



## **Economic and Market Update: July 2, 2010**

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### **Summary**

Growth is likely to slow moderately in the second half. Following a disappointing downward revision of first quarter growth to 2.7%, second quarter growth, to be reported on Friday, July 30, is likely to be a tepid 3%, at the lower end of my 3-4% forecast range. I forecast second half growth to be 1.5-2.5%, down from my previous forecast of 2-3%.

The major policy risk to second half growth is uncertainty over taxes. Absent passage of a tax bill, tax rates will move significantly upward in 2011, at a time when the economy remains very fragile. I feel confident that tax legislation will be adopted, but the uncertainty regarding the outcome is a far greater negative for the economy and markets than was the uncertainty over financial regulation.

Employment gains in the second quarter were disappointing both because of the weaker-than-expected loss of 125,000, and also because of the composition. Despite the 83,000 private sector jobs created in June more than half of the jobs over the entire quarter were temporary. Wage gains remain weak and will continue to be so. The hours worked declined 0.1 hours, a sign that labor demand may be weakening again. The numbers of "long-term" unemployed are at the highest level since the depression. The situation is not likely to improve much in the second half. Despite the fall in the unemployment rate to 9.5%, it now appears that the unemployment rate will again move to 10%. Unfortunately, the drop was due to workers leaving the labor force rather than hiring.

I expect Treasury rates to remain low for the remainder of the year. At its latest meeting, the Fed downgraded its assessment of the economy and will likely reduce its forecast estimates soon. Inflation remains subdued. Absent a dollar crisis (which is unlikely, but I don't rule out), the 10-year note is likely to remain in the 2.75-3.5% range in the second half.

I think the dollar rally is over. The dollar will likely fall over the next few months as the focus returns to U.S. problems. I am neutral on the Euro, but if I am correct that the focus centers on the dollar, the Euro will likely not go below its recent low just under 1.19. I have included a special note on the Chinese yuan. My conclusion is that it will appreciate slowly, but with a more erratic path than was the case in 2005-2008.

I remain negative on the S&P. Although I raised the top of my range to 1150 when the Chinese announced flexibility on their currency, the market response was disappointing. As a result, investors refocused on U.S. problems, both economic and political. The outlook remains negative for several more months and my downside target for the S&P is at least 970, the bottom of my previous 3-month range. In retrospect I think the one day move above 1120 was an aberration. I have not formulated a new intermediate-term range, but given the uncertainty over taxes, the downside for the S&P could be well below 970.

## **The Economy**

**Growth:** Second quarter growth, to be reported Friday, July 30 at 8:30am EDT, is likely to be near 2% as the quarter seemingly ended on a weak note. Although consumer confidence appears to be holding up, housing demand fell sharply following the end of buyer incentives and general retail spending remains sluggish. The most recent revision of first quarter growth increased the contribution of the improved inventory shift at the expense of final consumer demand. Finally, stocks have not been able to mount a substantial rally following a significant May correction.

A number of headwinds are facing the economy in the second half. The fall in the euro coupled with austerity measures in a number of European countries will slow export growth to Europe. State and local budget deficits will continue to negatively impact employment and spending. Concern over the Federal deficit will curb additional efforts at fiscal stimulus. Finally, without legislation, the Bush tax cuts are scheduled to expire at the end of 2010. While I feel confident that a tax law to rectify this situation will be passed in 2010, the uncertainty over its provisions will restrict business hiring and spending decisions (see the special note on taxes below). It will also have a negative impact on investor confidence.

ECRI leading indicators, a reasonably good predictor of economic activity have turned down sharply following a sharp move up that apparently overestimated recovery potential. Other forward looking measures also suggest a slowdown. Independent of my forecast, Jan Hatzius, Goldman Sachs' economist whom I respect, reduced his second half growth forecast to 1.5%. And I am reducing my second half growth forecast by ½% to 1.5-2.5%. The risk is that one of the two second half quarters will be flat.

**A special note on taxes:** The Bush tax cuts passed to foster the economic recovery following the 2001 recession are set to expire at the end of the year. That has many observers and investors concerned. Very little is certain in forecasting. But I can say with as much confidence as I ever have, that a new tax bill will be passed that will supersede the expiring bill. The problem for the economy and markets is the uncertainty over the provisions and tax rates of a replacement tax bill.

If the Bush cuts are allowed to expire without new legislation, the economy would likely sink back into an extended recession. The administration knows this. The Democrats in Congress know this. The Republicans know this. The problem, from the perspective of business leaders and investors, is the uncertainty over what will replace current tax rates. The following outlines what I think will be the outcome and the pitfalls facing Congress as it attempts to grapple with the tax issue going into the very important Fall mid-term election.

The jockeying surrounding any new tax legislation will more likely take the form of that associated with financial regulation than with health care, i.e. in the end it will be somewhat of a bipartisan bill rather than a bill passed only by Democrats with Republicans taking a “just say no” position. However, if a bill is not passed before the November election, and if the Republicans make substantial Congressional gains, the probability that the tax bill becomes a more purely Democratic bill in a lame duck session increases.

Time is of the essence. The uncertainty regarding the outcome will be as damaging, if not more so, than the final result. It is likely to have a much worse impact on decision making than did the uncertainty over financial regulation. At the same time, lawmakers will not be ready to give up on cherished positions until they realize that failure to come to an agreement may cause another crisis. Moreover, the issue will loom larger as each day in the second half unfolds.

I do not think investors will wait until after the November election to adjust their portfolios (see the equities section below). And businesses will likely hold off many of their hiring and investment decisions until Congress tackles the issue seriously. The optimistic outcome is that Congress gives the tax bill top priority and sets a deadline of August, well before the mid-term election, for passage. The pessimistic view is that party leaders, hoping to get an advantage in the election, delay serious negotiation. If this turns out to be the case, the probability of a double dip recession increases significantly. Thus, the timing is as important to monitor as the likely outcome.

My best guess is that the final bill will go easy on businesses and the middle class but hike taxes on the wealthy. Regarding business, the administration and the moderate leaders of both parties understand that, if the recovery is going to be sustained, business hiring must take over from fiscal stimulus as the economic driver. While some business tax loopholes may be eliminated, by and large I expect the bill to be relatively business friendly and less friendly for household consumption. For example, in exchange for an increase in capital gains taxes, the bill may lower the business tax rate and will almost certainly contain investment incentives and hiring subsidies.

The state of the economy is still too fragile to put much of the tax onus on households. Thus, I suspect that, consistent with the administration’s proposals, the total tax “bite” will not go up for lower to upper middle class incomes. The one area in which taxes are likely to be increased is for upper income households. Part, although not all of the tax rate declines passed under the Reagan bills, raised under Clinton and then lowered again with the Bush tax cuts will be rescinded. As long as the middle class voter is seen to not be penalized by the tax bill, it will be difficult for Republicans to defend keeping taxes for the wealthy at current levels.

In addition to some hike on marginal rates for very high incomes, I also expect a moderate rise in capital gains taxes. My work in supply-side economics suggests that small changes in marginal tax rates will not have the devastating impact that many ideologues suggest. At the same time the attempt to raise revenues by simply allowing the expiration of the Bush tax cut would be negative for the economy and for the efficient flow of capital in the U.S. relative to other countries. A small, say, 5% hike in the capital gains tax will increase revenues near-term, because some investors will take profits on stocks that they might otherwise have held., This, however, could have a negative impact on equities near term.

What Congress does with dividend taxes is a wild card. My best guess is that the maximum tax rate, currently 15% will go up 5% after tough negotiations, but will not return to the ordinary tax rate level. Again an increase of this magnitude will not have much impact on the economy and will definitely hike revenues.

With current and future budget deficits likely to restrict economic performance in the out years, a road to cuts in entitlement programs and to higher tax revenues is inevitable. The trick is to promote growth, and especially investment, so as to lower the debt to GDP level over an extended period. I do not expect a long-term tax and spend strategy to be adopted before the mid-term elections. And if the current groundswell to “throw the bums out” does not result in a Congress that is willing to work together for the good of American households and business as opposed to the party, a long-term solution will not be adopted without a significant crisis. Given the tendency for the most extreme politicians to be reelected in “solid” districts, both Democrat and Republican (the most recent Massachusetts senatorial election being an exception), I am not optimistic that throwing out a lot of incumbents will lead to a better, more rational Congress.

**Employment:** Employment gains in the second quarter were disappointing both because of the weaker-than-expected net gain 100,000 after 25,000 revision increases (temporary Census workers declined by 250,000), and also because of the composition. Despite the 83,000 private sector jobs created in June, more than half of the jobs created over the entire quarter were temporary. Wage gains remain weak and will continue to be so. The hours worked declined 0.1 hours, a sign that labor demand may be weakening again. The numbers of “long-term” unemployed are at the highest level since the depression. The situation is not likely to improve much in the second half. Despite the fall in the unemployment rate to 9.5%, it now appears that the unemployment rate will again move back to/above?? 10%. Unfortunately, the drop was due to workers leaving the labor force rather than hiring.

**Inflation, the Fed and fiscal policy:** Contrary to the fears of many just a few months ago, inflation is not a near-term problem. Even the most die-hard inflation hawks have redefined their argument away from the near-term danger to one that says that we are setting up the ingredients for inflation in the future by allowing excessively easy monetary policy and currently negative real rates.

I agree that inflation is a risk for the future, but the risk is not the growth in money supply, but rather the tendency of governments to “inflate” their way out of burdensome debt, thus penalizing the creditor rather than putting the onus entirely on the debtor. But that is a choice to be made and a risk to be taken in the future. Current debt levels combining both private and public debt are very high relative to GDP, indeed they are the highest in U.S. history. But this was true before the recent public deficits were incurred. In fact public debt is rising slower than private debt is falling. And were public debt not rising, the economy would be faced with even higher unemployment and slower growth.

As an aside, the difficulty of assessing the appropriate allocation of responsibility between creditor and debtor is highlighted by the current housing crisis. Should mortgage holders be held totally responsible for their debt or should lenders take a “haircut” and reduce the burden on

debtors. There are many moral and economic issues to consider. But one thing is clear. Both debtors and creditors are paying a huge price!

The more important question facing the U.S. is not whether inflation is inevitable, but rather how best to incur new debt even as deleveraging pays?? down old and, in many cases, bad debt. PIMCO's Bill Gross has pointed out in more than one of his monthly pieces (pimco.com), that new debt should be incurred for the purposes of investment. This is the way to maximize potential growth and minimize the burden of debt, independent of how the Fed decides to allocate the debt burden between creditors and debtors. I have and will continue to make this point in my monthly reports.

Near-term, the Fed has no choice. It must keep interest rates extremely low and may have to reintroduce quantitative easing if growth slows too quickly. The consequences of slow or negative growth on tax revenues is an extremely important determinate of the budget deficit. Moreover, on the margin, to the extent that the increased wealth created by an increase in "money balances" offers at least a little stimulus, it offsets the need for some of the deficit-increasing stimulus from greater fiscal stimulus.

## The Markets

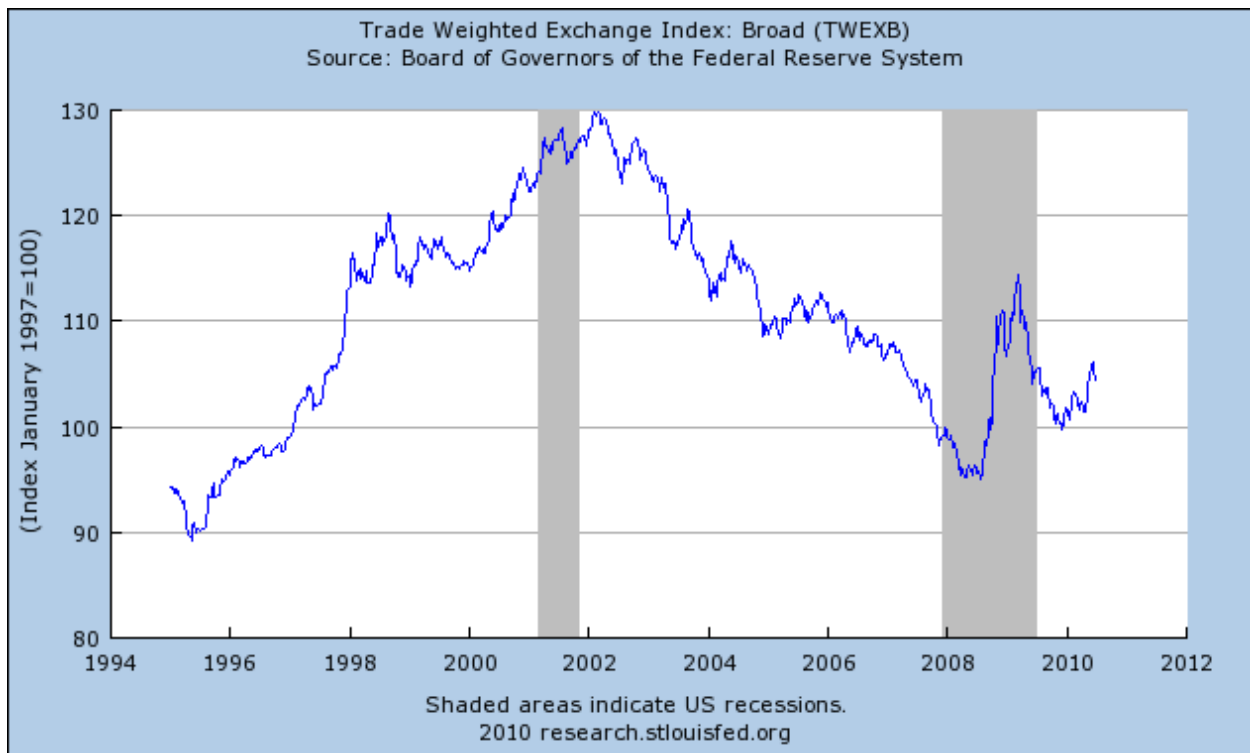
**Interest rates:** Last month I focused on the European debt crisis which resulted in a flight to the dollar and to the "safety" of U.S. Treasuries. As a result, the 10-year note fell several basis points below the bottom of my 3.25%-3.85% 2-3 month range. At the time, I said that if, as I forecast, the stock market corrected, rates could fall further. As a result, I lowered my estimate to 3-3.55% (I erroneously got the "handle" wrong and printed "4-4.55%" -- sorry). Again I underestimated the potential for a further fall in rates as the 10-year note rate is 2.95% as this is written. Given my negative forecast for equities and for a slowdown in economic growth, I am further lowering my 2-3 month forecast by 25 basis points to 2.75-3.30%.

The rush to Treasuries has resulted in further curve flattening. As the economy continues to expand and as attention on fiscal condition refocuses from Europe to the U.S., the yield curve will likely steepen. However, I do not expect this to happen until the fourth quarter, and only then if a rational tax package is legislated to replace the expiration of the Bush tax cuts.

**The dollar:** I think the dollar rally is over. Much of the rally was really a downward revision of the euro that, in a 6 month period, fell from \$1.50 to \$1.19, a very sharp fall for the world's second deepest and most liquid currency. While I am not particularly bullish on the euro, I think the focus is returning to the dollar and on the structural as well as cyclical problems facing the U.S.

From early 2002 to its low in 2008, the Federal Reserve's trade weighted dollar index fell from a high of 130 to a low near 96 (see chart below). It then rebounded sharply to 113 in just 9 months. From March of 2009, the index fell back to 100 near year end and then rose to a high just over 106 in early June. That rebound was mostly the result of the euro's decline. I now expect the dollar to resume the secular decline that began in 2002. If I am correct the first step in that process will be a retest of the 100 level over the next few months.

Regarding the euro, I am switching from emphasizing a “target”, which I use when I consider the currency in a trend, to a range. I have no particular opinion on whether the euro will rally or fall against the dollar. But I think that both will remain weak relative to most Asian currencies. Because of the slowdown in world growth that I envision, the resource-based currencies such as the currencies of Canada, Australia and Brazil (among these I only forecast the Canadian), may also be weak relative to Asian currencies over the next few months. My 2-3 month range on the euro is \$1.18-1.20 on the downside and \$1.25-1.27 on the upside.



Over the past few weeks the yen has benefitted from deleveraging as Japanese and other ‘carry-trade’ investors who borrowed cheaply in yen to buy Euro-based assets reduced their investments and paid off their loan. Until the Chinese indicated more currency flexibility, the Japanese authorities were successful in balancing flows and maintaining the 90-94 yen per dollar range that was also my forecast range. Although the Chinese currency has not yet rallied significantly, the combination of lowered risk tolerance and a potential upward revaluation of Asian currencies has driven the yen under 90 yen per dollar.

Japanese officials will smooth the rise in the yen and may even be able to keep it near 90 per dollar for a time. However, I am adjusting my yen value range upward to 85-91 yen per dollar with the risk for an even stronger yen.

My view on the Canadian dollar has not changed but I am raising my range slightly due to the favorable policy mix and Canada's excellent position as a dependable energy, mineral and agricultural resource provider. I remain concerned about world growth, though, and am only moving the top by a cent to \$.99 and the bottom by three cents to \$.93.

***A note on China and the yuan:*** In contrast to my forecast that the Chinese would adopt a policy similar to that of 2005 when they hiked the yuan value by two percent and then guided it approximately 5% higher per year for three years, the June 19 announcement by the Chinese does not appear to repeat this model. Rather, the initial reaction was a minimal 0.4% appreciation followed by two way movement in a very narrow range that has not yet exceeded 1.0% appreciation. For Chinese officials flexibility does not mean "let the market determine the value of the yuan". Rather it appears to mean that, rather than hold the yuan steady, the Chinese will continuously reset the yuan's value at the level that is most expedient to their economic and political objectives. For example, as Schumer and Congress push for tougher trade rules with China, the Chinese may let the yuan rise a bit faster.

I think yuan flexibility and appreciation is very beneficial for China as they put more emphasis on domestic development. It cheapens the price of scarce resources that the Chinese have to import. This will help hold inflation down and also gradually allow a broader portion of the Chinese population to enjoy a steady increase in their standard of living.

Yuan appreciation is likely to be gradual. This will give export-oriented industries time to adjust to changing circumstances. With the euro having cheapened considerably against the yuan, the currency is likely to appreciate very slowly against the dollar until the euro rebounds some against the dollar. European trade is very important for the Chinese and they have made it clear that they will target a currency basket rather than the dollar specifically.

***Equities:*** One of my equity themes the past two months has been that earnings will hold up well in 2010, but investors will put a lower value on those earnings, i.e. over the intermediate term (3-6 months) the PE ratio will contract. We are now well into the correction that I think will take the S&P to the bottom of the last month's forecast range of 970-1120. In the interim since the last report, I put out a brief comment raising the top of my near term range to 1150 while remaining negative over the intermediate term. However, the scope of the Chinese yuan move and the market's reaction was disappointing. This reaffirms my negative near-term view, and increases the probability that, if there is an interim summer rally, it will not be significant.

The resumption of the market downturn, and the ease with which the 1050 support level was breached suggest the market will go lower than I previously thought. The concerns expressed in the economic sections over uncertainty regarding tax policy will, in my opinion, deepen the correction more than I previously thought. One of my technical models indicates a target around the 830-840 level, well below the level I consider consistent with the economic and earnings fundamentals. On one hand the technical models I use may be indicating that a "double dip" is more likely than my fundamental research suggests. On the other it may just be that, as was the case in early 2009, the market overshoots as fears of a double dip and credit problems rise.

There is a huge dichotomy between my economic forecast, which suggests growth that is too slow to reduce the unemployment rate by much, and my earnings model, which suggests continued support for earnings as permanent workers with legacy costs are replaced by technology and temporary workers. The latter model supports somewhat higher equity prices if tax legislation is consistent with my forecast outcome. But this comes with two caveats:

- given that uncertainty over the issue is not likely to be resolved in the next two to three months, the unfolding economic slowdown is likely to carry the bigger weight.
- I think earnings will hold but, there is a definite risk that earnings are peaking and the rapid rebound in the past year will grind to a halt.

Having been unable to pierce the 1220 level more than briefly, and given the market's volatility and downward momentum, absent a positive political breakthrough, or unless my growth and employment forecast is wrong, I think the S&P is unlikely to rise above what now looks like heavy resistance in the 1075 to 1100 area. I am not ready to forecast a downside target below the 970 S&P level that represents the bottom of my range. But if the S&P does manage to hold near that level, I think a period of base-building will be needed before a late-year rally begins. Failure to signal rational tax legislation before the mid-term election is the scenario that is most likely to lead to an S&P level in the mid 800s.

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