



## **Economic and Market Update: April 5, 2010**

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### **Summary**

First quarter growth, to be announced Friday, April 30, will likely slow to 3-4% from the 5.6% fourth quarter 2009 level. Although auto sales picked up, residential housing was a modest drag on growth. Consumer spending remained restrained, growing near 2%. Second quarter growth is also likely to be 3-4% with job growth supporting another moderate increase in consumer spending. Ongoing momentum from the stimulus and the end of inventory liquidation is likely to increase jobs by 600,000-800,000 in the second quarter. However, job creation continues to lag GDP growth and corporate earnings increases.

Second half growth will likely remain subdued as positive cyclical factors are mitigated by continuing secular constraints brought about by the 2008 financial crisis, remaining private balance sheet problems, and federal, state and local financial deficits resulting from that crisis. Although growth is likely to be 2-3 percent, this will not be sufficient to bring the unemployment rate down quickly. Inflation will remain subdued, as wage growth continues to slow. The Fed will not hike the funds rate before the November election..

An improvement in U.S./Chinese relations removes a potential negative from developing in mid April when the economy and markets faced the prospect of the U.S. declaring China as a currency manipulator. Hu Jintao's April 13 trip to the U.S. defuses this possibility and likely signals that China will allow a small appreciation of its currency before the June G20 meeting. This development should remove the fear of both a trade war between the U.S. and China and the possibility that the long end of the Treasury market will be disrupted.

Although some observers think that equity prices have appreciated too much relative to the economy, I think the rise in prices reflects:

- The decline in fear that the financial crisis would return,
- The rapid rise in profits due to productivity gains and the drop in the wage component of corporations

Stock prices remain well below their previous highs and the robust rise has much to do with the "overshoot" on the downside. Moreover, until wages begin to rise more quickly and housing prices rise, the Fed is forced to support asset prices as a means to insure growth.

Longer term, interest rates will rise, the dollar will likely depreciate more against Asian and emerging market currencies and U.S. equity gains will be less than in previous economic cycles.

Near term, however, short term rates remain anchored near zero percent and I expect the dollar to extend recent gains against the euro and yen. I also expect equity prices to extend their gains in April.

## The Economy

**Growth:** First quarter growth, to be announced Friday, April 30, will likely slow to 3-4% from the 5.6% fourth quarter 2009 level. Auto sales picked up, especially in March as incentives spurred buying. Away from autos retail sales also held their own, although the contribution of household consumption to growth in the quarter was probably 2.5%, well up from the 1.16% contribution in the previous quarter. In contrast, residential housing likely subtracted half a percent as the impact of ongoing incentives does not appear to have overcome other negatives. The inventory overhang in both new and existing homes is still above where it needs to be for a healthy market. Clearly some of the growth in household consumption in the quarter came at the expense of residential housing.

Investment in equipment and software probably added several tenths to growth as temporary incentives from various stimulus programs and technology upgrades are spurring sales. However investment in commercial structures will continue to fall. And the contribution due to lower inventory liquidation will likely add just a percent to growth, well down from the 3.8% contribution in the previous quarter. As a whole, investment, excluding residential housing, will contribute about 1% to GDP.

If consumption and investment combined account for 3% growth, as is my forecast, then net exports and government will have to add an additional percent to reach the upper end of my 3-4% growth forecast. In the fourth quarter, the sum of these two added nothing as government spending subtracted 0.26% of the 0.27% that net exports added. And in the first quarter, net exports to date do not look to add to GDP. Moreover, state and local governments are constrained by deficits. While the error in my forecasts is likely a full percent either way, unless my forecast for household consumption is low, it appears the bias in my estimate is toward the lower end of my range.

I have raised my second quarter growth forecast by 1/2 % to 3-4%. Weather probably took a few tenths of growth out of the construction and manufacturing market in the first quarter and that will get added to the second quarter. Housing sales should rebound a bit more than the seasonal suggest in the second quarter as potential buyers rush to take advantage of housing credits that expire at the end of the quarter. Employment gains will also begin to allow earned income to grow faster, although continued softness in hourly earnings will weigh on personal income. Moreover, downsizing of postal service employment by 30,000 will mitigate the impact of census worker hiring. In general postal service pay exceeds that of temporary census workers.

**Employment:** I expect robust employment gains in the second quarter. At 162,000, the March employment gain came in below the consensus. However, there were some compensating factors. Revisions of the previous two months added 62,000 workers bringing the net change to 224,000. Only 48,000 census workers were added, versus estimates that over 100,000 would be added. As expected, construction workers increased. These workers were the most negatively

impacted by the bad weather in February and the gain simply amounts to a “bounce-back”, despite the poor performance of housing in the quarter. Temporary workers continue to be added and the workweek ticked up another 0.1 hour to 34 hours. Given that a couple hundred thousand temporary census workers will be added in the second quarter, the outlook is for employment to gain 600,000 to 800,000 or an average of more than 200,000 per month for the next three months.

Hourly and weekly earnings gains over the past year have, as is usual in a recession, been low, with the increase in the latter just 1.76%. Indeed real earnings over the past decade are barely up. Moreover, many of the hires that are currently taking place are temporary and thus not likely to have benefits associated with full time jobs. Thus, despite the expected employment increases, household income gains will be quite low.

***A note on cyclical vs. secular growth:*** There is a debate among economists as to whether the economy has entered a V-shaped recovery or, rather, a rebound that will transform into a sub-par “square root” recovery, i.e., one that will flatten out prematurely. Those looking for a V recovery rely on past recoveries that look like the current one to date and cite such a huge amount of monetary and fiscal policy has been “thrown” at the problem that the recovery will, in much shorter time than the consensus, bring down the employment rate. Robert Barbara is in this camp.

Those looking for a more restrained recovery agree with the notion that it currently looks like a V (5.6% growth in the fourth quarter 2010 and perhaps up to 4% in the first half of 2010). They also agree with the notion that a combination of monetary and fiscal policy is responsible for avoiding a more disastrous outcome and that employment gains in the second quarter will be significant. However, beyond that, the economy faces secular headwinds that are likely to significantly impede growth. Mohamed El-Erian of PIMCO espouses this view and calls it the “new normal”.

I am in the “square root” camp. Current growth is cyclical and is the result of the end of inventory liquidation combined with the policy response. Employment gains are emanating from that fact that, in their panic, businesses laid off too many workers in order to preserve cash and capital. Thus they have to hire workers to keep up with the demand that, fortunately, stabilized at levels above their worst fears.

Historically, once the cyclical rebound ended, a secular expansion continued. In the early years following WW2, this was fueled by pent up demand, rising wages, and investment in consumer products and services that were both delayed by the war and, in many cases, evolved out of technologies developed to fight the war (or in subsequent years were often by-products of the space program and cold-war arms race). Since the early 1980’s expansions were fueled by lower taxes, higher willingness to finance consumption with debt, positive demographics resulting from the “baby boom” moving through the life cycle and benefits from globalization.

Most of these positives have either been exhausted or, in some cases, reversed. In particular, positive demographics have become negative as baby boomers age and as concern over immigration has surfaced. Debt levels rose faster than GDP growth and to a level that could not

be sustained. Thus, household balance sheets are being repaired and the drive from asset-fueled consumer demand has now become and will remain a drag for several years. Moreover, tax incentives are likely to be replaced by tax increases or government demand cuts as politicians are forced “kicking and screaming” to bring outsized deficits (local, state and Federal) down. Either income to those expecting “entitlement” payments will be reduced or taxes will have to be raised. The alternative is a deterioration of credit quality, not unlike what has happened to households and bank institutions.

Finally, while globalization could remain a positive, it is, for the time being, a negative. Competition for resources is replacing the benefits from cheaper overseas production that has held down prices. Although productivity is higher in the U.S. for many goods, wages also remain higher and despite high unemployment, outsourcing will still occur. Moreover, many of the nations such as China with whom the U.S. has its biggest trade deficits protect their infant industries, often ones in which the U.S. could compete.

Debt levels cannot be brought into line too quickly, nor interest rates raised too quickly. If that occurs, demand will be insufficient to keep the economy and tax revenues growing. Thus, at best, the economy faces sub-par growth and probably a falling dollar until both the external and domestic debt levels can be supported by growth. In effect, the U.S. will have to “grow” into its debt payment ability by reallocating resources away from consumption, both private and public, and towards investment. But investment will only occur if incentives are restructured toward increasing exports. A portion of this “restructuring” is occurring through dollar depreciation against emerging-Asian economies and resource-intensive currencies.

Deficit-reducing state and local governments and banks continuing to repair balance sheets will mitigate growth in the private sector. As a result of this and the other headwinds cited above, once the “rebound” from bringing inventories into line with demand is over, growth will slow to a level, probably 2-3%. This may seem reasonable by historical standards but is insufficient to absorb many unemployed workers for years to come. Moreover, downward pressure on wages is likely to continue both as a result of unemployment and globalization. The current administration, which is perceived to be “biased” toward labor, can do little to stem these trends. The most it can do is to enact some redistribution of income to slow the increase in income inequality of the past couple decades. While this may be long overdue, it could impede progress in dealing with the U.S.’s increasing external debt.

***Inflation, the Fed and fiscal policy:*** Some of the headwinds the U.S. faces could eventually put upward pressure on prices. Certainly this is one of the current concerns of some observers. However, inflation is not “baked in the cake”. It is a choice the Fed has to consciously make in deciding how to bring the level of debt into line with our ability to service the debt.

Near term there is little threat of inflation and last month, I lowered my year-ahead inflation forecast by 0.2%. Core inflation is likely to remain under 2% for the next year or two. Moreover, as discussed in previous monthlies, the “only game in town” given the level of unemployment and concern that housing prices will fall further is to boost asset prices to spur demand. This is being done in concert with a fiscal policy that is also geared to demand creation.

Despite my forecast of a more robust pick up in employment, job gains will not be sufficient to increase wage pressures. Typically real wages decline in the early stages following a recession and, given the magnitude of unemployment, they can be expected to decline in the coming year. Although there are calls for removing language that locks the Fed into holding the funds rate near zero for many months, Chairman Bernanke is likely to guide the Fed to hold rates at current levels at least until after the fall election. Before raising rates he must be convinced that sustained growth last beyond the first half cyclical recovery, and that employment gains will continue in the second half of 2010.

Given the choice of low rates and tighter fiscal policy or higher rates and looser fiscal policy, both the administration and the Fed would overwhelmingly choose the first combination. Local and state governments will tighten fiscal policy because they have no choice. And there appears to be increasing pressure on Congress to do the same. Moreover, note that despite rhetoric to the contrary, over the recent past, Federal government direct spending has contributed little to GDP. Despite the recession its contribution to GDP growth was 0.39% in 2009 versus 0.59% in 2008. Most of the stimulus money represents a transfer payment to businesses and state governments.

The bottom line is that, although the wording of its communiqués will change, the Fed will not hike rates before the November election. It will continue to take additional steps to reverse the temporary emergency measures. In particular the discount rate will likely be raised another quarter point. But if the economy shows signs of faltering once the current cyclical rebound is exhausted, the Fed will hold rates near zero indefinitely and will, if necessary, resume buying assets to boost its balance sheet and offset the decline in leverage in the private system.

***A note on U.S./China economic relations:*** Domestic pressure has been building on the administration to designate China as a currency manipulator in an annual Treasury report due on April 15. Such a designation would be a “lose/lose” situation if China responded by implementing its own trade restrictions or, as some fear, by selling U.S. debt (I consider that an unwarranted fear since, although it would be disruptive to the markets, China would depreciate the value of its external assets enormously).

On Thursday, April 1<sup>st</sup>, the Administration announced that Hu Jintao, China’s president and, more importantly, General Secretary of the Chinese Communist Party will visit Washington on April 13. His visit tentatively reverses the recent deterioration in U.S. Chinese relations. More important and immediate for the markets is that it eliminates the possibility that the Treasury will designate China as a currency manipulator on April 15.

Given the increasing pressure on the administration to protect American workers and to “stand up to China”, especially from the Senator Schumer camp, it is unlikely that the administration would have agreed to the visit without a “behind the scenes” understanding that China would at some point in the near future make some concessions to avoid a trade war. In particular, I think that, before the June G20 meeting, China will make a small adjustment in the yuan, perhaps 2-3% and allow it to appreciate slowly thereafter. This would essentially be a repeat of the 2005-2008 policy and would buy time for the U.S. and China to develop further agreements on how to reduce the trade deficit without unduly disrupting the Treasury market.

## The Markets

**Fixed income:** The announcement that Hu Jintao will visit the U.S. on April 13 should ease near-term fears about a disruption from further deterioration of U.S./Chinese relations. Thus, despite the normal increase in rates associated with a pickup in the U.S. economy and rising stock market prices, this should stem a further widening in the curve, for now. Thus, despite the sudden 25 basis point March rise in the 10-year note yield, I am maintaining my 2-3 month range of 3.6-4.0%.

Longer term, yields across the curve should work higher, both because of normal cyclical factors, the increasing volume of debt and because of the subtle decline in the sovereign debt quality cited in last month's report. Indeed, if the U.S./Chinese trade deficit narrows and as the Chinese diversify their holdings into other assets more of the debt will have to be held elsewhere, and, mostly, domestically. Banks will continue to be aggressive purchasers at the short end of the curve and for their customers at the long end of the curve. However, to sustain their purchases rates will need to be high enough to offset opportunities elsewhere.

Although I am maintaining my near term range for the 10-year note, over the intermediate term, unless the Fed purchases longer-term Treasuries and allows its balance sheet to expand further, I think the rate will eventually move above 4% to the 4.25-4.50% area. And despite its historic steepness, the yield curve is likely to steepen further.

There is a somewhat prevalent view that if the Fed hiked rates, longer-term rates would ease. This is a mistaken view, at least early in the cycle. It is true that the yield curve tends to flatten, but only because short-term rates go up more than long-term rates. Only at the end of a business cycle when a rate rise is perceived to slow the economy do long-term rates begin to fall. The only situation that would cause longer-term rates to fall would be if a Fed move to hike rates was deemed to be a mistake and there was a flight to quality due to fears that the move would abort the recovery. And even in this case the impact would be mitigated by a deterioration of sovereign credit quality as investors would fear a downturn in tax revenues and a further widening of the fiscal deficit.

**The dollar (and gold):** As indicated above, I expect a Chinese move, within three months, to allow a limited appreciation of the yuan. Timing is difficult, but if widespread anticipation of a move results in massive speculation, the move could be sooner rather than later. The Chinese would probably like to wait until after Hu's meeting with Obama in order to dispel the notion that Hu capitulated to U.S. pressure. Nevertheless, a move before the meeting could be perceived as a "good will" gesture on the part of the Chinese. Historically, the Japanese have made such gestures, but other countries have not.

I am raising my 2-3 month range on the Canadian dollar to 96-101 cents from 94-98 cents per dollar. Of the major currencies that I comment on, I remain the most positive on the Canadian dollar. The Canadian government does not want to see their currency rise too quickly, but have only been able to smooth the upward trend.

I am shifting my view on the euro from neutral to cautiously negative. Although I am negative on the dollar longer term against the Asian and resource-based currencies, I am equally, if not more negative on the euro. The “fudge” solution adopted with Greece suggests, at a minimum, that the Euro-based nations will do what is necessary to preserve the currency union. This has been mildly supportive of the euro recently. But, the euro probably remains a bit overvalued relative to the dollar. Thus, if U.S. Chinese relations warm a bit, the bias for the euro will be another leg down to the 1.22-1.26 area.

Last month I forecast that dollar/yen would strengthen a bit toward the upper part of my 90-94 range. In fact it strengthened more than I thought, moving just above the 94 level. A warming of the U.S./Chinese relationship is generally good for other Asian currencies, including the yen. Near term, however, I think the trend to a higher dollar/yen will continue. I am raising my 2-3 month range to 92-97.

In last month’s report, I made a case for why gold would go higher in the intermediate to longer run. Specifically, I wrote:

- 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.

I added that the case for gold is one of currency risk and demand, not one of inflation. An easing of tension between the U.S. and China removes some of the risk factor. Thus, my near term bias is for a further downside correction in the price of gold. Longer term, I remain positive.

**Equities:** In the past month, the S&P rallied through the 1150 area considered by many as resistance and rallied into the bottom end of my 1175-1225 target area. The apparent breakthrough in U.S./Chinese relations eliminates what I considered to be the biggest negative that could have led to a nasty correction. And while markets do not go straight up without occasional corrections, the outlook for the next few weeks should remain positive.

The bulk of first quarter earnings will be reported between mid-April and mid March. Away from housing, the outlook is excellent. While much of this may already be built into the market, I think the S&P will move to the 1200-1225 level in anticipation of earnings.

My 2-3 month range is 1150-1225. Although I see higher levels in April, I still think the intermediate –term upside is limited by the less-than-stellar outlook beyond the first half of 2010. Thus, I expect another 10% correction from higher levels. See my previous monthly report for a summary of why the market continues to outperform the economy and forecast of many economists.

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