



STUART INVESTMENT
MANAGEMENT LIMITED

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Summary

After reporting a gain, including revisions, of 411,000 jobs in the May employment report, a May headline gain of 431,000 was reported in the June 4 report. However, when 411,000 temporary census jobs and the 20,000 downward revision for March are subtracted, the number was flat. Hourly earnings were up 0.3%, better than expected and hours worked and private sector temporary employment continued to increase. The economy is expanding, but hiring is disappointing.

I am maintaining my growth forecast for the second quarter at 3-4%. However, the risk is to the lower end of my range. Job gains, although less than expected, will offset the negative impact of weak earnings gains and the slowdown in the reversal of inventory liquidation to accumulation. But in the second half, the slowdown in Europe will mitigate U.S. growth gains. For now I am keeping my 2nd half growth at 2-3% having anticipated some headwinds during that period. But the risk is to the downside.

The European debt crisis has resulted in a flight to the dollar and “safe” U.S. Treasuries. As a result, the 10-year note fell several basis points below the bottom of my 4.25%-4.85% 2-3 month range. The stock market correction and on-going concerns in Europe will likely support Treasuries over the next few weeks and I have lowered my range to 4-4.55%. Given the uncertainty regarding Europe, the Fed will continue to be on hold. Near term, the risk of deflation remains greater than the risk of inflation.

The euro exceeded my downside forecast of a move to the 1.22-1.26 range. I am lowering my 2-3 month target to 116-120. The upside on the Euro is likely limited to the 1.24-1.26 area. The crisis temporarily sent the yen a bit higher than my forecast range, but I continue to expect Japanese authorities to guide it into and maintain a range of approximately 90-94 yen per dollar. I am lowering and widening my range on the Canadian dollar to 90-98 cents from 94-98 cents. The fall in commodity prices is taking a somewhat bigger toll than I previously anticipated but the willingness of the Bank of Canada to hike rates is a positive as long as the Canadian economy continues to grow robustly. I remain positive on the Canadian dollar longer term.

The likely passage of another \$200 billion fiscal package extending tax deductions for business and jobless benefits is, for the most part, an elimination of a negative for the economy and business earnings. Despite the potential negative impact of European debt problems and austerity measures, full year earnings, continued productivity gains and the resumption of moderate

consumer spending growth support the case for S&P earnings of \$75-\$80 this year. However, I continue to think a lower valuation will be put on the positive earnings outlook. As a result I am further lowering my 2-3 month S&P range to 970-1120.

The Economy

Employment: After taking a back seat to the European debt problems the past few weeks, U.S. economic data once again came to the forefront. The weaker-than-expected May private payroll increase (41,000) called into question the notion that the U.S. economy would easily sustain the growth momentum needed to “shrug off” the impact of defaults and austerity measures in Europe. Although the headline payroll number indicated a 431,000 increase in payrolls, 411,000 of the jobs created were temporary census jobs while government payrolls other than census workers declined 21,000. Add that to the 20,000 downward revision in March payrolls and subtracting this sum and the temporary census workers hired in March and April and it turns out that, absent census hires, the three month increase in private payrolls was weaker (136,000 per month) than expected.

The report was not all bad. Temporary workers increased for the sixth straight month. The hours worked increased for the second month in a row and hourly wages increased 0.3%, higher than expected. These are all signs that the economy is growing and usually precede a more general increase in payrolls. However, it is probably the case that, because of the severity of the downturn and the uncertainty regarding future taxes and regulation, employers will be even more reluctant than in past recoveries to put on permanent workers. Still, unlike the case for census workers whose jobs will end, the temporary help hired in the private sector is usually a sign that increased job needs will last.

What I think is different about the current job market is that the temporary jobs may remain just that. In a world of reduced credit and greater uncertainty, employers are likely to remain cautious about hiring permanent workers. Thus, the increase in hours worked and temporary workers will not turn into permanent hiring as quickly as in a “normal” cycle.

Despite the uptick 0.3% (3% plus annualized) increase in May wages, I remain pessimistic about wages. If workers are not put on permanently, then benefits will not increase as fast as in a normal cycle. Given the current high unemployment rate, I consider the May wage increase as an outlier. Despite the wider health care provided by new health care legislation, non-permanent workers will have to buy health care coverage or for greater out-of-pocket service costs, thus lowering their remaining disposable income.

On balance, the May jobs report suggests that the main force for reinforcing sustained growth is turning out to be much less powerful than the optimists hope or than in a normal recovery.

A note on small business employment: Much has been made of the notion that small businesses create most of the jobs. And there is a debate as to whether the absence of small business growth is due to the unavailability of credit or the lack of demand. There is also the notion that taxation

and regulatory uncertainty are slowing small business hiring. All three of the above are contributing factors. However, contrary to the conventional wisdom, small business growth is not the engine of growth in the initial stages of a recovery.

While it is true that small businesses have been responsible for a disproportionate portion of growth, most small business jobs are created as a byproduct of the recovery of large company growth and demand. As a recession unfolds, many layoffs in small businesses usually result from reduced demand from workers laid off *en-masse* from larger companies. Small businesses “hold out” as long as they can before closing or letting key workers go. Although very important, small business hiring tends to be a lagging indicator.

The “bias adjustment, also known as the “birth/death model” attempts to adjust monthly hiring based on an estimate of jobs created or lost in small businesses that do not get picked up on the payroll data. While this is a legitimate adjustment, it has its own bias in that it is based on past estimates of growth and the lead lag cycle of the small business response to growth. Unfortunately, however, it is based on a fixed formula and is least accurate when the business cycle is at an inflection point, i.e. turning from positive to negative or negative to positive, and at when the cycle is not “normal”, i.e. does not display an “average” character. It is wrong to throw out the adjustment as suggested by some analysts and commentators. However, it is reasonable to “second guess” the data trying to factor in the specific dynamics of the recovery. My own opinion is that, unfortunately, small businesses are being more negatively impacted than in the normal cycle. Thus, the bias adjustment is probably building in more jobs than are actually being created.

Another reason that small business jobs have represented a growing proportion of jobs created in the past couple of business cycles is that the past two recessions have been characterized by many more permanent layoffs than in previous recessions. The downsizing of manufacturing employment has resulted in fewer layoffs being temporary as happened in the past in, say, autos, steel and durable-goods production. Increases in productivity and outsourcing as the economy has become more global and increased use of temporary workers have also been influential factors. A number of those who lose permanent jobs end up in a new role working as temps. But others go into business for themselves or end up as consultants and are classified as small business hires. This increases the number of new jobs attributed to small businesses. However, because many of these jobs are simply replacements for big company jobs, the effect is not as positive as generally portrayed. Moreover, these jobs are dependent on the success of big businesses that use the consultants.

Growth: Despite the disappointing employment report, I am maintaining my forecast that second quarter growth will be 3-4%. The increase in hours worked and temporary employment is consistent with my forecast. Rather the onus of the report is that future growth will not be as robust since household income will increase more slowly.

Industrial production and both the ISM manufacturing and non-manufacturing reports indicated that production is increasing and auto and housing sales will contribute to the growth. However, in contrast to the robust start of the quarter, the second quarter may end on a weaker note as

housing purchase incentives expire and as the sharp drop in the stock market leads household's to be more cautious about spending.

The European Union and, in particular, the euro-based countries have responded to the debt crisis by greatly increasing sovereign debt guarantees and by adopting austerity measures to get future debt creation under control. But is the crisis over? It is not clear. Risk premiums are still rising in some countries, e.g. Italy, although this may be in part a belated reaction to revaluing debt rating assessments. What is clear is that measures already adopted will slow European growth. The slowdown will be mitigated by the better terms of trade flowing from the sharp drop in the euro. But for non-European countries, slower European growth and a weaker euro are both negatives that will reduce export growth to Europe.

As confidence builds that the Europeans are effectively dealing with their problems, attention may turn to other debt problems. Default rates continue to rise in the CMBS market. And despite help from the Federal government, state and local governments are still reigning in deficits. While immediate municipal default may not be an issue, the negative impact of austerity measures needed to get the situation under control will continue to be a negative for the U.S. economy.

For now, I am maintaining my 2-3% forecast for second half growth. I previously forecast that tailwinds helping the economy in the first half, namely cessation of inventory liquidation, fiscal stimulus and extremely easy monetary policy, will dissipate. However, new factors, the European debt crisis, the sharp stock market correction, an apparent slowing in Chinese growth and the discouraging impact of the ongoing gulf-oil crisis have greatly increased the downside risk. I do not forecast a "double dip", but based on second quarter data and events, I may lower my second half forecast by a percent.

A note on the "new normal": I refer to the recovery as a "square-root" recovery because, unlike the normal "V-shaped" recovery, I expect the upward slope of the V to be truncated. PIMCO fund managers have a similar concept and have coined it the "new normal". I am on board with this concept. Basically it posits that headwinds facing the economy are more onerous than in previous recoveries.

Near-term the headwinds the economy faces are:

- The ebbing of a huge fiscal stimulus and the negative impact of state and local government spending cuts.
- A negative income effect from the recent stock market correction.
- The absence of the "normal" positive wealth effect of rising housing prices and from the standard housing-purchase effect of low interest rates.
- A probable decline in export growth in Europe due to the rapid fall in the euro against the dollar and the austerity programs being adopted in several European countries.
- Continued uncertainty over tax and regulatory policy facing businesses.
- Continuation of a deeply divided government. This makes it more difficult to strike a consensus on how the government should proceed to deal with the conflicting need to support the economy in the early recovery stage while reigning in a huge fiscal deficit that cannot be sustained longer-term.

As indicated above, a powerful earnings recovery to counter these headwinds is not likely. And the positive impact of the end of inventory liquidation that has contributed 63% to growth in the past two reported quarters is likely to contribute very little in the second half of 2010.

Longer-term headwinds include:

- Aging baby-boomers who are not adequately prepared for retirement but whose productivity will slowly diminish.
- The approach of a steep increase in entitlement payments to aging baby-boomers that will greatly increase the fiscal deficit if a reduction of Medicare and Social Security entitlement costs is not adopted.
- The increasing reliance on external debt resulting from the ongoing trade deficit and the further debt servicing costs of the net external debt.
- A probable further increase in energy costs coupled with the absence of energy independence. This increases the level of external debt and, on balance, lowers the purchasing power of consumers.

I will be formulating my economic forecast for 2011 over the next month. The above headwinds suggest, to me, that growth will be less than needed to ensure a robust reduction in unemployment. Absent a further deficit-increasing fiscal stimulus, real growth will likely be 2.5% or lower. The unemployment rate will not be brought below 8%. My forecast for the unemployment rate at the end of 2010 is 9-9.5%. Jobs will be created in 2011, but at a level that is only slightly greater than the number of those entering the labor force.

The Markets

Interest rates: The European debt crisis has resulted in a flight to the dollar and to the “safety” of U.S. Treasuries. As a result, the 10-year note fell several basis points below the bottom of my 4.25%-4.85% 2-3 month range. Although I think the fall in rates is overdone, in the short run, Treasuries are likely to stay well bid. If the stock market has further to correct, as I forecast, Treasury rates may fall a bit further. Thus, I am lowering my 10-year note range by 25 basis points to 4-4.55%. Given the uncertainty regarding Europe and its impact on the U.S. economy, the Fed will continue to be on hold. The employment report and stock market correction reinforce my view.

Since short-term rates cannot go lower, the rush to Treasuries has resulted in some curve flattening. This flattening is resulting from both the flight to safety from the euro and from some reallocations from equities to treasuries as investors are reminded of the importance of “return of capital” as opposed to “return on capital”. Near term this is likely to remain the case. But as the economy continues to expand and as attention on fiscal condition refocuses from Europe to the U.S., the yield curve is likely to steepen.

If attention does focus on the U.S. fiscal situation, there will be calls for the U.S. to hike rates. And, like the Bank of Canada, the U.S. Federal Reserve may hike rates a bit to obtain more flexibility. I do not think this will occur this year, however. Moreover, the state of the economy will continue to be the focus of the Fed. The U.S. potentially faces a fiscal crisis, not a monetary

crisis. Inflation will remain low and, and given the trade deficit, the Fed is even less likely to engage in supporting the dollar than the ECB has been in supporting the Euro.

The dollar: In my opinion, the strong dollar is mostly the result of a weak Euro. The trade deficit has been rising and the external debt of the U.S. continues to rise with little prospect of a reversal. The debt is currently rising near 3%, about the same as the rise in nominal GDP and well down from the 6% prior to the recession. The U.S. is not in the situation of Greece and, if the debt rises at a rate lower than the nominal growth rate in the U.S., the ability to service the debt is not in question. However, the willingness of foreign entities to continue to build the debt at the current rate is questionable. Thus, once the focus returns from Europe to the U.S., the dollar is likely to come under renewed pressure.

The euro exceeded my downside target of a move to the 1.22-1.26 range. I am lowering my 2-3 month target to 116-120. There is no indication that European officials are yet concerned about the euro's price decline and government officials probably do not want to support it until their effort is likely to succeed. Although the ECB has an obligation to support the currency, Euro-based countries need a lower exchange rate over the intermediate term to offset the negative growth effects of deficit reduction policies. The upside should be limited to the 1.24-1.26 area on counter-trend rallies.

The crisis temporarily sent the yen a bit higher than my forecast range, but I expect Japanese authorities will continue to guide it into and maintain a range of approximately 90-94 yen per dollar. The change in Japanese leadership should not change exchange rate policy.

I am lowering and widening my range on the Canadian dollar to 90-98 cents from 94-98 cents. The fall in commodity prices is taking a somewhat bigger toll than I anticipated. However the Canadian economy continues to grow robustly and the April and May employment reports were strong and support this conclusion. Moreover, the fact that the Bank of Canada was willing to hike the rate in the face of European problems suggests the bank has confidence in the sustainability of Canadian growth. Canada continues to have the best fiscal and monetary policy mix of any of the G7 countries.

I remain positive on the Canadian dollar over the longer run. The fall in energy and commodity prices is likely temporary. Over time, the security of Canadian resources and rapidly rising demand from Asia, especially China make resource-rich Canada an attractive place to invest.

Equities: After focusing on European debt problems the past few weeks, investor attention refocused on the U.S. economic situation as the May employment report came in weaker than expected. Generally many market observers, especially those on the sell side, are viewing the recent market setback as a correction in an ongoing bull market. They have relied on the notion that European problems would affect the U.S. minimally, perhaps mitigating the growth in exports, but otherwise having little impact on U.S. growth. With momentum in the U.S. pointing to sustained growth, the notion has been that the recent setback will provide a buying opportunity for the next rally.

The employment report brought the strength of the U.S. recovery into question. As indicated in the growth section, I am firmly in the camp of the fund managers at PIMCO who think that, going forward, the economy will experience a “new normal.” As such, the question arises as to how much the market will have to correct to reflect if, as I anticipate, the consensus on growth and on its earnings impact deteriorates.

A new-normal economy is not all negative for equities. To date, the extreme reactions of employers to shed workers as they realized the severity of the downturn has boosted productivity well above what is normal. And so far the fact that business may have overreacted to the downturn has not led them to hire more expensive permanent workers as they increased production to stabilize inventory liquidation. Thus, productivity gains may well continue to be above normal. This contributed to analysts’ upward revisions to 2010 earnings. It also accounts for why, despite my embracing the new normal concept, I have been somewhat less negative on stock prices than more pessimistic endorsers of the idea.

Despite the earnings positive, other headwinds such as the tax and regulatory uncertainty are negatives for how investors value earnings. This accounts for why I lowered my S&P range 6 weeks ago despite maintaining the consensus earnings outlook. Now, however, my read of technical factors supports the notion that emerging headwinds, both related to Europe and the U.S., will take a bigger toll of stock prices than I previously forecast. I do not look for an economic double-dip, but I suspect that earnings forecasts for 2011 will not rise further and may be downgraded. Tax increases will almost certainly have a negative impact on high-income households in 2011 and beyond and may have a negative impact on corporations as well. Thus I am further lowering my S&P forecast for the next 2-3 months to 970-1120 from last month’s 1025-1175.

To put my thinking in perspective, recall that during the U.S. debt crisis in the second half of 2008, stock prices fell sharply in both October and November, leading some forecasters to conclude that the November low would be the bottom of the bear market. Often, but not always such a low is tested or undercut a bit. But in this particular case, the sharp nature of the economic downturn and layoffs led investors to fear a depression, even as the fiscal and monetary policy responses were massive and beginning to take hold. In early March, stock prices fell well below the November low, the move being exacerbated by forced selling. From a deeply oversold condition, the market rallied. And it did not retest the lows because investors realized that the market had discounted a much bigger downturn than was being realized. Moreover the better-than-expected profits generated by the sharp reduction in labor costs reinforced the upturn.

I consider the current European situation as an “aftershock” not a crisis of the dimension of the 2008 crisis. But it does have some similar characteristics, with a twist. Just as the scope of the 2008 crisis was only belated realized by policymakers and investors, the current European situation was met, in the U.S., by skepticism about its impact on the U.S. As with the 2008 crisis, stock prices underwent two sharp drops, one the day of the “flash crash” and the other a multi-day move between May 13 and May 25. The European Union’s response to the emerging crises and quick moves by Greece and Spain to curb offending deficits (somewhat) appeared to stabilize the market. But then, the May U.S. employment report (released Friday, June 4)

reminded investors of the economic fragility that will be worsened by ongoing debt problems. Thus another leg down, similar to the first quarter 2009 fall, is likely.

The twist is that, because of what was learned by the previous crisis and the fact that monetary policymakers were already “on alert”, the current crisis will likely be less onerous than the 2008 crisis. At the same time, however, policymakers have “shot” most of their bullets. With policy interest rates near zero monetary options are limited. Fiscal policies are even more constrained. The U.S. is much closer to a point where further deficit-increasing “pump priming” will have a negative impact on confidence and on expectations for future tax hikes and necessary spending cuts.

As a result of the policy alertness and the fact that the current crisis is an aftershock, I do not see the market collapsing as it did in late 2008 and early 2009. Forced selling will be less of a factor although reduced liquidity from the aftermath of the “flash crash” will likely cause the market to remain relatively volatile.

Although the market price drop may be more muted than in 2008-early 2009, the limited policy options will lead to a much longer period of base-building before a rally to new highs occurs. Even if, as I expect, a late year rally develops, I do not foresee the S&P exceeding the April 26 high of 1220.

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