



Economic and Market Update: May 10, 2010

David Horner
Economist

Summary

Despite a more encouraging 3.6% increase in household consumption and a 1.57% contribution in inventories, first quarter growth came in a bit weaker than expected. At 3.2% vs. the consensus of 3.4%, it raises the possibility that the “square root” (growth flattening out too soon) growth path is emerging a bit sooner than I expected. I am holding my forecast for second quarter growth at 3-4%. However, due to concerns that European debt problems will be “contagious” I am more cautious than previously about second half, 2010 growth (a section on the European debt crisis is included following the growth discussion).

Including upward revisions to February and March, the Labor department reported 411,000 job gains in the Friday, May 7 report. The gains were broad-based. Nevertheless, caveats to the healthy report are:

- temporary employment is garnering too big a share of the gains,
- compared with previous recessions, job losses are, to date, very high relative to rebound-related gains, and
- hourly earnings gains are very weak with a minimal increase reported for April.

The rise in the unemployment rate to 9.9 million was actually a sign of strength as the 0.2% rise was due to an increase in the number of people willing to look for a job. On the negative side, the broader measure of unemployment, including part-time and discouraged workers, increased to 17.1%

Fiscal debt concerns and the difficulty of finding appropriate solutions are the chief headwinds to U.S. and world growth in the second half of 2009. Problems in the euro-based countries are dominating the headlines, but debt in Eastern European countries and U.S. based state and local entities are also quite important, but receiving less press at the moment. As a result, the interest rate on U.S. treasuries is faring better than would otherwise be the case as a flight to safety has helped the dollar, gold and U.S. treasuries.

The above-mentioned fiscal problem is one of several reasons why the stock market is correcting. Second quarter earnings, continued productivity gains and the resumption of moderate consumer spending growth support the case for S&P earnings of at least \$80 this year. Near-term, however, the uncertainties are likely to result in a lower valuation being put on the positive outlook. My 2-3 month S&P range is 1025-1175.

The Economy

First quarter GDP came in at 3.2%, 0.2% less than the 3.4% consensus. Personal consumption grew 3.6% and was higher than expected and much higher than the 1.6% of the fourth quarter of 2009. The upward revised job gains and a strong ending to the quarter made it likely that subsequent revisions will move the estimate up to between 3.5% and 4%.. Expressed as their contributions to growth, personal consumption contributed 2.55% vs. the 1.16% in the first quarter. There are caveats:

- Residential housing spending subtracted 0.29%. I add this to personal consumption since the spending emanates from households. This reduces consumer spending contribution to 2.26%, better than the last quarter but still tepid.
- Investment spending net of the inventory change contributed 0.38%, slower than the 0.51% in the previous quarter. As in the previous quarter equipment and software growth was robust (13.4%), contributing 0.83%, but commercial real estate continued weak, subtracting 0.44% (0.83% minus 0.44% equals 0.38 rounded).
- Inventory liquidation was replaced by inventory accumulation and contributed 1.57%. This is good, but temporary. A “typical” increase would contribute, say, 0.5% to growth. Without the temporary inventory stimulus growth would have been closer to 2.1%. Recall that the inventory swing in the previous quarter contributed 3.79% or two thirds of the 5.6% fourth quarter 2009 growth.
- As is the norm, more consumption resulted in a disproportionate growth in the trade deficit and net exports subtracted 0.61% from growth despite a continued pickup in U.S. exports.
- Finally, State and Local governments remain strapped and their spending subtracted 0.48% from growth, more than offsetting the small 0.11% contribution of the Federal government.

Inflation (1.6%) and employment costs (+0.6%) remain subdued, although benefit costs rose 1.1%. There is no inflation problem, yet. At 3.6% productivity gains, while less than the previous quarter’s 6.3% gain, brought the year-over-year gain to 6.3%. Unit labor costs fell 1.6% (annualized) resulting in a year-over-year drop of 3.7%.

Given the upward revision in job gains for the first quarter and a solid start to the second quarter, I am holding my estimate for second quarter growth at 3-4%. Retail sales rose 1.6% in March, raising the base of sales in the second quarter (April sales – to be reported Friday, May 14 - are expected to increase a tepid 0.2%) However, the rise in household spending is leading to a widening of the trade deficit. My initial estimates for the contributions to second quarter growth are:

Consumption + Residential housing	2.8%
Investment minus Res and inventory change	0.6%
Inventory change	0.8%

Net exports	-0.5%
Net government	-0.2%
Total	3.5% (+ or – 0.5%)

Personal consumption and housing will be healthy, growing at, say, 4%. Residential housing will be boosted by the normal seasonal rebound augmented by buying before the expiration of tax incentives. However, the huge inventory swing that contributed so much to growth the past two quarters will not likely to help second quarter as much.

The “square root” recovery is unfolding. The strong end to the first quarter “teed up” the second quarter for a healthy gain. In contrast, I think the European debt crisis and stock market setback will produce some risk-aversion that will moderate growth in household spending near the end of the quarter. Thus, the third quarter is likely to get off to a more lackluster start than the current quarter. Moreover, the end of housing tax incentives will slow the rebound in housing. My forecast is for growth in the third quarter to be 2-3%, down a percent from the second quarter. If gyrations from the European debt crisis are not quelled by forceful action on the part of the ECB and European policymakers, the risk to the forecast is to the downside.

I do not look for a double dip, but in the U.S. faces other growth headwinds:

- The stimulative effect of fiscal policy is peaking and rising concerns over deficits will make it difficult to enact further spending measures.
- State and local government spending constraints will continue to be a negative.
- Demand for U.S. exports from Europe will stop expanding.
- Prospects for a damaging rise in taxes as the Bush tax cuts expire at the end of the year will result in a very public bruising political fight as the mid-term election nears.
- The correction in equity prices and potential for a more volatile market will slow household spending growth.

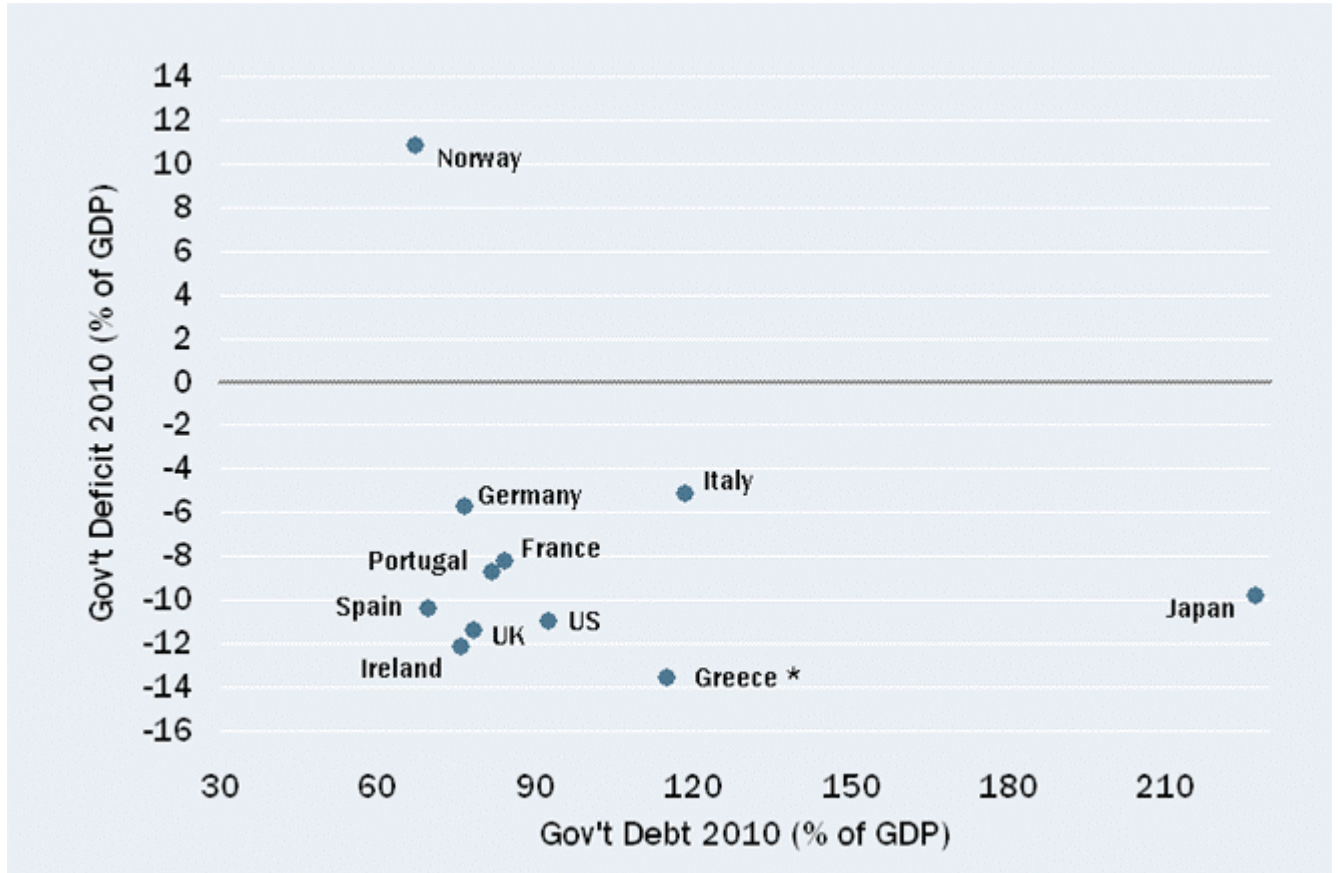
There is a strong positive, most notably continued employment gains. However, wage increases will be retrained. Continued attempts by households to repair their balance sheets will mitigate the usual rebound in spending associated with pent up demand. And the end to fiscal incentives will also mitigate spending. Thus second half growth will likely be 2-3%.

A note on the European debt crisis: The European debt crisis raises a number of questions and important global implications. What determines a dangerous debt level? If Greece is isolated, will the easing of the crisis be temporary? Will Greece default and restructure its debt? Is the Euro doomed? How far will the Greek debt “tentacles” reach? The chart on the next page gives a picture of the deficit and debt levels relative to GDP for key countries.

In my opinion fiscal debt levels become dangerous:

- as the cost of financing the debt approaches the ability to pay off the debt. This is straightforward and analogous to an individual’s household’s debt,
- if it is financed externally,
- if a countries savings rate is low, and
- if government processes make it hard to adopt a workable solution.

Japan has a debt level in excess of 200% of GDP, the result of running high deficits year after year. The classic defense of deficits is that the costs of the debt are paid by taxing the money from households and businesses but returning the money in the form of interest payments to households and businesses. Figuratively, Japan is robbing Peter to pay Paul (or, in this case robbing Yoshi to pay Hiroki). The effect is mostly on the distribution of income, but absent inflation, savers benefit most. In a “closed” economy, one that is not affected by trade, deficits are not a problem as savings begets investment.



Source: IMF World Economic Outlook, April 2010 Update. * Greece uses 2009 figures.

In a global economy, the burden of debt is determined by who holds the debt. The Japanese are huge savers and, not only is their net fiscal debt entirely financed internally, the Japanese also are creditors to the rest of the world. Thus, there is some risk to the payment stream from the external debt they hold, but the Japanese fiscal debt has only distributional implications.

In contrast, Greeks, like Americans, have financed much of their debt externally. The basic method of servicing such debt is to run a trade surplus that exceeds the service payments. Otherwise, as the U.S. has been doing since the mid-1980's, the servicing is essentially done by accumulating more debt. Thus the debt to GDP ratio is much more important to Greece than to

Japan. If too much of the GDP is needed to service the debt, there is less room for investment and domestic consumption.

In addition to the problem of servicing external debt the Greeks, like the Italians, also have a problem with raising taxes to finance fiscal spending. Greece is not a rich country so the lack of a system that can tax households effectively essentially means that inflation to disenfranchise the debt holders and/or austerity to restrict services that Greeks rely on are the only way out. Hence, there are riots and capital is pouring out of the country.

Foreign lenders to Greece have relied on the fact that, because Greek debt is tied to the Euro, it would not as likely be repaid in a depreciated currency (although the current dilemma is undermining the strength of the euro). As long as Greece remains in the Euro zone, it does not have the option of controlling the depreciation of the debt through devaluation as other countries have done to reduce the burden of their debt.

If, as I believe, Greece is not rich enough to service its debt, one or all of the following must happen:

- Other euro-zone nations must subsidize Greece.
- Greece must restructure the debt resulting in lenders taking a haircut (losing a portion of their principal).
- Greece must exit the euro-zone, effectively depreciating the lenders principal.

By lending Greece money at below market rates to roll over its existing debt and accumulate new debt, other euro-zone countries and IMF countries have already implicitly agreed to subsidize Greece.

Will the subsidy be enough? Investors are fearful that the answer is no. That is why risk premiums have been rising rapidly and a crisis has developed. I, too, think the ultimate answer is “no”, but the current agreement to assume \$130 billion in debt should temporarily ease the immediate crisis.

Is the euro-zone in danger? Yes. The levels of debt are dangerous in several countries, Italy, Portugal, and Spain both because savings rates and the tax system is incapable of generating the revenues to service the debt internally and because the external debt is too large a proportion of the total debt and without currency depreciation, the debt cannot be repaid without a subsidy or restructuring.

In addition, the political processes in the euro-zone make it difficult to deal effectively with the situation. As the New York times reports, “the European Union...[has] no single government, no single treasury, no effective fiscal coordination, no mechanism for crisis management”. The German and French commitment to preserving the euro-zone are critical, but it is not yet clear if they are sufficient to succeed.

I do not think the euro-zone will completely fall apart, but it may contract rather than expand over the next few years. Greece may opt out, but hopefully, Spain, Portugal and Italy will see the implications of imprudent debt accumulation and are still in a position to effect austerity

measures that are strong enough to ease their debt servicing burden and, at the same time, not so drastic as to unduly undermine the economy.

I see several global ramifications of the Greek debt crisis:

- Still reeling from the 2008 private debt crisis associated with housing and excess leverage, international banks now face the prospect of future public debt write-offs. While the banks may not have to take immediate haircuts, the prospect raises the cost of capital and could thus curb lending.
- The austerity programs necessary to get public debt under control will likely slow European growth and thus imports from the rest of the world. This will, in turn, slow world growth. In particular, the U.S. exports to Europe will slow or fall.
- The mere fact that the European debt situation turned into a crisis will indirectly affect the U.S. in several ways. First, the crisis may focus more attention on the U.S. fiscal problem at all levels, federal, state and local. Second, as risk premiums rise, financing costs for U.S. private and public debtors will rise. Third, the impact of the crisis on U.S. equity and other asset prices will negatively affect consumer and business confidence and could slow the recovery.

The U.S. economy is currently rebounding and that is a positive. But the European crisis reinforces my notion that we are facing a “square root” recovery. The risk to growth over the next few quarters is rising.

Employment: Despite continued high jobless claims, the anticipated robust employment gains of the second quarter are materializing. Payrolls increased by 290,000 in April and upward revisions in February and March added an additional 121,000 jobs. Second quarter job creation is likely to be near 800,000.

The rise in the unemployment rate to 9.9% was a sign of strength as the 0.2% rise resulted from 805,000 individuals entering or reentering the job market. The increases were broad-based and the number of private-sector full-time permanent hires led the way. Only 66,000 temporary census workers were hired, less than expected.

Despite the healthy report, caveats remain:

- Temporary employment is still garnering too big a share of the gains.
- Compared with previous recessions, job losses are, to date, very high relative to rebound-related gains.
- Hourly earnings gains are very weak with a minimal one cent increase reported for April.
- The broader measure of unemployment rose to 17.1%, indicating the depth of the employment situation.
- Hard-core unemployment continues to rise, with 6.7 million workers, 45.9% of the total unemployed out of work longer than 27 weeks. While some of this may be due to the extended period that workers can receive UI benefits, many workers will never be reemployed at their previous level of wages. Permanent layoffs are a bigger fraction of total job losses than in the days when many layoffs in the manufacturing sector were temporary.

Even if growth slows, I expect another 700,000-1,000,000 jobs to be created in the second half. This would bring the gains to 1,700,000-2,000,000 for the year. But to put this in context, 8,318,000 jobs were lost from peak to trough. Thus, payroll job losses even after 2010 gains will exceed 6 million. The tendency for discouraged workers to move back into the labor force and the natural increase in workers as the youth population increases will likely keep the unemployment rate above 9% for the rest of the year. I do not rule out a temporary return to above the 10% level.

Inflation, the Fed and fiscal policy: Fears that upward price pressures will reemerge continue to be expressed by many observers who expect some central banks to choose the relatively politically expedient method of inflating the countries way out of the fiscal debt burden. And in some countries, e.g. Greece, this outcome may be used along with debt restructuring to spread the pain of adjustment. However, for the U.S., inflation is not inevitable as some believe. It is a choice.

Near term, inflation in the U.S. is dormant. As indicated above, year-over-year unit labor costs, representing nearly 70% of value added declined by 3.7%. And even commodity prices that have been rising are correcting recent increases. The ISM and PPI data do indicate an increase in input prices, but that should ease in coming months and represents a small fraction of total labor inputs. I lowered my estimate of 2010 core inflation two months ago to 1.8%. The risk is to the downside. Overall inflation, including energy and food prices, is likely to be near 2%, down from 2.8% in 2009.

Federal Reserve policy is on hold and will likely remain so through the fall election. Despite some unease on the part of the monetary hawks, the Fed retained the language that rates will remain fixed for an “extended” period in its March communiqué. Concerns that financial problems in Europe will be contagious reinforce the current policy. Treasury rates in the U.S. have fallen in response to the recent problem. Although I consider it unlikely, the Fed may decide to reverse some of its withdrawal of special emergency measures. The ECB will almost certainly introduce temporary quantitative easing or some equivalent measure to insure liquidity.

Although my longer-term fiscal concerns remain, the near-term fiscal picture is improving. Healthy growth and employment gains have reversed the decline in tax revenues. Near-term, the budget deficit will come in less than forecast. Even state and local fiscal problems, while onerous, will be less bad than feared.

The Markets

Fixed income: European financial dislocations prompted a return to U.S. treasuries as a safe haven. As a result, the 10-year note rate fell precipitously to the 3.40% range from its recent 4.05% high. I think ECB and European Union measures to contain the damage from loss of confidence in Greek debt will be temporarily successful. But investors will remain cautious. Memories of how the U.S. CDO and SIV problems became contagious and resulted in a plunge in asset prices have been rekindled and will only subside slowly.

My 2-3 month range for the 10-year note is 4.25-4.85% well down from my previous 3.6-4.0%. Longer-term, rates are likely to rise as governments undertake the austerity programs necessary to stem the outsized deficits. The U.S. economic recovery will boost tax revenues and gradually lower the U.S. deficit. However, the continued rise in the debt to GDP level and the inability of Congress to deal with the tough choices concerning the future explosion of entitlement obligations will put upward pressure on rates. As concerns over the European debt situation ease, U.S. rates will resume their upward path.

The dollar, currencies and gold). Dollar appreciation is mostly against the euro, although recent concern that the European problem will spread has strengthened the dollar against almost every market currency except the yen. I expect the dollar to remain well bid for a time as European leaders grapple with the debt problems of Greece, Portugal, Spain, Italy and Ireland. At the same time I remain negative on the dollar longer term. Asian currencies as European countries adopt austerity measures and slowly get their fiscal deficits under control. But emerging market currencies in resource-exporting countries will likely correct as concern over slowing world growth affect commodity prices negatively. U.S. fiscal and external debt problems, currently overshadowed by the immediacy of the Greek situation, will continue to be a negative for the dollar.

Periodically, I review the notion that external debt, i.e., the rising debt to foreign creditors is a greater problem than U.S. fiscal debt. Currently the fiscal deficit is rising faster than growth. But until recently growth in the external debt was slowing as the U.S. recession cut imports. However, the trade deficit began to rise in the first quarter and the threat is that external debt will again rise faster than U.S. growth. This is negative for the dollar longer-term.

Improvement in U.S. China relations raised hopes, including mine, for a quick move by China to allow the yuan to appreciate vs. the dollar. However the rapid fall in the euro and the consequences of the fall for damaging world growth have lowered, but not eliminated the probability of a near-term move. Exports from China to Europe exceed exports from China to the U.S. and China's export growth will likely slow as a result. Whether or not a Chinese move to allow some appreciation of the yuan takes place before the June G20 meeting will depend on how quickly the European debt situation normalizes. When the policy move does occur, I expect it to be a repeat of the 2005-2008 policy that included a 2-2.5% immediate upward revaluation and then a controlled 5% yearly appreciation.

After raising my range on the Canadian dollar to 96-101 cents from 94-98 cents per dollar (it hit 100.50 cents) last month, I am lowering the range back to 94-98. Economic conditions remain quite positive in Canada as April payrolls expanded by over 100,000 (equivalent to a monthly rise of more than a million U.S. jobs). The Canadian dollar briefly plunged to 92.50 cents on Thursday, May 6, but quickly recovered. Despite a healthy economy and a more sound financial system, this temporary drop reflects the concern that problems in Europe and the U.S. will affect Canada. Resource demand and investment in Canada could both suffer for a period.

The Bank of Canada appears poised to begin a series of rate increases. However, I think the bank will not hike rates in June and will delay the start of rate hikes until the international financial situation settles down. The strength of the Canadian dollar represents an implicit tightening.

I remain negative on the euro. Last month I forecast that the euro could move into the 1.22-1.26 range. I am sticking with that downside target area. And even as the ECB and euro-based countries adopt measures to stabilize the financial turmoil, I think any near term rebound to relieve an “oversold” condition is limited to the 1.30-1.32 area.

The yen has been an important funding currency as investors have borrowed at very low rates in Japan to finance investments elsewhere. Despite concerns by Japanese officials that a strong yen will undermine economic recovery efforts by dampening export demand, the financial problems in Europe have prompted investors to reduce their risk by reducing their leverage and paying back or hedging yen-based loans. Thus, the dollar/yen briefly plunged under 90 yen per dollar, before recovering to the 92 area on Friday, May 7. My forecast is for the yen to stay in the 90-95 range over the next few weeks. Japanese officials would like to see it closer to 100, but market pressures will keep dollar/yen well below that level.

Regarding gold, the importance of easing tension between the U.S. and China that I referred to in last month’s report was quickly overshadowed by rapidly rising fears of financial turmoil in Europe. As a result, gold once again became a surrogate for a “safe” currency, rising so dramatically against the Euro that gold even reached new highs vis.-a-vis. the stronger dollar. Gold will likely continue to be most affected by concerns that European debt problems reflect a deeper debt problem that will engulf the U.S. and Asia as well. As such it will rise and fall with these fears. On balance, I remain positive on its price over the longer term.

Equities: I am lowering and widening my 2-3 month range on the S&P to 1025-1175 from 1150-1225. In my opinion the break in the stock market is definitive. On one hand, second quarter earnings, continued productivity gains and the resumption of moderate consumer spending growth support the case for S&P earnings of at least \$80 this year. Near-term, however, the uncertainties are likely to result in a lower valuation being put on the positive outlook.

Reviewing, gains in the market over the past 13 months have resulted from:

- The oversold condition of the market in March 2009, when the consensus was that the U.S. was potentially headed for a depression
- A vast improvement in earnings much of which has resulted from inordinate productivity gains as labor was shed aggressively
- Underlying liquidity provided by the Federal Reserve, and
- A huge fiscal stimulus.

In my opinion, the first two factors have been priced into the market and the fourth factor as reached its peak as concerns over public deficits are growing. Only the liquidity factor remains a positive.

The reasons for valuing the market at a somewhat lower level are:

- Growing concern that the fiscal debt problem in Europe will spill over into the U.S. lower growth in Europe and a drop in the European demand for U.S. exports.
- Background concerns that U.S. debt problems are headwinds that are replacing the tailwind from fiscal stimulation.

- A general rise in “free-floating” anxiety concerning “counter-party” risk, exacerbated by the short-lived, but market-disruptive price May 6 stock market plunge.
- Realization that household income growth and spending patterns are likely to remain restrained. Despite growth in employment, wage gains remain weak and the consumer balance sheet needs further repairing.

The aforementioned liquidity, the Federal Reserve’s awareness of the fragility of the system, and the knowledge that asset price appreciation remains an important part of the recovery will mitigate the decline. Thus, I do not expect a repeat of the conditions that led to the 58% stock market decline in 2008-early 2009. However, increased recent volatility, associated with the early May decline will likely reinforce the retail public’s aversion to moving into the market for the next few months.

Third Party Research Disclosure

This third party publication is not prepared or approved by Stuart Investment Management Limited and therefore does not meet Canadian research disclosure requirements applicable to Stuart Investment Management Limited. The

opinions, estimates and projections contained in the publication are those of the author alone as of the date indicated and are subject to change without notice. Stuart Investment Management Limited makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors or omissions which may be contained therein and accepts no liability whatsoever for any loss arising from any use of or reliance on the report or its contents. The provision of 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.