



Economic and Market Update: October 10, 2010

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Summary

The third quarter growth estimate, to be released on Friday, October 29, is likely to be a sluggish 1.5-2.0%, near second quarter growth. Demand appears to have slowed in July and August, and stabilized in September. My estimate of third quarter GDP growth somewhat masks the slowing because of a statistical anomaly that pulled growth out of the second quarter putting into the third quarter. The lack of employment gains remains the biggest obstacle to more robust growth as the estimates of third quarter payroll growth, 218,000, slowed dramatically from the 570,000 second quarter gain. The good news is that net private sector gains, 274,000, replaced public sector losses, most of which were concentrated among temporary census employees. But the August and September private payroll data have been disappointing.

I estimate fourth quarter growth will be 1.5-2.5%. I think the slowdown in growth in mid-year will be stemmed by the prospects of aggressive monetary policy going forward. Nevertheless, I expect growth to remain below what is needed to lower the employment rate. My tentative growth rate for the first half of 2011 is 2-2.5% with symmetrical risk. Policy moves will be supportive, but the ongoing fiscal crisis at the state and local levels will continue to be a drag.

A bill to extend the Bush tax cuts was not passed before the mid-term election. I still think an extension will be passed after the election but the failure to pass the bill in a timely matter is anegative for both household and business confidence. Offsetting this negative is the September 21, Federal Reserve communiqué that has increased the expectation that the Fed will further hike its balance sheet to force more liquidity into the economy. Moreover, M2, a money supply measure that is correlated with economic activity has been growing more rapidly in the past 13 weeks. On balance, the Fed move was very negative for the dollar but supportive of equity prices.

I do not expect the election result to have much of an impact on the economic outlook or the intermediate-term market performance. The 2008 election resulted in many Republican moderates losing their seats in swing districts, allowing the right wing to gain control of the party. The upcoming election may result in a number of moderate Democrats losing their seats to ideologically-oriented Republican opponents. With centrists in both parties losing even more seats, it may be harder to pass policies that work for the good of the country. Gridlock may be good when economic times are good, but with the U.S. failing to have an energy policy, a plan to curtail entitlements or promote national investment, gridlock may result in a further drift toward crisis.

State and local finances remain perilous. Meredith Whitney, a respected Wall Street banking analyst, has recently completed a study assessing state finances. She compares the state and local financial situation with the banking crisis, noting that off-balance sheet items mask the extent of the problem. By borrowing against and not funding pensions, states have left themselves in a position in which their future obligations far outstrip their ability to pay.

The prospect of quantitative easing will keep short term rates near zero for the foreseeable future. With economic growth likely to remain below potential, interest rates at the long end of the curve will also remain in their current ranges although, if the Fed's policy of trying to boost nominal growth is successful, the yield curve will re-steepen in time.

The Fed's signal that they will likely provide more liquidity was a significant negative for the dollar. I raised my range on the Euro immediately following the Fed's communiqué but am raising my two-month range further, to \$1.32-1.42 based on the rise that have already occurred since the September 21st announcement. I have also raised my range on the yen. The Fed's announcement is also a positive for asset values. I am cautiously raising my range on the S&P to 1120-1180 but shortening the forecast period to one month. The failure to pass a tax extension before the mid-term election is a distinct negative as is the negative impact of sluggish growth on profit forecasts. And the failure of the G20 to deal effectively with recent currency movements could result in near-term volatility.

The Economy

Growth: The recent commitment of the Fed to grow their balance sheet if economic growth does not pick up and result in more hiring, should have a positive impact on asset prices and, indirectly, on consumer spending (see discussion below in the Fed policy section). At the same time, the failure of Congress to extend the Bush tax cuts in some form is, in my opinion, delaying a confidence boost in both the household and business sectors (see discussion below in Tax policy section). Although most observers, including me, expect the extension to get passed eventually, the uncertainty associated with the final nature of taxes in 2011 is a negative.

I expect growth in the third quarter, to be released on Friday, October 29, to be 1.5-2.0%, close to the revised 1.7% reported in the second quarter. An anomaly holding second quarter growth down was the subtraction of 3.5% due to the huge fall in net exports. At the same time inventories contributed 0.8% to growth as, I suspect, some of the reported increase in imports landed on businesses shelves. Absent the effects of net exports and the inventory change, growth in the second quarter would have been 4.4%, and gross domestic purchases increased by 5.1%.

Gross domestic purchases peaked in the second quarter and will be down substantially in the third quarter, by as much as 2-3%. However, because of the statistical anomaly that resulted in such a low second quarter growth in the second quarter, it is more likely that third quarter growth will be closer to the corresponding demand than was the case in the second quarter. Thus, although reported third quarter growth may be near second quarter growth, my concern is that slowing demand will keep future growth below potential.

A big swing factor in third quarter growth will be the extent to which the contribution of net trade is no longer negative and the net inventory change reflects a slowdown in the accumulation of inventories. My estimate is that the net trade contribution will subtract ½% from third quarter growth, i.e. it will not reverse and contribute to growth, but will not deteriorate to the extent it did on the second quarter. Only one month of trade in the third quarter has been reported to date, and this is near the average of the months in the second quarter. Moreover, I assume that some of the inventory contribution was undesired and that slower growth in the third quarter will subtract 1/2% from growth. The U.S will report August results for trade and another month for business inventories before the October 29th GDP release and forecasters, including myself, will revise their forecasts accordingly.

Personal consumption expenditures will probably contribute a bit more than the 1.54% in the second quarter. The reason is that the sizable drop-off in residential housing purchases due to the expiration of tax credits in the second quarter, frees up some household income for other purchases. However, the contribution of household demand, including housing purchases, 2.09% in the second quarter, will likely drop to near the 1.2% level. Plant and equipment expenditure will likely contribute a bit less at 1.3%, than the 1.52% in the second quarter. And government expenditures, which contributed 0.8% in the second quarter will likely contribute, say, 0.3% as temporary census spending winds down and as state and local spending growth slows after a small, anomalous second quarter rise.

My “point estimate” for third quarter GDP is 1.8%, but this belies the slowdown in domestic demand between the second and third quarters. Looking ahead, I see the downturn in housing in the third quarter as a one-time reaction to the end of the tax credits and see the sum of PCE and housing expenditures as rebounding a bit to near two percent. However, plant and equipment expenditures will likely slow as businesses hope for a more friendly business climate, including the possibility of a more generous capital expenditure credit in 2011. If some improvement in the trade deficit due to weak household consumption is partly offset by a further subtraction from still slowing inventory accumulation, then growth in the fourth quarter will likely be 1.5-2.5%.

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Employment: The 95,000 decline in September payrolls continues a stream of disappointing numbers. Manufacturing gains had been relatively stronger in the to-date weak recovery, but then declined by 26,000 in August and another 6,000 in September. The service economy added 86,000 jobs, but they tended to be lower paying, contributing to the absence of any increase in weekly or hourly earnings.

The layoff of 83,000 permanent workers at the state and local government level, was the biggest source of weakness in the employment report. Most of those workers were in education as local governments shed 76,000 workers. Teachers generally earn more than the average wage, and

this was another contributor to the weak wage and salary component. As expected, 77,000 temporary census workers lost their jobs.

Although private sector job increases are relatively desirable in the recovery, layoffs at the state and local governments will continue to hold back the recovery as, ultimately, final demand is based on income and household confidence. The layoff of permanent workers, regardless of the sector is a negative for both income and confidence. Moreover, the 64,000 increase in private sector jobs was not only skewed to lower-skilled and low paying jobs, but in the past three months, the increase in private payrolls has slowed and is far below the level needed to lower the unemployment rate, especially if, as I suspect, there will be more net state and local layoffs over the next year. Note, however, the decline in state and local workers will not be as much as in September since there were disproportionately more laid off due to the start of the school year and the end of monies coming from the 2009 Federal stimulus program. Indeed, the recent passage of a \$26 billion bill to help the states and local governments may result in some rehiring.

Much has been made of the rebound in the manufacturing sector and this is indeed good news, especially for trade. Manufacturing jobs tend to pay more, relative to the education level (not skill level) needed. The rapid increase in productivity is also good news. And the increase has stemmed the loss of manufacturing jobs. Unfortunately, however, the more robust manufacturing sector has not yet led to much net hiring as only 136,000 manufacturing jobs have been created in the first 9 months of the year after **a loss of 5,743,000 manufacturing jobs in the past decade!** Moreover, in the past two months 32,000 manufacturing jobs have been lost. Most of the jobs created this year were temporary and occurred as industry was rebuilding inventories after cutting them too much in reacting to the late 2008 financial crisis.

Increases in productivity over the past year and business disgorgement of workers has resulted in huge cash and greater profits. Thus, businesses are now in a position to hire if they see growing demand. However, demand is not going to occur spontaneously, and businesses will continue to invest in labor-saving technology and to further rationalize production. Thus, absent more aggressive monetary policy and fiscal stimulus, I see little chance that growth in 2011 will make much of a dent in the unemployment rate. Thus, I continue to look for the rate to hover near 10%.

Fed policy: At the conclusion of their September 21 meeting, the Federal Reserve issued an asymmetrical directive on the economy. Their concern for growth was no longer tempered with the notion that growth would pick up without further policy help. As a result, the FOMC warned that a further increase in their balance sheet, quantitative easing (QE), might be needed if their concerns were justified. The increased probability that the Fed would “push out” more liquidity had very negative implications for the dollar. The implication for equities is positive, but more qualified.

Four questions arise:

- Is QE actually needed and will the Fed use it?
- How will the Fed proceed?
- Will it work?
- Will it cause future inflation?

I do not think that the economy is about to enter a double dip. At the same time, I do not think growth will be sufficient to bring down the numbers of unemployed at an acceptable rate. It appears to me that in his recent speeches, Fed Chairman Bernanke would introduce QE in order to facilitate faster growth and bring down unemployment without requiring that the economy relapse into recession. Moreover the New York Fed president, William Dudley, supported the notion that QE is being considered. And while there are several members of the committee that disagree with the strategy, I doubt that there is enough resistance to prevent the Fed from acting. In my opinion QE is both needed and will be used.

St. Louis Federal Reserve President, James Bullard, was one the first officials of the Fed other than Chairman Bernanke and New York Fed president Dudley to outline why QE might be needed and, more recently, how it should be applied. Basically, his notion is that, unlike in the financial crisis, when “shock and awe” was appropriate, QE should be applied in a measured way, but continuously, until GDP growth can be sustained without such help and is robust enough to bring down the unemployment rate as quickly as possible without engendering inflation. Bullard is a “Chicago-style” monetarist, and very, very smart. Thus, he gives Chairman Bernanke credibility with the more conservative members of the FOMC.

There is a legitimate debate, both inside and outside the Fed, on the impact that QE would have on the economy. Dudley estimates that the effect of a further \$500 billion increase in the Fed’s balance sheet would be equivalent to a 50-75 basis point reduction in rates. But even if that is true, would it stimulate demand enough to make much of a difference?

My previously-stated opinion is that the rise in asset prices resulting from more liquidity would, in time, make households feel richer and they would spend more as a result. Former Chairman Greenspan and others have maintained that an increase in wealth translates into a small increase in spending. I agree. And in the absence of robust earnings increases, the attempt to support asset prices is warranted. But given the transmission mechanism, i.e., that the effect works via an increase in asset prices, it is very important that businesses and households understand the process and endorse it. If so, confidence will increase and this will speed up the impact on the economy.

While I think business leaders will come to understand the process, I am somewhat skeptical that households will and, ultimately, households create most of the demand. The problem is that a significant portion of household members will continue to be unemployed or fear for their jobs. Adding to the problem, is that many of these households are swayed by ideologues such as Glenn Beck or those who, in good faith, speak out of emotion rather than reason. The general public is understandably frustrated and angry at the evolution of the economy over the past few years, but media manipulation by emotion and ideology is contributing significantly to the headwinds facing the economy.

Will aggressive liquidity additions lead to future inflation? They could, but only if the central banks fail to reign in the liquidity once their goals are accomplished. Some observers maintain that recent increases in commodity prices are a warning of inflation to come. I disagree. Rather commodities can be viewed as hard assets as well as inputs into production. I regard the current

increase in commodities as an indication that a more aggressive Fed policy will get the desired result. Commodities represent less than 7% of the inputs into GDP and the recent increase in commodities as well as profits are simply a reflection of the relative input price shift away from labor and structures to other factors of production, commodities and profits. Only if wage costs begin to increase faster than productivity gains on an ongoing basis, will the increase in liquidity translate into inflationary pressures. The current unemployment rate and capacity utilization rates suggest a greater risk of deflation than inflation.

Finally, will the Fed allow more inflation to occur to lower the burden of debtors, especially the government? This is a real risk, and it is clear that Chairman Bernanke would like to see a somewhat higher inflation rate in the period ahead, at least until GDP growth is more robust and begins to result in significant employment gains. Monetary policy cannot dictate the distribution between inflation and real growth. The Fed can only pursue policy that boosts nominal growth. Still, I have no reason to believe that the Fed will tolerate a continuously rising level of inflation once employment gains are significant and sustained.

Tax policy update: Last month I forecast that Congress would pass some form of an extension of the Bush tax cuts before the mid-term election. I was wrong. It now appears that Congress will be forced to pass the extension in the lame duck session of Congress following the election. Given my assessment that the equity prices would be negatively impacted if the Congress does not pass such a bill, the absence of passage could lead to a market crisis.

My revised opinion is that Congress will pass a tax cut extension in the lame duck session. It is still not clear that the extension will apply to all income levels. However, more Democrats have recently declared that, at least temporarily, the extension should be made for all incomes. One proposal that represents a compromise, is to allow tax cuts to expire for higher income households, but to raise the level of income at which the tax cuts will expire. Even if the Republicans win the House and have an equal number of Senators as the Democrats, there will still be enough Democrats in Congress to block a veto-proof extension without some changes. In addition, if a temporary extension is passed without changes, a move to a more rational permanent tax policy is put off in a way that makes Congress look impotent (which it may be). Thus my best guess is that the extension will delay the small tax hike (the president wants 5%) on capital gains and dividend taxes and that, taxes will rise for higher income households.

The election, fiscal policy and the economy: At the signing of the Declaration of Independence Benjamin Franklin purportedly said, "We must all hang together, or assuredly we shall all hang separately". I do not usually comment on political matters unless I can tie them firmly to their economic consequences. And I try to keep my own political biases out of the argument. Thus, in writing the following, I am treading on grounds that many of you may disagree with based on principle rather than because of faulty analysis (although that may be present as well). Moreover, I am an economist not a political scientist. Thus, just as I regularly take non-economists to task for drawing unjustified economic conclusions, I risk justifiable censure based on the following analysis. Nevertheless I think it is broadly relevant to the economic outcome that lies ahead.

As those clients with whom I have regular briefings know, I think the outcome of tax policy is more important than the outcome of the election. My reasoning for giving great weight to tax

policy is that, with respect to the extension of the Bush tax cuts, either with or without an extension for high income households, the impact is huge. Failure to pass an extension in any form will, in my opinion, have a much more negative impact on consumer and business confidence than is reflected by the consensus. As such, any tax revenue that might be gained by higher rates will potentially be more than lost because of the negative impact on growth. Essentially, this outcome could be tantamount to the 1937 economic relapse that occurred when the Fed and Administration prematurely curtailed stimulative policies. Conversely, passage of the extension in almost any form will eliminate an uncertainty that now inhibits both consumer and business confidence.

Before considering the impact of the election results, first examine the bills that have been passed in the first two years of the current administration. They have been compromises that were cobbled together more by what could be done than by a rational approach to the problem. Democrats were in disarray following their huge victory. Rather than focus on integrating what could be done with the public interest, the left and moderates refused to support centrist policies that might have been both in their interest and the public interest. Meanwhile, Republicans were uncooperative, choosing to focus more on how to rebuild the party than on the public interest. And unfortunately, the public interest and party rebuilding are, in this case, inconsistent. Thus, there was a failure of moderates in both parties to build a coalition that could result in reasonable legislation.

As an example of one result, the health bill is a mishmash of requirements that broadens coverage, but does not appear to bend the cost curve. Moreover it is not “clean” and contains some perverse incentives. Making things worse, politicians of all stripes have preferred to “spin” the result to their advantage even if it means misinterpreting what was done.

Now consider the impact of the coming election. There is no range of Republican gains in the House and Senate that would allow policies of the GOP to override an Obama veto. Moreover, the public, understandably angry, frustrated and hurting, has little idea what hit them. The one thing they know, and I agree with, is that their elected officials, whether Republican or Democrat have collectively failed them. Thus, many of the more candidates who have already forced out incumbents in the primaries have won their candidacy due to an emotional, not rational response to Congressional failure. Moreover, most of the new Republican candidates have an “anti-government” bent and will likely reinforce the “just say no” spirit that has prevailed on the party. And in many cases, the “spin doctors” that the electorate are listening to have a very negative message that seem to me to be more disruptive, rather than uniting once the new Congress is seated. Hence, my Benjamin Franklin quote above.

One result of the 2008 election was that the Democrat landslide generally removed moderate Republicans that were elected in swing districts. As a result the right wing has not only gained in strength, virtually taking over the party, but this wing has successfully motivated a vocal activist group to put up candidates that are ideologically motivated. In this election, I predict that many moderate Democrats will lose in the swing districts. Thus, the Congressional middle may be hollowed out even more than before.

An argument that I often hear is that gridlock is good. I have previously made the case that gridlock is good only when the economic times are good and “rocking the boat” is likely to have negative consequences. Moreover, in a counter example, the Republican-controlled Congress and Clinton administration passed a number of bills including welfare reform and compromise spending and tax bills that, along with coordinating monetary policy with the Fed, resulted in both growth and budget surpluses.

Gridlock is bad when strong policies are necessary. We have no energy policy. We need to bend the cost curve on medical expenses. We are getting near the crisis stage regarding future entitlement claims relative to tax revenues. We have not targeted public and private resources to infrastructure, communications, export and investment. I see politicians on both sides acknowledging the need to curb entitlements, but no one giving the specifics to accomplish this goal for fear that it will offend voters (which it probably would). A recent news item shows a protesters placard reading “stop socialism, save social security.” It may well be the case that the American public is indeed not ready to make the sacrifices needed to service the public debt and make the investments necessary to remain competitive in an increasing global economy. I consider the “mood” as similar to that of the drug addict that is willing to “shoot up” on put off accepting the inevitable pain but, in the process, increasing future pain.

There are many examples in the past when Republicans and Democrats compromised their differences with the good of the country in mind. The Interstate system was financed publically and built privately. And, aside from the portion of the stimulus that went to mitigating deteriorating state and local finances and thus preserving public safety and education jobs, much of the stimulus money was distributed in contracts, and many earmarks, to private companies who used private sector workers to accomplish the goals. Yet many of those whom I predict will be elected think that government should not be involved with things that, in my opinion, can only work through public and private cooperation. Thus the legitimate anger over the fact that many politicians have put their own and the party interest above the public interest will not, in my opinion, result in an improvement after the election.

One final but important example of cooperation is central to what must be done but isn't being done. In the 1970's, the Tower commission, made up of two Republicans, Senator John Tower of Tennessee, and Alan Greenspan (in his role as a “policy wonk” long before he became Federal Reserve Chairman), and Democrat Senator Ed Muskie worked out a solution for putting Social Security on a solid financial footing. Their recommendations were largely accepted and passed by Congress. Moreover, the legislation was passed long before a crisis ensued. In today's environment, hard decisions for dealing with a looming entitlement crisis have been put off and concrete solutions have been avoided by politicians from both parties, in large part because the public seems to want impossible painless solutions.

My conclusion is that the impact of the election will make it more difficult, rather than less to implement rational economic policy. My hope is that both Democrats and Republicans realize that neither can achieve their goals without cooperation and compromise. My fear is that there will be too few centrists left to work out the necessary compromises. Some things will get done. A tax bill will, at some point, extend most or all of the Bush tax cuts. My best guess is that, final passage will be approximately what the Administration is proposing. One difference is that some or all of the money gained by allowing the tax cuts on higher incomes expire will be funneled

back to the middle class or, better in my opinion, funneled to business. After all, it is business that creates jobs and we need to continue to feature investment over consumption on the margin. However, in the present situation in which there are a lot of unused resources, we need increased consumption as well in order to justify some of the investment.

State and local government debt: Previously, I have suggested that the state and local financial situation in some ways resembled that of Europe where some nations, Greece, Ireland, Italy, Portugal and Spain, had major debt burdens and had to rely on the backing of other nations such as Germany to get them through a transitional period. Naturally, the supporting nations demand that those countries with huge debts introduce enough austerity to protect the investment of the lending countries. Like the Euro-zone countries, the U.S.A. has a common monetary policy, but individual states have separate fiscal situations. Of course there are differences with respect to culture and language.

In the past year the Federal government has mitigated the state and local budget shortfalls. Approximately one-third of the fiscal stimulus money went to preserving jobs at the state and local level. Recently, another \$26 billion bill was passed to preserve these education, health and safety jobs. Still, given the depth of the recession, many state and local budgets cannot be balanced without further sharp cuts in services and, perhaps, increased tax revenues. Since states are not likely to increase tax rates in the present situation, growth is the best prospect for boosting tax revenues and reducing the demand for services.

Meredith Whitney has published a study suggesting that the states have a characteristic that resembles the banking situation just before the crisis. Specifically, states have used off-balance-sheet financing to make achieve their required fiscal balance. Moreover they have borrowed heavily from their pension funds which are now underfunded to the tune of more than a trillion dollars. As a result, Whitney thinks, and I agree, that some local governments are vulnerable to defaults at a time when state budgets are also in trouble and the political climate for further fiscal stimulus is not good.

It seems almost certain that, in the next year or two, that state and local government spending and job cuts will negatively impact the economy, providing an offsetting headwind to further monetary and fiscal stimulus. There will be no painless solution to the country's fiscal problems. On one hand we badly need to spend more fiscally on infrastructure and those things that will support an expansion of business competitiveness and job creation over the near to intermediate term. This is the only way to create the kind of growth that will allow us to service and slowly pay down debt over time. At the same time, to avoid a fiscal crisis at all levels of government, the Federal government must cut entitlements while preserving the safety net. And it would be preferable to accomplish this in the same way as the Tower commission, i.e. without forcing a large portion of the lower-income public to face a precipitous drop in expected income. By delaying the process until a crisis arises, it may well be impossible to achieve the latter goal.

The Markets

Interest Rates: In contrast to the forecast of numerous observers warning that bonds are a bubble, rates are likely to stay low for the foreseeable future. I expect the Fed to increase its balance sheet by \$500 billion to \$1 trillion on a gradual basis over the next year or more. In order to keep mortgage and other private rates down, they will likely buy along the yield curve as needed to prevent it from steepening too much. As a result it is not surprising that yields out to 5-years have fallen to new generational lows. It now appears to me that the 10-year note will likewise test the financial-crisis low. I am lowering my two month range on the 10-year note to 2.15-2.55%.

Two things are needed to reverse the powerful downward move in rates. Either nominal GDP growth must pick up more robustly, or the situation worsens to the point that investors, including foreign sovereign funds, lose confidence in the dollar or the U.S. recovery. The Fed is well aware of this and will act accordingly. Those who contend that an aggressive Fed policy to increase their balance sheet will weaken the dollar and result in a loss of confidence have a point. But consider the alternative. An economy that slips back into recession will further undermine the ability to pay off the debt by lowering tax revenues relative to spending. And in this scenario the dollar could collapse!

I am not looking for a double dip, but I feel strongly that the Fed will announce a form of QE at their next meeting. The prospect of continued growth will eventually overcome the downward pressure on the dollar except for those countries in Asia such as China where there is a need to boost domestic demand and increase the value of the currency to hold down the price of energy and food that they will increasingly need. My best guess is that the G20, meeting in Seoul, South Korea on November 11-13, will issue a communiqué that helps stabilize the dollar and lower the prospects for a boycott of U.S. fixed income securities.

Currencies: The Fed's asymmetrical assessment of the U.S. economy and prospects for QE was a distinct negative for the dollar, causing me to raise my range on the euro following the meeting. I am also raising my range for the Japanese yen and Canadian dollar. However, I don't agree that the U.S. intentionally started a round of competitive currency devaluation. Rather, the Fed's motive is to support nominal GDP growth in the U.S. Fed officials clearly knew that a falling dollar would be a consequence of their policy communiqué and decided that this was acceptable. Indeed it forces other countries to either introduce similar policy strategies or face somewhat diminished competitiveness against U.S. goods.

Does the Fed want a lower dollar? Ideally it does not. However, the near term result might prevent a worse longer-term result if the U.S. falls back into recession. Moreover, competitive devaluation, if it does result, is preferable to increased protectionism. If all countries enact a more stimulative monetary policy, then more, not less trade will result. Conversely, protectionism leads to a loss of productivity and less efficient production.

If my thinking is correct, the November 11-13 G20 meeting will arrive at some agreement on mutually beneficial monetary policies that will restore confidence in the dollar and stabilize it. My revised ranges assume that the G20 will accept the new somewhat lower level of the dollar. However, if I am wrong and confidence is not restored a currency "crisis" could result. Also, not

that there is an October 21-23 meeting of central bank heads in Korea that could also result in a market-moving announcement that prepares investors for the outcome of the November meeting.

My new ranges are: euro \$1.34-1.42, dollar/yen 80-86, and Canadian \$0.96-1.02. The risk if I am wrong in my assessment of the forthcoming G20 meeting is that the euro will move back to its \$ 1.60372 July 2008 high and that dollar/yen will move through its 1995 low just below 80 yen per dollar.

The Canadian dollar is more dependent on Asian growth. A currency crisis for the U.S. dollar is not as obviously positive for the Canadian dollar, as it could undermine confidence in world growth.

It appears that a number of countries, especially in Europe, are falling in line with the U.S. call for faster yuan appreciation. China resists outside pressure, but the stakes are high and China understands it is not in their interest to contribute to a trade war that might increasingly involve trade restrictions. It also realizes that, as it increases domestic demand and the welfare of its citizens, a gradual rise in the yuan is beneficial. I have been overly optimistic in the past about the speed of yuan appreciation, but I am again forecasting the pace of appreciation will increase. I suspect that, although it will remain secret, the Chinese will commit to a specific appreciation schedule. My best guess is that the yuan will appreciate 12-15% over the next year. It has appreciated 2.5% since the June announcement that it would become more flexible (4 months). It appreciated 0.3% on Friday, October 8, following the October 7 meeting of deputy G20 nations. That puts in on a pace to appreciate 7-8% a year. I think the pace will probably increase a bit and that will keep the U.S. and European administrations from allowing their respective Congresses and Parliament's from completing the enactment of punitive legislation. However, the Chinese will continue to increase the rate gradually and not announce a one-time-only revaluation as was done at the onset of the 2005 appreciation. But, ironically, the scope of appreciation will likely be close to or even a bit faster than it was in the 2005-2008 period.

Equities: The Fed's September 21 communiqué has been a significant positive for all asset prices, lowering yields and boosting stocks and gold alike. As David Tepper, the highly successful founder of the Appaloosa hedge fund, said on CNBC a couple days after the Fed meeting, the Fed has provided a "put" on the stock market. If the economy picks up, it is good for stock prices. If the economy continues to slow, the Fed will introduce QE and this is good for asset prices, including stocks.

I agree with Tepper. Since the Fed's announcement, the economy has remained sluggish and Congress failed to agree on an extension of the Bush tax cut. I consider both of these developments, especially the failure to pass a tax bill as negative for equity prices. Still the market rallied another 2.2% despite recent bad economic and tax news.

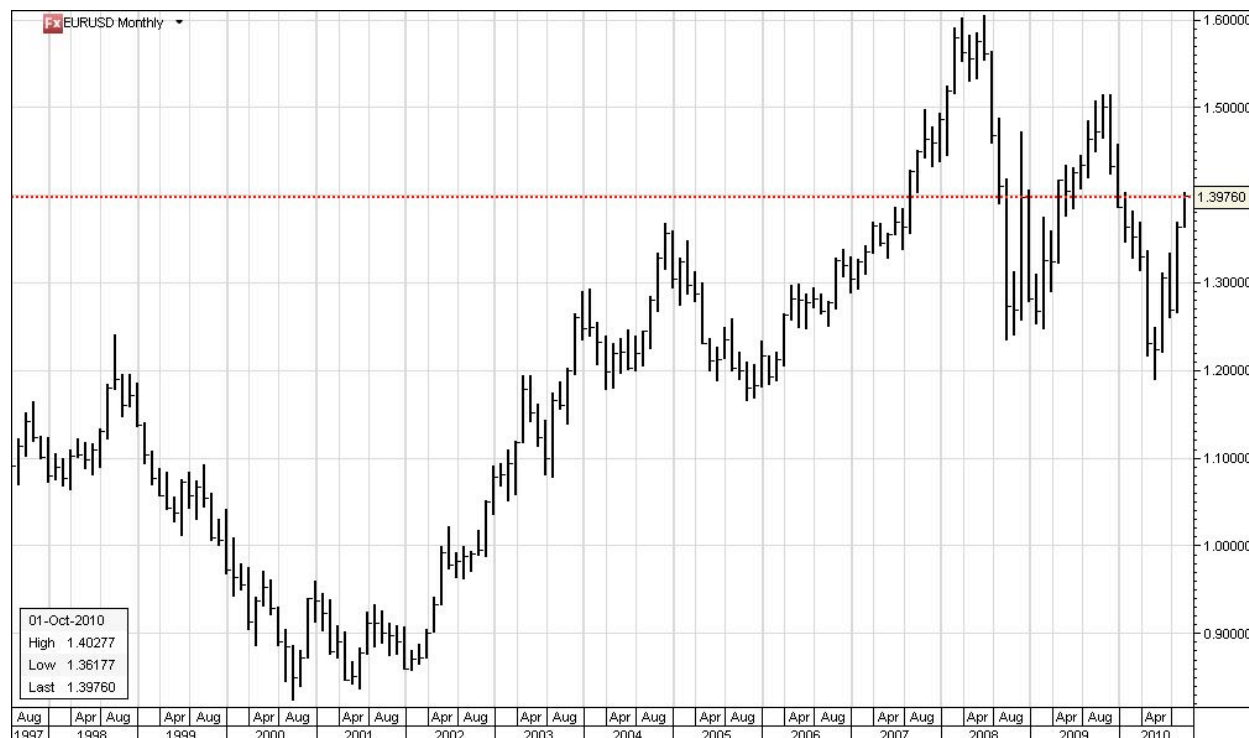
I am, frankly, torn between forecasting a significant correction based on the political and economic negatives and "giving in" to the reality that the Fed has a great deal of power to boost asset prices by flooding the market with liquidity. Stock prices are nominal and, in the intermediate term, are insulated from an increase in inflation expectations. And despite the failure to extend tax cuts before the election, most investors think passage of a bill in some form

is almost a certainty in the lame duck session. Thus I am somewhat confident that, if the S&P does correct in the near term, the price drop will be contained. As a result, I am raising the downside on my S&P to 1115 from 1050 but shortening the time period to one month.

Two policy developments could derail the stock market really, one immediate, the other before yearend. First, the IMF and G20 did nothing to calm the currency markets at the just-completed meeting, and stock prices could undergo a correction in advance of the mid-term election. The dollar is likely to fall further in the absence of G20 action, and a further dollar drop may not be as beneficial for the market as has recently been the case. Second, if Congress does not pass a tax cut extension in the lame duck session, I think the stock market will undergo a significant correction between the election and year-end. In this case the S&P will likely test and possibly fall below the 1050 support level, as a market crisis response to this failure forces Congress to act.

Despite the fact that the market has moved above a significant intermediate-term support level, I am skeptical that the market can gain more momentum before the mid-term election. Earnings are not likely to surprise on the upside, although most forecasters have already lowered their expectations given the slowdown in third quarter demand. Still, I am raising the top of my range to 1180 with the realization that, near-term, the burden of proof for a market reversal now lies with the bears. And if the upcoming G20 meeting is successful, this should be supportive of equity prices. Conversely, if the November meeting does not stabilize currencies, a further dollar drop could be destabilizing and could raise fears that our trading partners could back away from U.S. asset purchases.

In summary, my one month range for the S&P is 1115-1180. Based on the outcome of the G20 meeting and tax legislation following the election, I will revise my range accordingly.



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