consumer demand should add 1.5% and investment another percent. Housing construction will subtract less and government will likely add a few tenths. Net exports are a wild card, but are not likely to contribute much. And inventories are likely to be a small contributor, less than 1%. On balance, I expect growth to be 2.5-3.5%.

Growth in the second half of 2010, and beyond, will likely stay in the 2-3 percent range, as the contribution from the inventory swing ends. This growth rate is insufficient to return to potential GDP or reemploy the jobless in less than 4-5 years. It is also insufficient to outstrip the growth in external debt. Consumers will continue to repair their balance sheets, many workers will remain unemployed and a significant subgroup will have trouble keeping up with their mortgage and other debt payments. Businesses, especially small businesses, will remain uncertain about tax and regulation policy as few issues will get resolved in this Congress. In particular, both household and business tax cuts related to the 2001 recovery act will expire at the end of the year and, to date, this issue has not been addressed in Congress. Net exports are not likely to provide growth if the dollar remains stable and overseas growth remains tepid. Finally, state and local government budget cuts will offset much of the remaining stimulus coming from the Federal government. Moreover, the rise in public debt to offset the decline in private lending is reaching the limits of public acceptance. In summary, the normal tendency of the economy to sustain growth following a recession will be countered by the particular headwinds associated with the end of the 25 year tax cut and excessive debt creation stimulus that began in 1982 and ended with the 2008 credit implosion.

A note on investment-led growth: Some observers predict an “investment-led” recovery, citing an 18.2% annualized growth rate in investment expenditures in equipment and software (and excluding commercial and residential structures) in the fourth quarter. And I often write of the need to increase investment relative to consumption to generate the productivity and growth needed to service the increasing external debt. But **the idea of an investment-led recovery is absurd.** Even with low interest rates, investment will only take place if businesses perceive a

demand for their goods or services. So over the intermediate to longer term, investment will only grow if aggregate demand grows.

Statistically, equipment and software represent only 7% of GDP. Thus, the 18.2% rebound in investment spending, resulting from a recession-low rebound, contributed only 1.1% or 12% of the 5.9% fourth quarter growth. What is needed to spur the kind of investment needed to service our external and domestic debt is an increase in net export demand and a shortage of labor. Like the U.S., Canada has long had an external debt, as foreign investors poured capital into Canada. Unlike the U.S. however, much of this influx of capital was used to invest rather than consume. As important is the fact that Canada generally has enjoyed a trade surplus, allowing it to service the debt, have an appreciating currency (in recent years) and, thus hold down the burden and the rise in external debt. In contrast, even with the trade deficit cut in half, the external debt of the U.S. is increasing at a rate near 3% of GDP. This would not be so bad if growth prospects in the U.S. were 4-5% and if the external debt level, at about 35% of GDP and rising, were not so high.

Employment: There's good news and bad news on the employment front. The good news is that job gains over the next 4 months should be robust, averaging more than 200,000. Any weather-related job losses in February should add to gains in March, especially in construction. The Challenger data indicate mass layoffs have dropped to a level that is consistent with net payroll gains. The move from inventory liquidation to moderate accumulation in the first quarter should lead to some hiring in the goods sector. Hiring of temporary workers, a sign of increased job opportunities, increased another 48,000 in February bringing the net hires to 284,000 in the past five months. Finally, nearly a million temporary government workers will be hired in the next few months to conduct the decennial census.

Unfortunately, the bad news is that, in February, the number of under-unemployed added to the unemployed raised the combined rate to 16.8% from 16.5%. The number of long-term unemployed (more than 26 weeks) remains 6.1 million or 40% of the total unemployed. Many, especially older workers, will not find comparable work. Census jobs are not permanent and will reduce net job gains in the second half of 2010. On balance, the unemployment rate is likely to remain between 9 and 10% in 2010 and would likely rise above 10% if not for census employment.

Expanding on the employment situation, there are many statistics in the Bureau of Labor Statistics (BLS) report that indicate the severity of the situation. The table on the following page (Table A-13 in the BLS report) illustrates how job losses over the past year are distributed. Keeping in mind that nearly half of the losses were incurred before February 2009, the bulk of the 2.9 million job losses in the past year were in goods production. And within the service occupations, the job losses were concentrated in sales and support. Professional and managerial jobs actually increased marginally, although the unemployment rate rose in these professions as those seeking such jobs increased more than the jobs available.

Inflation and productivity: I am lowering my 2010 inflation forecast to 2.0%. Previously, I forecast overall inflation, including food and energy to increase quarter by quarter and to be 2.3% in 2010 (vs. 2.8% in 2009). The main reason for the reduction is that I am lowering my estimate of 2010 core inflation to 1.8% from 2.1%.

Regarding overall inflation energy prices have been the chief upside driver of CPI in the past few years and that will likely continue to be the case. Commodity prices in general are in a secular bull market driven by increasing Asian demand that, to date, has been outstripping supply increases.

Employed and unemployed persons by occupation, not seasonally adjusted

HOUSEHOLD DATA						
Employed and unemployed persons by occupation, not seasonally adjusted Numbers in thousands						
Occupation	Employed		Unemployed		Unemployment rates	
	Feb. 2009	Feb. 2010	Feb. 2009	Feb. 2010	Feb. 2009	Feb. 2010
Total, 16 years and over⁽¹⁾	140,105	137,203	13,699	15,991	8.9	10.4
Management, professional, and related occupations	52,196	52,324	2,137	2,637	3.9	4.8
Management, business, and financial operations occupations	21,668	21,573	1,018	1,165	4.5	5.1
Professional and related occupations	30,528	30,752	1,119	1,471	3.5	4.6
Service occupations	24,110	24,133	2,415	2,878	9.1	10.7
Sales and office occupations	34,161	33,118	2,983	3,465	8.0	9.5
Sales and related occupations	15,676	15,081	1,438	1,704	8.4	10.2
Office and administrative support occupations	18,485	18,037	1,545	1,761	7.7	8.9
Natural resources, construction, and maintenance occupations	13,191	12,407	2,845	3,259	17.7	20.8
Farming, fishing, and forestry occupations	821	856	238	252	22.5	22.7
Construction and extraction occupations	7,328	6,819	2,163	2,457	22.8	26.5
Installation, maintenance, and repair occupations	5,041	4,732	445	549	8.1	10.4
Production, transportation, and material moving occupations	16,448	15,220	2,469	2,720	13.1	15.2
Production occupations	7,868	7,404	1,246	1,343	13.7	15.4
Transportation and material moving occupations	8,580	7,816	1,223	1,377	12.5	15.0
Footnote						
⁽¹⁾ Persons with no previous work experience and persons whose last job was in the U.S. Armed Forces are included in the unemployed total.						

My rationale for lowering my core inflation estimate is the huge productivity gains and reductions in unit labor costs in 2009. Productivity increased 5.8% and unit labor costs fell 4.7%. Labor represents more than 70% of all goods and services inputs while commodities represent less than 8%. Both labor and capital are in excess supply and will remain so in 2010. Corporate profits have risen inordinately despite the fall in demand in 2010. This will promote more competition in those industries that have lower barriers to entry. For example continued excess capital in the trucking industry has been steadily lowering transportation costs. Moreover, technology advances are lowering the cost of many consumer and industrial goods. Generally, inflation lags the economy even more than employment. Thus, it is “normal” for core inflation to fall in the first year or two of an expansion as aggregate demand increases but labor and capital costs continue to fall. In this case, however, because of relatively aggressive layoffs some of the productivity gains that usually result in the initial expansion may have already been realized. Were that not the case, I would lower my core inflation forecast even more.

A note on the Fed: Donald Kohn, vice chairman of the Fed is resigning in mid year, opening up a third slot on the board. Before being appointed as vice chairman, Kohn was a career staff member at the Fed and is probably the most knowledgeable vice chair ever with regard to the “nuts and bolts” workings of the Fed. His exit leaves a significant void in the institutional memory and expertise at the Fed.

Before Kohn, the vice chair of the Fed served the role of political liaison between the Fed and the Administration. Many have come from the Council of Economic Advisors (CEA). Thus, Christina Romer (current head of the CEA), Austan Goolsbee (current member of the CEA), and Janet Yellen (former CEA head, former Fed board member, and current San Francisco Federal Reserve Bank president) are likely candidates for the Vice Chair job. Despite their association with the Democratic party, all are competent professionals, respected by key Senate members of both parties. One of the other two spots will likely be filled by a banking and/or banking regulation expert. If Romer goes to the Fed board, Goolsbee will likely head the CEA.

The Markets

Fixed income: As indicated in the economy section, inflation is not a risk in 2010 and “rampant” fears of inflation over the longer-term are overblown and not at all “baked in the cake” as some observers fear. At the same time, near-term burdensome supply and credit risk are likely to keep both the risk premium high and the yield curve steep.

Even as the Fed continues the process of normalization, cautiously removing the emergency measures, two facets of the policy will remain in place for “an extended period”

- The fed funds rate will remain anchored at 0-.25% until at least the fourth quarter.
- The Fed’s balance sheet will remain historically elevated, likely well above \$2 trillion and possibly approaching \$2.5 trillion if the Fed feels it has to continue to buy mortgages past the April 1 cutoff date.

Early in the year New York Fed president, William Dudley, suggested a Fed balance sheet of \$2.5 trillion was appropriate (the balance sheet stood at \$800 billion before the financial crisis).

As I have pointed out previously if, as I expect, banks moves to put their off-balance sheet accounts back on the balance sheet are not reversed (and I don't think they will be), the pre-crisis Fed balance sheet was insufficient to support the economy. **Until and unless credit leverages up to its previous level relative to real production, a much higher balance sheet is warranted and is not inflationary.**

Two year treasury yields will continue to be held down by near-zero three month rates and a steady fed funds rate. They have, however, risen marginally above my one percent forecast. I expect them to stay in the 1-1.25% range for next few months. Absent an unexpected negative financial or political shock, I expect the 10-year Treasury note yield to stay in the 3.60-4.00% range, the upper end being tested if, as I expect, the equity rally lasts a few more weeks.

As Bill Gross has pointed out in his latest report (Pimco.com), sovereign debt risk is rising. And even though the U.S. retains an AAA rating, a portion of the risk premium referred to above is reflected in the steepness of the Treasury yield curve. Currently the spread between A-rated corporate and Treasuries ranges between approximately 1.9% and 2.4% in the 2-year to 20-year duration area. Treasury rates might be lower and the spread wider if the Federal budget deficit and future projections were not so onerous.

The dollar (and gold): It's a "Mexican standoff". Dollar/euro appears to have settled into a range between approximately 1.34-1.38. Bears on the euro cite sovereign debt and slow growth as the primary reasons for the euro to move lower. Dollar bulls add that, whatever the financial problems facing the U.S., problems in Europe are worse.

Dollar bears, and I am one longer term, are concerned about the onus of the rising external debt. As is the case with falling job losses, the fall in the trade deficit is "less bad", not positive. Near term, the recent rise in U.S. equities and the "availability" of increased triple-A debt should be attracting investment in the U.S. However, I suspect that the appetite for yet more U.S. sovereign debt is waning, offsetting the inflows of capital to buy U.S. equities. As indicated in the growth section, state budget deficits, will weigh on the economy and result in higher Treasury debt as the Federal government will continue to come to the aid of needy states.

Near term, I view the risks as balanced and am neutral on the euro. I suspect the downside is limited to 1.32-1.34 and the upside below 1.4. A muddled-but coping European strategy for managing the debt problems of Greece and other countries will keep a floor on the euro. Conversely, there is no near-term catalyst for the euro to rise above the 1.38-1.40 range.

The yen has been in a range of 88-94 per dollar since late November, 2009. Compared with the U.S. and Europe, Japanese sovereign debt relative to GDP is considerably higher and rising. At the same time, Japan has a much larger external surplus than Europe and contrasts with the huge U.S. external deficit. Coupled with its high domestic savings rate, debt is not the problem it would be if the U.S. or European country debt levels were as high. This offers the biggest support for the yen.

Near term, the yen has been propped up by some repatriation of capital resulting from deleveraging. Because of the extremely low borrowing rates in Japan over the past two decades,

many institutions, many of them non-Japanese, borrowed and leveraged huge amounts of debt denominated in yen during the world credit expansion and are now paying down a portion of their commitments. Thus despite calls by dollar bulls for yen depreciation and a concern by Japanese officials about the value of the yen, the yen has maintained its value against the dollar.

Over the next few weeks, I think the yen could move back to the 92-93 level vs. the dollar, as capital flows to the U.S. and Europe (in part to finance European debt). My 3-4 month range is 90-94.

Despite the recent correction in commodity prices, the Canadian dollar remains well bid. I continue to expect it to retain its value against the dollar. My 3-4 month range is 94-98. At its present value, \$.97, it is nearing the top of my range. The Canadian government would like to see it stable and a bit lower. But the fundamentals remain the most positive of the G7 countries. Thus, longer term, I expect the Canadian dollar to rise above parity with the dollar.

Despite official remarks to the contrary, I continue to think that the Chinese government will soon allow a limited upward appreciation of the Chinese yuan. Domestically this would help to alleviate inflation pressures and lower the cost of imported resources. The results of a recent stress test allegedly show that profits in several key export industries, such as textiles would be severely hurt. However, the rising external surplus coupled with an increased probability that Chinese trading nations will adopt anti-free trade measures will force the Chinese to “bite the bullet” following the upcoming party strategy convention. And they need to refocus their efforts even more to improve domestic living standards. I think that the yuan will be revalued up by 2-2.5% in the second quarter and, as was the case in the middle of the last decade, be allowed to gradually appreciate another 10-12% over the next two years.

Due to high budget deficits and the rising stock of debt relative to GDP (see last month’s chart), the soundness of financial currencies is in question. While I am not a “gold bug” – see Marc Faber’s latest diatribe, recommending monthly purchases of gold “forever” -- I agree that the price of gold is likely to rise further over the intermediate to longer term. Specifically:

- Viewed as a currency, gold will be stronger than the U.S. dollar, the euro and the yen by default.
- The rapid rise in Chinese and Indian incomes will increase the demand for gold and silver.
- Asian central banks, Japan excepted, are likely to continue to diversify their reserve holdings and increase their holdings of gold in the process.

The case for gold is one of currency risk and demand, not one of inflation.

Equities: Following a moderate (9%) early year correction, stocks, on average, have regained most of their losses. The horrendous developments in the first quarter of 2009 makes recent data look good by comparison. And while there has been a sharp rotation, e.g. a number of dividend paying stocks such as Verizon and Pfizer and technology stocks, Microsoft and IBM, have corrected more than the market, on balance, the market looks poised to move higher. Apple and Cisco are already at new recovery highs. A further rally should be broad-based. At the same time, this leg of the rally should end within 4-6 weeks.

Before enumerating the positives, I will attempt to put a bit of perspective on the relationship of the economy to stock prices. And in doing so, a confession is in order. Many economists, **myself included**, have underestimated or even missed (David Rosenberg and Nouriel Roubini) the stock market advance. The reason for this, in my opinion, is that, unlike in previous post WWII recessions, the relationship between employment and corporate profits is significantly different. Businesses were both much quicker to lay off workers and cut their labor force much deeper, leading to higher margins than historically would have been the case. A lesser reason for the miss is the propensity to view the substitution of public support in the markets vs. private credit creation as more negative than it is. The depth of the bear market that preceded the rebound assumed that fiscal policy would not have the supportive impact that it did. Finally, interest rates are likely to remain lower for a sustained period relative to other post war recoveries, supporting a higher PE ratio than is typical.

In addition to the positive impact of low interest rates, other positives supporting the stock market advance are:

- The bear market overcapitalized the extent of the “great recession”, leading to a powerful rebound.
- Consistent with the aggressive layoffs, productivity and thus profit margins have fared much better than expected.
- Domestic opportunities in competing investments, housing and longer-dated fixed income have been relatively less appealing.
- As a corollary to the opportunity cost comparison, the liquidity provided by the Fed to support the financial markets as private credit deleverages, is finding its way into both stocks and non-housing real goods, e.g. commodities.

Given my longer-term view on the economy, I find it difficult to overcome my cautiousness on the stock market. However, near-term, absent a negative credit shock or hostilities in the Middle East, the positive factors cited above will likely take the market somewhat higher. In my January monthly, I raised my yearly S&P range to 980-1300, from 880-1250 citing the above positives. I also established a first quarter range of 920-1160. We did not quite get to the bottom of that range (the S&P inter-day low was 1040), and the risk is now that the S&P will move a bit above my previous 1160 high to the 1175 to 1225 level. However, in the immediate future, the market will have to break through the 1150 area that stopped it in mid-January. While it is not my base case, I don’t rule out a “bull trap”.

Likely earnings of \$80 a share and continued low interest rates at the short end will support both PE’s and stock prices this year. But the negatives, including the prospects that the Fed will slowly normalize the emergency liquidity measures and that the public sector will eventually have to make “claims” on the private sector, will weigh on stock prices over the longer run.

A lower dollar and huge investment expenditures related to expanding exports are the key to growth in the longer run and to a higher stock market. These developments will counter the negatives. But the mix of plusses and minuses are likely result in equity gains that are below the long-term historical norm.

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