STUART INVESTMENT
MANAGEMENT LIMITED

Economic and Market Update: November 8, 2010

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Summary

Third quarter growth came in at 2%, right on the consensus and at the upper end of my 1.5-2% forecast. The components were disappointing but, as a result of somewhat improved employment prospects and the positive-recent response to the resumption of quantitative easing (QE2), I am raising my estimate of fourth quarter growth to 2.5-3.5%, up a full percent from my previous forecast. I am tentatively forecasting 3-4% growth in the first half of 2011. Housing and state and local budget constraints are the main factors holding growth down.

The 151,000 gain in payrolls and the upward revision of 110,000 in payrolls for the past two months was a very encouraging positive shift in employment momentum relative to the past few reports. There is a long way to go, but it appears that private payrolls are beginning to increase at a rate that will allow the economy to continue to grow. Even if the employment rate does not fall, it will be very positive for the economy if future payroll increases bring more discouraged workers back into the labor force.

The election results were pretty much as the market expected. I continue to maintain that the importance of the election per se is not as important as whether Congress can work more cooperatively with the administration. The present administration did not cause the financial crisis and could not, under any circumstances, revive the economy to its former dynamism in just two years. What is more important is whether Congress and the Administration can constructively deal with

- necessary tax changes,
- the need for business and government to act cooperatively to promote investment and competitiveness in a global world,
- developing a sound energy policy,
- dealing with rising health-care costs, and
- Managing the ticking time bomb of future entitlements obligations in a fair and economically sound way.

Gridlock is not a viable option.

In contrast to fiscal policy, monetary policy is already contributing to and reinforcing growth. Even before the Fed announced the scope of the second round of QE2 asset markets rallied,

suggesting a positive “expectation” response. In contrast to many observers, I think QE2 is an appropriate Fed response to the current economic situation, especially in view of the nature of fiscal problems. Over the next few months, Treasury rates will stay near zero at the short end. With the Fed’s intent to maintain a duration between 5-7 years, I expect to see intermediate-term treasury rates stay begin to rise well before the mid-year, 2011 end of QE2.

Based on the improved economic outlook and the impact of QE2, I am raising my 2 month S&P forecast range to 1,180-1,280. The downside risk is if Congress and the Administration do not extend the Bush tax cuts in the “lame duck” session. Were it not for the fact that investors have already built in some of the QE2 effects, the top of my S&P range would be even higher.

Despite the near-term negative impact of QE2 on the dollar, I view the longer-term impact as positive. The process makes U.S. growth more robust than would otherwise be the case. Moreover, the positive impact of QE2 on asset prices will attract investment into the U.S. A dynamic economy is much more important for the dollar than QE2. As a result, I think the dollar will bottom between now and the coming week’s G20 meeting (November 11-13). The risk is if the G20 meeting ends in discord.

The Economy

Growth: Recent economic data suggest the economy is beginning to grow a bit faster, led by an increase in business profits and private payroll gains. As a result of this pickup and of what I believe will be the benefits of quantitative easing, I am raising my forecast for fourth quarter growth by one percentage point to 2.5-3.5%. I am also increasing and widening my tentative first half, 2011 growth forecast from 2-2.5% to 3-4%, with upside risk. However, this forecast is based on an assumption that the “lame duck” Congress passes an extension of most or all of the Bush tax cuts.

The apparent pickup of new orders, private payrolls and the implementation of quantitative easing are the factors responsible for my more aggressive growth forecast. Following sluggish 1.7% and 2.0% growth in the second and third quarters, I expect the pickup to be more broad-based in the fourth quarter. For example net exports subtracted 3.5 and 2.01 percentage points from second and third quarter growth while housing subtracted 0.8 percentage points from the third quarter. My only concern with fourth quarter growth is that part of the inventory build in the third quarter (it contributed 1.44 percentage points to growth), was undesired.

Personal consumption expenditures (PCE) contributed 1.54 and 1.79 percentage points in the second and third quarters respectively. I expect a 1.5-2.0 percentage point contribution in the fourth quarter. This is still sluggish by historical standards and largely due to continued debt loads and high unemployment. However, after a weak third quarter, I expect housing to stabilize and even add a bit, say 0.25-0.5 percentage points, to fourth quarter growth (seasonally adjusted). Housing weakness in the third quarter was to some extent a “payback” from the end of tax credits that pulled growth forward. I like to add the PCE and housing contributions together since a fall in one tends to leave more discretionary spending available in the other. Taken together, I expect growth from household spending to contribute 1.75-2.50 percentage points to fourth quarter growth.

Non-residential investment is very hard to predict. It contributed 1.51 and 0.91 percentage points in the second and third quarters respectively. I expect it to contribute between 1-1.25 percentage points in the third quarter. A general pickup in growth will likely lead to greater investment, but guidance has been cautious. Almost all of the investment is in equipment and software and nearly none in structures. I expect that pattern to continue for a few more quarters. Inventory accumulation will likely contribute less to growth than the 1.44 percentage points of the second quarter. I estimate a 0.25-0.50 percentage point contribution.

Net exports will eventually benefit from the weaker dollar. But increased consumer spending has a disproportionate effect on imports. Thus, the reduction in the trade deficit is likely to be gradual. Still with the G20 focus on the U.S. deficit, I expect trade to subtract just 0.5-1.0 percentage points from fourth quarter growth, less than the 3.5 and 2.01 percentage points of the second and third quarters.

State and local governments will continue to struggle with budgets that must be balanced. Moreover the contribution of the Federal stimulus to government expense will continue to wane. On balance, I expect governments at all levels to contribute 0-.25 percentage to fourth quarter growth.

My first half growth forecast range of 4-5% is based on three factors.

- First, QE2 has already had a positive impact on asset prices and business confidence even before it was implemented. I expect this momentum to continue to build over the next two quarters.
- Second, the fall in the dollar will increasingly have a positive impact on reducing the trade deficit.
- Third, I expect an extension of most or all of the Bush tax cuts.

Failure to pass a tax cut extension will reduce my growth forecast.

I will issue my 2011 forecast in December's monthly report. The above positives will be mitigated by both a still sluggish housing market and the drag from continuing state and local budget problems. Were it not for these negatives, I would forecast 4-5% growth for the entire year.

Employment: The 151,000 increase in October payrolls beat the consensus by 91,000. Moreover revisions in the previous two months increased the measured payrolls by an additional 110,000 making the total increase 261,000 relative to the September number. Private payrolls improved even more adding 159,000 jobs in October and 409,000 for the past three months. Job losses in the government sector were 300,000 but most of those were temporary census jobs.

Hourly earnings increased by seven cents to $19.17 while hours worked increased to 33.6 from 33.5 per week. While it is risky to extrapolate from one month's numbers, it was the most encouraging employment report in several months and could presage more sustained increases, less dependent on the inventory rebuilding and census hiring that boosted employment in the spring. And although the unemployment rate remained at 9.6%, the fourth quarter is off to a good start.

Fiscal Policy and the Election: I expect an extension of most of the Bush tax cuts to take place in the lame duck session of Congress. But it is not a "done deal". Neither party can force a solution. Democrats are divided with some willing to extend all cuts, including those for high income households. But the President could veto such a result if he does not get some compromise such as a five percent increase in dividend or capital gains taxes or expiration of tax cuts for high income households Similarly, Senate Republicans can prevent passage of the Administration's proposal using the filibuster.

The willingness to find a compromise that removes uncertainty for both households and businesses is key to continuing what appears to be an emerging, potentially sustained boost in growth. And despite the fact that the make-up of Congress will be changed next year, passage of a tax cut extension in some form will be an important determinant of whether the parties will be able to work together for the good of the American people or will continue, as happened in the past Congress, to position for personal and party gain. As I have written several times, gridlock in a situation where much needs to be done to improve the U.S. economic and political standing, is a huge negative.

Some observers are optimistic that a pragmatic president and Congress will put aside their differences at least enough to pass necessary legislation to curb health costs, promote business investment and job creation, achieve more energy security and gradually eliminate the budget deficit in a reasonable and equitable way. They cite the ability of a Republican Congress and Clinton administration to pass welfare legislation, pay-go, that resulted in two surpluses.

I am not as optimistic (although I hope the optimists are correct). The 2008 Obama "sweep" removed a number of moderate Republicans who were willing to reach across party lines to achieve compromise legislation that was economically thoughtful and of benefit to the U.S. It left the party in the hands of a more ideological and, frankly, emotional group. The 2010 "reaction" election has removed many of the more moderate Democrats, leaving the party more in the hands of a similarly ideological group. Such groups on the left and right are necessary for crystallizing issues. But they have taken over the Congress and compromise seems less, not more likely as these groups vie for power in 2012. The center has increasingly been hollowed out. Thus it will be more difficult to achieve a rational solution to reduce the "consumptive" portions of government spending while redirecting spending to promote investment and jobs.

Monetary policy: In previous reports, I have written about my support of QE2, explaining how it is supposed to work, and comparing it with the alternative. Briefly, QE2, boosts asset prices, making households and other holders of those assets feel richer and thus they spend more. It also tends to lower interest rates a bit and, in the near-term, undermines a key factor supporting the dollar. Much of the focus and criticism is in regard to the latter factor. My view is that, absent a more stimulative fiscal policy, the prospect of robust growth and lower unemployment is poor. And, frankly, the U.S. cannot afford a stimulative fiscal policy unless it also includes credible future deficit reductions.

Three criticisms of QE2 and recent critics (that I respect) are:

- “It will cause runaway inflation” (Former Tiger hedge fund manager and investor Julian Robertson).
- “It won’t work” (Brazilian Finance Minister Mantega).
- “It cheapens the dollar” (German Finance Minister Schauble).
- “It will result in an asset bubble” (Investor and market observer Jeremy Grantham).
- “It’s a Ponzi scheme” (PIMCO’s Bill Gross).

Some of these critics went out of their way to express the situation in dire terms that, in my opinion, undercut their arguments.

Milton Friedman characterized inflation as “too much money chasing too few goods”. In our modern global economy I would rephrase that as “too much credit chasing too few goods”. When credit is contracting (velocity falling), as is currently the case in the U.S., more money is needed to support the existing credit potential.

While I respect Robertson immensely and agree with a lot of his observations, he used Zimbabwe as an example of what could happen. This is pure scare tactic and completely unwarranted. Yes Zimbabwe has hyperinflation, but it has virtually no credit and its problem is not lack of demand, but lack of ability to supply that demand. Thus printing money simply allows buyers to bid up the price and does not increase supply. It is a classic example of the Friedman concern and has no validity as regards the U.S. Robertson is a very temperate person and I am not sure why he used this example.

In the present situation the Fed Chairman claims to want a bit more inflation but, in my opinion, what is really the case is that he is willing to accept more inflation to boost demand and thus make use of more labor and capital that are in excess supply. With our system of relatively unencumbered labor and capital markets, increased demand will initially be satisfied by increased productivity, although an unintended consequence has been to reinforce the rise in commodity prices. If the U.S. is fortunate enough to increase demand and reverse the downturn in velocity, the Fed can just as easily sell off and roll off the assets it accumulates, thus lowering its balance sheet as needed. It also has the ability to raise interest rates. Yes, we could have inflation, but that is a Fed “mistake” that could be made down the road, not now.

I am more sympathetic to the concern that QE2 won’t work. But it is “the only game in town”. The alternative is to do nothing, which almost certainly would result in less growth and still a weaker dollar in the long run. It is true that QE2 works very indirectly to create jobs by raising demand, but direct job creation would almost certainly hike the budget deficit, whereas QE2, if anything lowers the deficit by lowering interest rates, and therefore financing costs a bit. It also increases profits at the Fed that and those can be turned over to the Federal government to reduce the deficit (the Fed’s profits rose 122% in 2009 vs. 2008), almost entirely resulting from its increased balance sheet. It’s a very small, but positive benefit.

Returning to the question of “will it work”, I point out that asset prices have risen since the prospects of QE2 were announced and even job creation appears to be picking up. Given all the other negatives that are facing the U.S. economy, I maintain that there is a strong possibility that, given the importance of expectations, QE2 may be more powerful and work more quickly than the naysayers think.

Regarding the concern of Schauble and others that QE2 cheapens the dollar, again consider the alternative. The dollar has been falling in a controlled fashion for years (with some periodic rebounds) and, unfortunately, I suspect will continue to do so. But the reason is not too many inflationary dollars but rather, both because we have underinvested (over-consumed) in the U.S. and do not have a level playing field with some countries such as Japan and China. If the U.S. does not stimulate growth and, especially investment in education and capital, the dollar could easily fall in a less-controlled manner. QE2 is negative for the U.S. in the very short run but, if it works, it will actually strengthen the dollar as foreigners invest more in the U.S. and U.S. growth rebounds.

Jeremy Grantham is correct that QE2 will increase asset prices but his conclusion reminds me of Gerald Ford's "WIN" buttons (Whip Inflation Now). An increase in asset prices at this point is an economic positive because it augments growth. It was a negative when the U.S. was growing robustly and at full employment and should have been running surpluses. At that time, the Fed should have been "blowing against the wind" regarding the housing price bubble or, in the late 1990's, against the NASDAQ bubble.

Finally, I have nothing but respect for Bill Gross's financial acumen (and willingly invest in his fixed income funds), but he likes to entertain with his writing. It is emotive and folksy and I will attribute his Ponzi scheme reference to his attempt to entertain. A Ponzi scheme pays investors out of principle, telling them it is a return on assets. QE2 is an accumulation of low-risk assets with no attempt to pay out the proceeds, except for the audited profits that it makes on the interest. And, as mentioned above, those profits go to reducing the budget deficit. I will continue to invest with Gross but prefer to read Joyce Carol Oates or Elmore Leonard for my fiction.

Frankly, I think these "titans" of industry and money management are simply fearful because the solution has not been tried before under the present circumstances. However, the "do-nothing" policy has been tried in the early 1930s and made things a lot worse. We are in a difficult economic situation with little wiggle room on the fiscal side. To the extent that monetary policy is pursued with a "heavy hand" it is, in my opinion a lot better than other alternatives.

The Markets

Interest Rates: There is a good and bad reason for interest rates to rise. The bad reason is when the economy or a business is doing poorly and the rating (ability to pay) falls. The good reason is when a business or the economy is healthy and the Fed hikes rates, driving all rates up. In the case of Treasuries, a sluggish or contracting economy can erode the tax base. Alternatively, spending that does not contribute to growth can increase the deficit and the "burden" of the debt. In both cases, the "rating" goes down as the debt takes more of the economic resources to service.

To the extent that the debt is owned domestically, it is a "zero-sum" game, i.e. the interest on the debt is recirculated but the income is not siphoned away from the economy. However, when the debt is owned outside the country, the benefit accrues elsewhere. Domestically held debt has distribution of income implications but the income to foreign debt holders represents a net loss to

the economy. I am not at all against cross-country investment, but if the U.S. uses the proceeds of those "passive" investments such as Treasury purchases to consume rather than invest, it undermines the ability to service the external debt. That, not QE2 is my concern for the dollar.

In my opinion, the QE2 policy not only keeps more of the interest on the debt circulating domestically, to the extent that it is returned to the Treasury, it also has a positive effect on the public deficit. To the extent it does boost growth, it will, in time, cause interest rates to rise as the economy becomes more healthy. This is the "positive" reason for rates to rise. If I am correct, then, QE2 will work quicker and more powerfully than the observers think. Investors are already boosting asset prices in anticipation of success.

As this is written, the 5-year note rate is 1.09% while the 10-year note rate is 2.53%. Because the Fed purchases will be concentrated in the 4-6 year portion of the curve, I expect these rates to be stable for a few more months. Thus the 5 year note is likely to range between 1-1.25%. However, since I expect the Fed policy to be more successful than the consensus, rates will eventually rise in anticipation of this success and before the Fed completes its 8-month long intention to buy Treasuries. Because of its success, I think that inflation over the next 5 years will move up to average 2-3% in the 3-5 year period, even if, as I expect, the Fed begins to reverse the asset purchases once it is convinced that the economy can grow in a sustained fashion on its own and reemploy unused labor and capital. As the economy grows, say, 3% on average and with nominal growth, say, 5.5% (inflation plus real growth), the five year note yields will likely rise back to the 4-5% range in this period. But I reiterate, I expect this result to be a positive response to a more dynamic, competitive economy.

Over the near to intermediate term, I think that 5-year note rates will bottom near its present level and be rising by the end of the first quarter. The success of the policy will likely allow the Fed to stop expanding its balance sheet by mid-2011. There will be no QE3. It won't be needed. Thus, while I do not regard QE2 to be a Ponzi scheme, I agree with PIMCO's Gross that the great bull market in Treasuries is ending.

The dollar: To Finance Minister Schauble's characterization of Bernanke's policy as "clueless" I reply "Nuts" (for my younger readers, General McAuliffe's "reported" response to the German high command's request that the 101st Airborne "Screaming Eagles" surrender at the Battle of Bastogne). Germany has reason to fear inflation. And the situation with the Euro perhaps requires a different response than in the U.S. Moreover, the U.S. has made numerous policy mistakes over the past three decades, but mostly, they involve irresponsible fiscal and regulatory policy. But Schauble's inflammatory response to the Fed policy reflects more on his own lack of political skill and, frankly ignorance, than anything else. In the short run, the fate of the dollar will rest much more on the success of the G20 to coordinate their policies and work together than on QE2, not on discord and name calling!

If the U.S. does not get its economy going in a manner that will minimize the accumulation of more debt, the dollar will fall more on the longer term, not less. Indeed, because I think the policy will be more successful than critics think (investors already seem to understand this by bidding up asset prices), the dollar will soon begin to regain some of its recent losses. And if the

outcome of the G20 meeting (November 11-13 in Seoul, Korea) is constructive, it will be the impetus for a dollar rally.

My rationale for a dollar rally is that, if agreement is reached on reducing trade imbalances and, if G20 leaders come to understand the same outcome that is causing asset prices to rise, then foreign investment in the U.S. will increase at a time when the U.S. trade deficit begins to stabilize, if not decline. The problems facing the U.S. may continue to put pressure on the dollar over the longer run but, in the short run, the dollar is oversold and under-owned. The risks to both the dollar and stock prices (see below) are lack of G20 cooperation and U.S. policy gridlock on fiscal policy.

Specifically, my 2-month forecast for the euro is $1.34-1.44, dollar/yen 80-84, and Canadian dollar $0. 96-1.02. If the G20 meeting ends in discord or if Congress fails to pass a tax bill, my forecast will be wrong and the dollar will continue to slide into year end with the possibility of the euro rising to the $1.45-1.48 area and dollar/yen moving through 80 to the 75-78 area.

In both my base case and the risk case the Canadian dollar will likely move higher. In both cases, QE2 will boost the economy and the Asian demand for more resources will continue. Canada continues to enjoy the benefit of its strategic resource position and the best mix of fiscal and monetary policy.

Equities: I am boosting my 2- month range for the S&P to 1,180-1,280. The downside, if reached or breached will result from a natural correction after the recent rally coupled with concern that Congress may not prevent the Bush tax cuts from expiring. If the S&P does correct to near the bottom of my range and the lame duck Congress passes a tax cut extension it will be a buying opportunity.

The risk to the market over the intermediate term is policy gridlock that extends into the coming year. However, if a tax bill passes, the markets will enjoy a multi-month breathing spell from political risk because, the true determination on how well the new Congress and Administration can work together will not be known until the spring budget deadline looms. Everything prior to that in the new Congress amounts to a political jockeying for position.

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