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Economic and Market 2011 Forecast: December 6, 2010

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Summary

My base case for 2011 is optimistic. I look for growth to be near 3% and the S&P to move to the upper 1300s. I expect 1.5 to 1.8 million jobs to be created although reentry of discouraged workers and an increase in hours of those employed part time will likely keep the number from being higher and the unemployment rate from falling below the 8 to 8.5% level. The risk is mostly to the downside and is based on the very real possibility that Congress and the Administration will not be able to agree on a sensible fiscal policy that avoids an economic "train wreck" in the "out" years.

My base case assumes that Congress will extend the Bush tax cuts at a minimum for all but the wealthy and temporarily preserve most of the cuts for higher incomes as well. At worst, the maximum increase for dividend and capital gains taxes will be 5% and more likely these taxes will remain the same. Some form of estate taxes will be adopted but it will be much less that the pre-Bush tax cut rate.

I estimate fourth quarter growth to be near 3%. If my tax scenario is correct, the S&P will likely begin 2011 in the mid-1200 level. With business profits leading the recovery, the S&P should continue to rise during the year, toward the 1400 level. And while I have concerns that the dollar has further to fall in the longer run, the moderate recovery in the economy and asset markets coupled with continuing debt problems in Europe will should allow the dollar to rally against the euro and remain well bid against the yen. I foresee a moderate rise for both the Canadian dollar and the Chinese yuan against the dollar.

In contrast to many critics, I see the Fed policy of expanding its balance sheet as constructive for both the economy and asset prices. By reinforcing the recovery with asset-boosting Treasury purchases, the Fed is likely to achieve its goal of augmenting job growth in a period with minimal inflation risk. Again in contrast to the view of others, I see the significant rise in commodity prices as a relative price shift and not a harbinger of general inflation.

The biggest risk to my forecast is Congressional gridlock. Without legislation to curb the rise in entitlements and raise revenues in a way to tax consumption relative to investment, the U.S. is headed to ever-rising external debt and a weakening ability to service both external and internal

debt. The U.S. needs to maintain a higher savings rate and to redirect both public and private spending to investments that maintain competitiveness in an increasingly global economy. I think that both parties and the Administration agree that incentives should be directed more toward business and away from consumption, but the Republican reluctance to raise any taxes prevents Congress from lowering taxes to the business sector where it is needed.

Although it does not affect my economic forecast for 2011, if Congress fails to adopt the appropriate set of fiscal policies to reinforce monetary policy in the near-term but curb deficits in the longer term, the attractiveness of the U.S. as a destination for foreign capital will wane before the rapid rise in external debt is brought under control. By hollowing out the political center, the last two national elections have left a disproportionate number of ideologues in Congress that could lead to the very gridlock the U.S. needs to avoid.

The Economy

Despite a weak November employment report, Fourth quarter growth appears on track to be near 3%. Both the monthly manufacturing and non-manufacturing ISM reports indicate such growth and the New Orders components suggest continuing growth. Housing and state and local budgets remain economic drags, but it appears that construction is leveling off. And although inventories are rising, they appear in line with the recent moderate growth in domestic demand.

An area of continuing concern is the impact of the trade deficit on growth. European debt problems will slow growth in Europe over the next several quarters at a time when the U.S. propensity to disproportionately import consumer goods will continue boost the trade deficit. The third quarter dollar weakness does not appear strong enough to offset this deterioration. Because the rise in the trade deficit has been so large in the second and third quarters, I am assuming it will not subtract much from the fourth quarter. But the risk to third quarter growth is a bit to the downside.

Although many observers think the Fed's move to increase its balance sheet by $600 billion (QE2) by the middle of 2011 is a mistake, I think it is a prudent way to buy insurance against an economic slowdown as the positive impact of inventory rebuilding and fiscal stimulus wane. By supporting asset prices, the Fed hopes to gain a positive "wealth effect" that will stimulate spending. Income growth is very weak as take home wage increases remain miniscule. So, despite the fact that QE2 is not a powerful tool, it should augment growth by, say, a half a percent in 2011.

My forecast for quarterly growth and other key economic variables is presented in Table 1. Because it represents about 70% of GDP, household spending will be by far the largest determinant of growth in 2011. I expect household incomes to increase by about 3.0% and, if households maintain their current rate of savings, household consumption should increase by about the same amount. The negative wealth effect of some further deterioration in housing prices will likely be partially offset by a positive impact of net worth in financial assets. On balance, I expect the household contribution to GDP growth (excluding housing) to be about 2.5%.

I expect residential housing to reverse its downward slide and contribute ½% to growth although the median price for housing may contract a bit further. The impact of foreclosures and those wanting to sell but unable to realize their desired price continues to overhang the market. Moreover, unemployment has forced many families and households to consolidate, undercutting the normal growth in housing demand. Counteracting this is the fact that housing deterioration due to neglect has increased the destruction of homes at a time when the new home building is well below the underlying growth in the housing need. Thus new construction, the determinate of the GDP contribution, is likely to increase moderately over the course of 2011.

I expect investment to contribute 1% to growth in 2011. Corporations are under extreme pressure to remain competitive in the global economy at a time when domestic revenue growth is very slow. Plant and software expenditures contributed about 1.3% of my estimated 2.7% growth in calendar year 2010. However, the drag from commercial structures resulted in non-residential fixed investment contributing about one percent to GDP. If as I expect commercial construction spending is neutral in 2011, then investment is the one area of my forecast in which there is more upside than downside risk.

I expect net exports to subtract ½% from 2011 growth. Given the disproportionate impact of increased household consumption in spurring imports, this area of domestic growth tends to widen the trade deficit. And despite concern over the effect of QE2 in weakening the dollar, the trade weighted index at the end of November was at the same level as a year ago as early year gains were recently given up. Thus, even if exports grow at the same rate as imports, the fact that the level of exports is so much lower than the level of imports will result in a further deterioration in net exports.

One good development is that growth in emerging markets is increasing faster than U.S. growth. And as emerging markets gain in their share of the overall world economy, U.S. exports should begin to grow faster than imports. However, a much lower dollar and a lot of time is needed to narrow the gap, since U.S. exports are only 76% of imports. Were it not for the improved growth in exports relative to imports that I expect in 2011, net trade would be subtracting more from growth.

Tax revenues for state and local governments have been growing for three quarters and will lessen the pressure on government entities to further reduce spending. However, state and local government spending is still likely to subtract a half percent from growth in 2011, offsetting the reversal in housing. And with somewhat reduced fiscal spending on stimulus, I expect the contribution of the federal government to GDP to be minimal.

Table 1: Economic Forecast 2011

	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.
Growth (%)	2.5-3.5%	3.0-4.0%	2.5-3.5%	2.5-3.5%
Unemployment Rate (%)	9.5-10.0%	9.2-9.7%	8.7-9.3%	8.4-8.8%
Inflation (%)	1.5%	2.0%	2.5%	2.5%
Core Inflation (%)	1.0%	1.2%	1.5%	1.8%

Fed Funds (%)	0-0.25%	0-0.25%	0-0.25%	0.25-0.50%

Employment: Although the November report was very disappointing (payrolls increased a weak 39,000 and the unemployment rate "ticked" up 0.2% to 9.8%) the economy is on track to generate nearly one million jobs in 2010. Unfortunately 8.7 million jobs were lost as a result of the credit crisis and economic downturn. Thus, there is an unacceptably huge reserve of unused labor resources in the U.S.
In somewhat of a coincidence, the increase in temporary workers was nearly the same as the overall 39,000 payroll increase. Over the past year temporary employment has increased sharply. Usually this is a very good sign of recovery and increases in permanent jobs follow. Tempering this optimistic outlook is that it appears that many corporations are substituting temporary workers for permanent workers. To the extent this is the case, lost benefits and, perhaps lower wages, while good for corporate profits, inhibit the increase in household income and act as a drag rather than a harbinger of better things to come.

It is risky to make too much of one month's employment. However, the three month gain is also weak, despite some evidence that growth is improving a bit from the mid-year slump. Private payrolls over the previous three months increased by 107,000 per month while overall payrolls inched up just 62,000 as net government workers declined by 42,000 per month. Manufacturing and construction continue to experience job losses although the losses in construction have almost ended.

Hourly earnings were flat in November while weekly take-home pay declined a bit. The former is up 2% from a year ago, while the latter is up 2.9% year-over-year. Worker pay is just keeping up with productivity gains this year after falling 1.6% in 2009. While this is good for corporate profits, it results in sluggish growth in aggregate demand. On balance, there is a tremendous reserve of unused labor and there are absolutely no wage-generated inflationary pressures.

I expect asset price increases, a leveling out of manufacturing and construction worker declines and a general increase in service-sector jobs to result in the net creation of 1.5-1.8 million jobs in 2011. This is better than the 86,000 and 100,000 monthly job increases in the first 11 months of 2010 as measured by the establishment and household surveys respectively. The forecast gains depend on the Fed aggressively working to boost asset prices and the removal of some household and business uncertainty from an extension of the Bush tax cuts. I am also assuming no further decline in net exports. But with Federal stimulus likely to decline and remaining political uncertainty over fiscal and public debt policies, the risk to my employment forecast is to the downside.

Finally, although I expect a net decline of about a percent in the unemployment rate, it may first go back to the 10% level or a bit above as the increase in new and reentering individuals is greater than the jobs created.

Inflation and Fed Policy: In the past 12 months overall inflation has been 1.2% while core inflation has been 0.6%. Both are trending down. Moreover, the norm for the first two to three years of recovery is for inflation to continue trending down. Even those not trained in economics

need only look at the depression of the 1930's or Japan in the past two decades to observe the danger of deflation.

At a time when the U.S. is in greater danger of asset collapse, it is hard to understand the reasoning of those who warn of an asset bubble or inflation. And those who do, at least those with some credibility and training, cite what they (and I) think was the mistaken policy during the mid 2000s that allowed housing prices to appreciate to the extent that they augmented consumer spending at a time of full employment. I underscore that we are not in that situation now and that an attempt to increase asset prices is the only policy other than more fiscal spending to deal with the current underutilization of resources.

Another argument I have heard against QE2 is that it is more government spending that we cannot afford. Actually, QE2 is the purchase of income producing assets, the profits of which the Fed turns over to the Treasury to reduce the deficit.

The final argument I hear is that the rise in commodity prices has a signal of inflation. It can be, but in this case it is a relative shift away from other goods to commodities. And I expect this relative price shift to continue as emerging Asian countries are growing faster than the U.S. and Europe and utilize commodities more intensively. Moreover, away from commodity prices core inflation is falling.

One argument I am sympathetic to is that overall inflation is the true measure rather than the price changes excluding energy and food. Core inflation is important because energy and food prices tend to be more volatile than other prices and, over time, core inflation is a better measure of inflation pressures. However, if, as is currently happening, there is a longer-term secular relative price shift toward energy and food, then the full measure including all goods is the relevant one.

Since both overall inflation, i.e. prices including food and energy, and core inflation are moderating, and because another measure of potential price pressures, namely unit wage costs, are flat to downward trending, I am very much in agreement with those at the Fed who think deflation is currently the greater danger.

In my opinion, deflation is a greater problem in the U.S. than in say, Japan. The U.S. is building a formidable external debt that essentially shifts the rewards of domestic production away from the U.S. and with a huge external credit and a population that is shrinking in, per capita income in Japan, a better measure of the living standard than aggregate income, is still rising. The U.S. can ill afford a deflation that further increases the burden of servicing its external debt.

The U.S. economy is credit-driven rather than money-driven. With deleveraging continuing and consumer balance sheets in need of further repair, an increasing Fed balance sheet is the only way, short of quickly reversing the trade deficit, to offset the negative impact on aggregate demand of debt deleveraging. I do not see it as a problem that the Fed holds an increasing portion of the debt in order to smooth the transition away from household debt and its impact on consumption.

Will the Fed carry through on its announcement to buy $600 billion in fixed income securities by mid-2011? Will it follow QE2 up with more purchases beyond that? Yes to the first question, and yes, if they need to, to the second question. The unemployment rate is not likely to fall enough before mid-2011, nor inflation to rise enough to curb the Fed's announced policy. Whether they continue to increase the balance sheet beyond mid-2011 depends on their growth, employment and inflation forecast in mid-2011.

Marty Zweig said "Don't fight the Fed". My economic and market forecasts depends on this adage. Inflation and asset prices will rise, although I expect inflation to rise very little over the next 12 months.

Fiscal Policy: I am not as optimistic about fiscal policy as I am about the appropriateness of monetary policy. What is needed is more spending and tax incentives to business in the short run to promote investment, and the curing of entitlement costs, and higher tax revenues to curb consumption over the intermediate to longer term. Only these measures will lower the federal budget deficit, and thus preserve the integrity of public finances with international investors. The U.S. also needs a tax and spending policy that brings more certainty to businesses and households in order to allow them to plan accordingly. Finally, the "pain" of a curb on public and private consumption needs to be shared, so as not to fall disproportionally on any one group of Americans.

A recent survey of households indicates that the majority of Americans want to eliminate the budget deficit, but want others to absorb the burden of reducing the public deficit without incurring a burden themselves. And several of those recently elected to Congress do not want to see any tax increases. Thus they would not agree to hike taxes on, say, higher income households in exchange for lowering taxes and providing more incentives for businesses. Similarly, there are those in Congress that will not agree to any deficit-reducing measures that would lower the benefits from Medicare or Social Security. However, unless the cost curves of entitlement programs are curbed, and revenues are raised for the most affluent, there is no way to bring deficits under control. Wage freezes and earmark eliminations may appear to the public as ways to reduce the deficit without incurring pain, but their overall collective impact is miniscule relative to the size of the problem.

The path to reducing the deficit is very important. Private debt accumulation used to finance consumption has been a driving factor in U.S. GDP growth over the past three decades. To the extent that economic stimulus such as tax cuts and government spending result in more consumption, the potential for growth is reduced. The proposals for the Simpson/Bowles commission largely recognize this issue, and debt reduction should be accomplished by both reducing the rise in entitlement spending while raising revenue in a way that curbs consumption relative to investment. For example while tax rates are reduced for business, some deductions that go mostly to the wealthy and to promote household consumption are eliminated. Moreover, a tax on consumption is recommended. At the same time, while it is not the focus of the commission to reduce the budget deficit, the Obama administration has proposed increased infrastructure investment and tax incentives to spur private research.

The above measures are, in my opinion, key to a healthy and sustained recovery. In addition, I would propose shifting the health burden completely away from corporations. This would help U.S. corporations compete more effectively in the international arena where businesses do not generally bear the cost of health benefits to their employees.

While the above outlines what could and, in my opinion, should be done, I am not optimistic about fiscal policy. While the newly-elected Republicans can not alone control the legislative policy, the past two elections have made it much more difficult to achieve the compromise necessary to achieve objectives that support healthy growth that is not overly driven by consumption and debt creation. The Obama landslide eliminated a number of centrist Republicans while the recent election did likewise to centrist Democrats. Thus Congress is left with a disproportionate number of ideologues whose mantra seems to be "my way or the highway".

As New Hampshire Senator Judd Gregg has opined, in the U.S. form of government, no one gets everything they want. Thus, a "just say no" policy will lead to gridlock. In good times, that is not so bad. But when it is critical to legislate policies to extract the U.S. from onerous problems, gridlock is highly detrimental. For example, had Congress failed to extend tax breaks in some form, the economy could fall back into recession and tax revenues would be adversely affected, despite the hike in rates.

Forecast Risk: Despite my optimistic economic and market outlook for 2011, I am pessimistic that Congress will agree to Simpson/Bowles-like solutions to the longer-term problem of bringing the Federal Budget deficit under control. Many of the Republican proposals are anti-growth (although they think otherwise) because they continue to rely on driving the economy via consumption. Many Democrats, on the other hand, are not willing to agree to admittedly-painful cuts in entitlement programs and certain special interest programs. And Republicans are not likely to want to incur the wrath of the voter by going it alone in this regard. Moreover, neither party has the numbers needed to pass legislation without bipartisan support.

Given my pessimistic outlook for long-term solutions, the reason I remain optimistic about 2011 is that I think Congress will pass legislation on infrastructure spending and on tax incentives to businesses. Thus, my concern is more for years beyond 2011. Nevertheless, to the extent that investors sour on prospects for Congress and the Administration to solve problems before a crisis ensues, U.S. markets, especially equity prices, could carry a lower value than otherwise would be the case. And business confidence could be negatively affected as well.

European debt problems and ongoing concerns about growth are the other risk that I see. If, as I expect, Asian growth slows a bit to counter rising inflation problems in China and India, then a slowdown in Europe could worsen the U.S. trade deficit more than I expect. On balance, I have built this into my forecast, but there is still downside risk if European debt problems reach crisis proportion.

Some slowdown in China and India would not be a problem for the U.S. if there is a commensurate increase in domestic demand that increases U.S. exports to Asia. And a slowdown in China would likely be healthy in as much as it might reduce inflation pressures somewhat.

The Markets

Table 2 indicates my quarterly estimates for key interest rate, currency and stock indicators. As with my economic forecast these forecast levels depend heavily on a mix of monetary and fiscal policies that includes sustained QE2 and the absence of complete gridlock.

Table 2: Market Forecast Ranges 2011

	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.
10 yr. Treasury Rate (%)	2.75-3.25%	3.20-3.60%	3.50-4.00%	3.70-4.10%
Dollar Index (futures)	68-76	76-82	80-86	78-84
Euro (in U.S$)	1.20-1.36	1.20-1.32	118-1.32	1.08-1.24
Dollar/Yen	82-86	84-88	83-87	85-90
Canadian (in U.S.$)	.96-1.04	.96-1.04	.98-106	1.00-1.06
S&P	1220-1320	1250-1350	1300-1380	1280-1350

Interest Rates: I expect Treasury rates of 2-year or more duration to rise moderately in 2011, not because QE2 does not work, as some observers have already concluded, but because it does work. In a healthy recovery, the real component of interest rates should rise slowly as will the inflation component. Falling rates are generally an indication of a weakening economy.

Of course it is important that rates do not rise quickly. Not only would this slow the recovery, but it would likely be an indication that the risk component is rising. Indeed, this is what some forecasters are looking for as they expect both domestic and foreign investors to back away from Treasuries.

In assessing the reasons for a rate rise one has to look at all three aspects, inflation potential, default risk and the health of the economy. If, over time, the U.S. can adopt policies to reduce the trade deficit, then the huge purchases of Treasuries by foreign sovereign funds as countries such as China have less need to offset their net exports with such purchases, will diminish. At the same time it is important that policies be adopted to reduce the domestic budget deficit and thus, issuance. But most important is to ensure sufficient revenues to service the debt and that is why the health of the economy is the main determinate of whether an interest rate rise is good or bad.

Regarding the yield curve, I expect some steepening as the economic outlook improves. Generally, I expect the two-year note rate (currently 0.55%) to rise 50-75 basis points, the 10-year note to (currently 2.95%) to rise 75-100 basis points and the 30-year note (currently 4.25%) to rise 100-1.25 basis points. With the Fed purchases likely to center on the 4-6 year duration, the risk is that the 2-5 year portion of the curve will not steepen to the extent of the rest of the curve.

The Dollar: In previous reports I have maintained that, while quantitative easing may have a negative near-term effect on the dollar, it helps to strengthen the economy. The net result will be a stronger dollar than would otherwise be the case. Having said that, I continue to be negative on the dollar over the longer run, especially against Asian currencies, such as the Chinese, Taiwan and Singapore currencies that buy huge sums of U.S. fixed income assets in order to hold down their currencies. In particular, I expect the Chinese yuan to appreciate another 12% from its present level by the end of 2011.

I think the euro currency will be the weakest of the major currencies in 2011. European debt problems will ebb and flow but, on balance, the solution to these problems is to coordinate fiscal policies among countries, and to assure investors that their sovereign and banking investments will be honored. I have little doubt that the sovereign debt will be honored, but Germany is already suggesting that, in the case of banks, e.g. especially in Ireland, investors take a haircut.

The risk to the euro is twofold. First, countries with huge fiscal debts are curbing their fiscal expenditures and this will result in a slowdown in European growth. Second, if there is a threat to the viability of the euro volatility could increase. If the risk is for countries such as Greece leaving the euro, then implicitly, foreign sovereign debt holders would effectively incur losses as the currency devalues and the value of these securities falls. A worse threat, although I see it as highly unlikely, is that Germany leaves the euro. In this case, the German currency (presumably a return to the mark) would rise and the euro would fall, probably dramatically.

Other than periodic “runs” on European sovereign and banking securities and a slowdown in growth, we see a very low probability that the euro will collapse. But I do think it will lose value on balance in 2011. My range is $1.08-1.36.

I look for little movement of dollar/yen next year. Recently the dollar/yen bounced off the post-WW2 low of 80 first achieved in the 1990’s. Although the Japanese government does not manage the yen in the same way the Chinese manage the yuan, they do set up “lines of defense” at extreme points. Over the longer run (several years), I expect dollar/yen to drop below 80. But unless the political/policy risk to my forecast is borne out, I think the yen will trade in a range above 80 through 2011. It is likely to revert toward a central tendency in the 85-90 range as the U.S. economy recovers.

Over the past few years, the Canadian dollar has benefitted from a beneficial combination of fiscal and monetary policy and as a source of reliable commodities. I expect that trend to continue. As a result, I think the Canadian dollar will work its way above parity against the dollar over the course of 2011. The only risk is if the U.S. slips back into recession and the price of world commodities drops significantly. My range is 96-106, indicating a gradual trend to appreciation.

Equities: I am optimistic that stock prices will continue to move higher in 2011. My upside S&P objective is 1380. This is not as high as some stock forecasters such as Goldman Sachs that look for 1450 or higher, but higher than forecasts of other economists that I respect, but who are more cautious.

While housing has been very weak, the Federal government has built a huge deficit, state and local governments are struggling, unemployment is very high, households are rebuilding their balance sheets and the economy is growing sluggishly; businesses, in contrast, have rebuilt profits, gained productivity and generally improved margins. Moreover low interest rates generally signal putting a high value (PE ratio) on equities. If Wall Street profit estimates for the S&P in 2011 ($90-96) are near the mark, this should signal a fairly robust rise in stock prices. A typical PE ratio in a market of low interest rates would be 15-18 times earnings. This implies an S&P range of 1500-1700.

The method by which corporations have rebuilt profits differs from the usual recovery increase that relies on a rebound in revenues. In this case, corporations fired workers in greater numbers and much more quickly as CEO's and boards acted to cut costs in a period in which survival was questioned. As such, profits will continue to rise if the Fed's policy boosts growth in the coming year.

One reason I am not more optimistic on stock prices is that Wall Street profit estimates do not consider "one time only" write-offs. However, in the current environment, companies seem to have such write-offs every year. Thus I think investors discount earnings when making their decisions.

Another reason for being conservative on PE ratios is that there are likely to be future revenue burdens on either corporations or their customers as the rise in public debt forces lawmakers to make big budget cuts. For example, Cisco recently reported a sharp drop in orders from public entities in both the U.S. and Europe.

Finally, globalization continues to provide cost-reducing outsourcing opportunities, but also more price-controlling competition as emerging-market multinational companies become a bigger factor. For this and the above reasons, my optimism on stock prices is tempered. Nevertheless, the impact of QE2 and moderate revenue growth from private household consumption underpin my expectation that the S&P will, at some point in 2011 be 12% higher than the current level (approximately 1220).

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