



## STUART INVESTMENT MANAGEMENT LIMITED

### **Economic and Market Update – January 10, 2011**

*David Horner*  
*Economist*

#### **Summary**

I remain optimistic on the economy in 2011, especially for the first half. Over the past month the consensus has moved up and, at this point, my 3.0% growth forecast is several tenths below the consensus. The impetus for the rise in the consensus is a combination of better economic data and the passage of the tax bill that removes uncertainty and, along with the preservation of current tax rates (except for estate taxes), also provides additional stimulus in the form of UI transfer payments and an extension of incentives to business. I estimate fourth quarter 2010 growth, to be released on January 25, at 3.0%, near the consensus.

Housing, state and local government budgets and European sovereign deficits are negatives, but a bit less so than when I wrote last month. The positives are investment and consumer spending. Despite slow employment growth, it now appears that enough jobs are being created to help sustain the recovery. The average payroll growth of the past three months, 128,000, is still weak but should pick up a bit in the first half of 2011. I expect private payrolls to increase by more than 150,000 on a monthly basis in the first half.

Some observers have concluded that the recent Treasury interest rate rise is evidence that the Fed's QE2 policy is not working. Contrary to their opinion, I interpret the rate rise as evidence supporting the efficacy of the policy. Rates are rising because:

- The policy is "risk on" and investors are moving out the fixed income risk matrix and into stocks.
- The pickup in economic activity due to the QE2 policy is driving real rates up.
- The knowledge that the Fed wants to avoid a further decline in inflation is raising the inflation expectations.
- The recent extension of tax cuts and supplementary spending has removed uncertainty, supporting the above reasons and also increasing the budget deficit.

As for inflation, I have already built in an increase this year. The risk is that the rise will exceed my forecast. In particular food prices are increasing, but this is more important for developing countries where food is a higher proportion of the consumer basket, than in the U.S.

I have included a section of what I expect from the new Congress comparing it with what I think should happen. Progress will be slow in the first several months as the various factions of both parties continue to "stake out" their positions. However, it is critical to make rational progress on

the budget in the second and third quarters. Thus, the effect of Congressional action is more likely to be felt in the second half and beyond than in the first half of 2011.

There are no changes in my currency or stock forecasts. I remain comfortable with my first quarter range, 1220-1320 for the S&P. However, I have raised my forecast for Treasury rates for the first six months as the reaction in anticipation of the fiscal and monetary policy results has worked its way into the market faster than I forecast a month ago.

## Economy

Table 1 indicates my forecast for key economic variables in calendar 2011. They are unchanged from a month ago. As indicated in the text below, the risks is that my unemployment rate will proved to be too pessimistic (a hope), and that the inflation rate will be too low (a fear).

**Table 1: Economic Forecast 2011**

|                     | 1 <sup>st</sup> Qtr. | 2 <sup>nd</sup> Qtr. | 3 <sup>rd</sup> Qtr. | 4 <sup>th</sup> Qtr. |
|---------------------|----------------------|----------------------|----------------------|----------------------|
| Growth (%)          | 2.5-3.5%             | 3.0-4.0%             | 2.5-3.5%             | 2.5-3.5%             |
| Unemployment (%)    | 9.4-10.0%            | 9.0-9.4%             | 8.8-9.4%             | 8.6-9.2%             |
| Inflation (qtrly %) | 1.5%                 | 2.0%                 | 2.5%                 | 2.5%                 |
| Core Inflation (%)  | 1.0%                 | 1.2%                 | 1.5%                 | 1.8%                 |
| Fed Funds10 yr.     | 0-0.25%              | 0-0.25%              | 0-0.25%              | 0.25-0.50%           |

**Growth:** Fourth quarter growth will be announced Friday, January 28. I expect it to be 3 percent. The weaker-than-expected employment gains should not curb the result as corporations continue to increase their production with minimal labor increases. Consumer spending and, to a lesser extent, investment will contribute the bulk of, if not the entire growth. Trade and inventory changes will likely be less impactful than in the previous quarters. Housing and state and local government will likely be small negative contributor.

With employment a bit weaker in the fourth quarter than expected, there is a small downside risk to my first quarter forecast range of 2.5-3.5% as the slow earnings and employment gains will hold back household income. At the same time, the Fed remains committed to quantitative easing and advice from critics both outside and inside the Fed that it reduce announced purchases for the next six months will not be heeded. In his testimony, Friday, January 7 Bernanke made it clear that, despite his expectation that the economy can grow on a sustained basis, unemployment will remain too high for several more years and now is not the time to let up on the liquification policy. Moreover there are still risks in housing and state and local governments that will impede growth and could, if fiscal and monetary policy were not stimulative, abort growth.

Frankly, I am surprised that so many critics called for a change in policy just because the data is looking better. Policy should not be reversed or changed that quickly and certainly not on the basis of one month or even on one quarter's data. Were it not for what I expect will be the positive interaction between the recent tax and fiscal legislation and QE2, I would be forecasting much slower growth.

Consumer spending should grow at a 3-3.5% (real) rate in 2011, thus contributing about 2.3-2.5% to growth. The increase in asset prices brought about by QE2 will keep the savings rate from increasing further, as consumers continue to de-lever and as, unfortunately, housing prices remain under pressure (see below). The growth in household spending will come almost entirely from income growth in employment, earnings income from transfer payments and dividends from a cash-rich corporate sector.

Investment will likely contribute a percent to growth, about the same as in 2010, as corporate exports to Asia and Latin America continue to grow and as government tax incentives and contracts bring investment forward.

Although I see the need for continued stimulus, I am also encouraged by what I see as less negative developments in the housing and state and local government sectors. In the case of housing, known negatives remain. Foreclosures and other forced sellers that continue to hold out for unrealistic prices continue to over-hang the market. Thus, I think prices will, on average, continue to fall in 2011 (although prices in some areas that got hit particularly hard in California and several other places have rebounded). Moreover forced "doubling up" is reducing the demand for housing. And recent immigration phobia is limiting population increases from that source. On the other side, however, house abandonment is damaging and reducing the stock much faster than normal depreciation would. In addition, new home starts have fallen far below potential household formation. Thus, despite my expectation for some further price erosion, I think housing construction activity will actually contribute a small amount (less than 0.5%) to growth this year.

State and local government finances are the biggest negative in the coming year. As with several European countries, states are being forced to cut spending to bring them in line with reduced revenues. As Meredith Whitney has pointed out, many states and local entities are meeting their balanced-budget requirement by putting some liabilities off balance sheet. She has compared the problem with that of the banks, where much of the losses came from off-balance sheet transactions and holdings.

I agree with Whitney's critics that the problem is probably not as bad as her recent research paper suggests. Admittedly, underfunded pension fund liabilities are huge and will force state and local entities to restrictive budgetary solutions for years. But because the obligations are spread out long into the future, the problem, like that of entitlements in the Federal government, will not force immediate bankruptcy (there are a few local entities however that have immediate needs that they cannot meet). Thus the problem is not one of insolvency, but is more like a chronic disease that has no viable short-run cure.

The positive that I see, is that it appears that many state and local employees, including those that are unionized, are beginning to come to the bargaining table with a better realization that they will have to make concessions. Further, although it is painful, many areas, such as in New York City and areas of New Jersey and other states are already reducing costs, unfortunately, in some cases, by cutting essential services such as policing, education and medical care.

The other positive is that, as the economy grows, revenues are recovering a bit. Still, on balance, I expect state and local governments to subtract growth from the economy for several years to come. The good news, if any, is that the economic burden will be spread across several years and not fall entirely on 2011.

Europe remains the other negative. I do not consider the financing problems in Europe to be a U.S. problem but the consequent slowing in European growth as highly-indebted countries reduce services, and the fall in the euro will have a negative impact on the growth in U.S. exports. The resulting impact is similar to that of the negative stimulus coming from the domestic state and local sector in the U.S.

**Employment:** The employment report was weaker than expected. Payrolls increased by 103,000, less than the 180,000 expected. Discouraged workers increased by 389,000, although this may be largely due to the temporary expiration of UI benefits. And although the previous two months were revised up by 70,000 jobs, the three month average for both the increase in private and total enrollment is still a lackluster 128,000.

Average hourly earnings continued to increase slowly with the 1.8% yearly increase only 0.7% above the 12 month inflation increase. And while the unemployment rate fell 0.4% to 9.4%, I consider this an anomaly, driven in part by a fall in those looking for work. On balance, I expect wages to continue to increase weakly and, over the next 3-6 months, for the unemployment rate to remain above 9%. I do not rule out a temporary return to 10% resulting from continuing “noise” from the reinstatement of UI claims and the possibility that workers will reenter the job market.

Although the past two employment reports have not met expectations, the pace of job growth appears to be improving. I expect 800,000 to 1,000,000 private sector jobs to be created in the first six months of 2011, as economic activity continues to grow at near a 3% rate and as more workers are finally needed to obtain desired production increases. And as the table indicates, I expect the unemployment rate to fall slowly during the year ending between 8 and 9%. The risk is that the rate will fall more than I currently forecast and. Depending on the outcome of the January and February reports, I hope to be able to revise my year-end unemployment rate forecast down to the 7% range.

The chart below shows the depth of the job losses relative to other recent recessions. Even if the rate comes down more than I currently forecast, the chart illustrates why Chairman Bernanke is persistent in his policy to continue to liquefy and continues to base it, in part, on the need to bring down unemployment more quickly. Idle capital depreciates, but idle labor starves or, at a minimum, taxes community resources.

### Comparing Recoveries: Job Changes

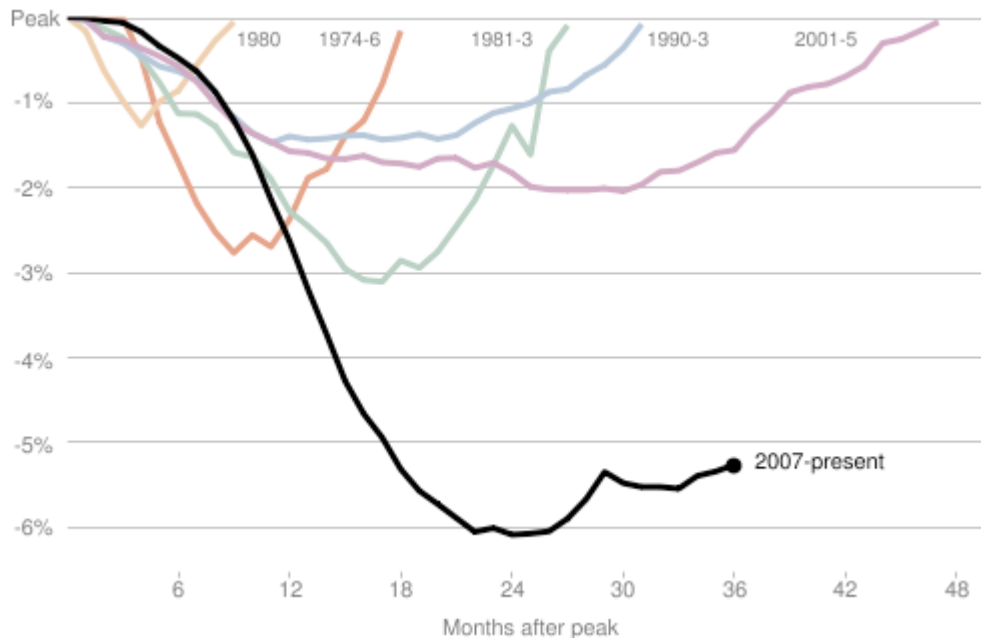


Chart via [Economix](#)

~~~

**Inflation:** For most of the past two years, I have been cautioning that the rise in commodity prices was not, as they have been in the past, an indication of a general price rise. Rather, it is a relative price shift, driven primarily by faster growth in emerging markets that disproportionately consume commodities. There has also been an increase in inventory accumulation by users and speculators as one would expect when prices are rising consistently.

Recently, the biggest increases have been in food prices. Indeed, world food prices have doubled in the past decade and are increasing at a faster rate over the past year. However, hereto the impact is less on the U.S. than on developing countries where the households spend a greater portion of their budgets on food. And unfortunately, food prices will likely stay up and could rise further in 2011.

Although I have been sanguine about overall inflation, I am forecasting an increase in 2011. Specifically, I look for overall inflation to be rising to 2.5% by the end of 2011 and the core rate to be rising to near 2%. We are in the first period since WW2 that the Fed is setting policy in a manner that will induce more inflation. I agree with most observers that, partly as a result of Fed

policy, inflation will increase. I disagree with those that think the Fed will not be able to contain inflation once its concern for disinflation abates and the combination of fiscal and monetary policy result in a more robust labor market.

***Fiscal policy and the budget:*** Although I do not expect it to affect growth in the first half of 2011, Congressional legislation and/or gridlock will have a critical effect on whether the U.S. is able to remain a viable economic leader in the world economy. Extension of both the Bush tax cuts and tax incentives to business, as well as UI payments, are sufficient to remove a measure of uncertainty and contribute to growth in the first half of 2011.

As mentioned in previous monthlies, my prescription for what should be done over the longer run to achieve a sustainable level of debt in the U.S. would be to:

- reduce the growth of (?) and, in some cases lower entitlement program liabilities,
- provide increased tax revenues from consumption, and
- reduce tax rates that restrict investment.

The Simpson/Bowles commission proposed a number of solutions, most of which conform to my prescription. Eleven of the 18 members of the commission supported the report including 5 Republicans, 5 Democrats and one independent.

Several problems arise when specifics are discussed, which undermines support. For example, two of the best ways to restrict consumption are to eliminate the mortgage deduction for mortgages above a certain threshold, and to allow the Bush tax cuts for incomes above a certain level to expire. This would spread the pain to upper income households, offsetting the pain to lower households from cutting entitlement and income support programs and from a consumption tax that is regressive. The right-wing ideologues won't support these measures while the left-wing ideologues won't support cutting the growth in entitlements. And the lobbyists from both camps have a huge influence on members of Congress.

Another problem is the difficulty of constructing legislation that effects big change. This was seen in the case of the health bill. The objectives were to broaden care and bend the cost curve. In principle, both sides agreed. Yet the "mish mash" of changes and regulations in the bill resulted in a backlash, especially from the right, and the bill did not achieve the second objective (although a recent CBO study suggests the bill will save money relative to the absence of the bill). As another example, passing tax reform legislation that would substitute a consumption tax in exchange for lowering taxes for corporations would reorient the economy in a way to better compete in the globalized world. Yet getting agreement on the format and conditions is almost impossible, especially with the current polarized Congress.

Still another problem is scheduling deficit reduction. Fortunately, tax revenues should increase enough this year to allow the deficit to fall. But it will remain well above the sustainable level. In several recent testimonies, Fed Chairman Bernanke, a budget hawk, has warned that Congress must be careful not to enact cuts that will counter the stimulation needed to keep the economy on a sustained growth path. One of the biggest dangers is that, in their zeal to show that they are tough on government spending, Congress will pass foolish legislation that cuts spending but negatively impacts growth and tax revenues.

I do not know what the outcome will be regarding economic legislation this year. My hope is that the spring budget process will produce some spending curbs. But legislation to slow or reverse spending in the out years may require actions outside of the budget process. As New Hampshire Republican Judd Gregg has indicated, compromise is a must in our political system and absolute positions that do not compromise will lead to a highly detrimental gridlock. If there were enough centrists in Congress to form a majority, then the views of the right and left could be ignored and the necessary compromises could be made. However the past two elections have eliminated many of the centrists in both parties. Thus the only way to achieve reasonable budget and legislative solutions are if the left and right can be persuaded to compromise their principles, hold their noses and jump into the pool together for the good of the country. The president's "tack" to the center is helpful, but the outcome is very uncertain.

Fortunately for the economy and markets, the legislative outcome will not affect the first half of 2011. Investors are well aware that first quarter political pronouncements are posturing. The budget process has a "behind closed doors" element that will ultimately determine the outcome. The results of this process will not become known until the critical deadlines for progress approach in April and May. These deadlines have often been missed and, in the most recent case not met. And with the new Congress,, it is most likely that they will be missed again. Moreover "brinkmanship" is likely to precede any compromises, producing an "it is darkest before the dawn" atmosphere. My best guess is that little will be known with certainty before summer.

Finally, I am not as optimistic that reasonable solutions will be adopted. While most agree that the budget deficit should be cut, surveys of both Congress and their constituents indicate that most don't want to share the pain. With most households worse off in recent years, the sense is that others should bear the burden. For this reason, I think the risk for the second half of 2011 and beyond is that the current positive economic and market momentum could falter as U.S. sovereign debt holders become more concerned and as the U.S. fails to generate the investment and growth that is needed to sustain tax revenues in a manner that will reduce the need for damaging budget cuts and tax hikes. The corollary risk is that a budget solution is adopted that, like the health bill, is a compromise that produces unintended negative consequences that outweigh positives.

## **Markets**

Table 2 (on the next page) indicates my quarterly forecast ranges for interest rates, currencies and the S&P for calendar 2011. Except for the 10-year note where I have raised my ranges for the first two quarters, they are unchanged for my estimates a month ago.

**Interest rates:** As indicated in the summary, I think the recent increase in Treasury rates is a sign that QE2 is achieving the desired result. there is a misperception that if QE2 is working, Treasury rates should fall. And the Fed has contributed to that perception. However, in previous monthlies, I have explained that, theoretically, QE2 is designed to make households and businesses feel financially better off and that the primary effect is to raise asset prices.

In my opinion, Chairman Bernanke has responded to fierce criticism by painting a somewhat positively-biased picture of QE2, suggesting it is not responsible for commodity price rises and

that the Fed is not printing money (which is technically correct since the Treasury “prints” the money and the Fed dispenses it). As I see it, the purpose of quantitative easing is to increase liquidity and thus provide more “fuel” to be used to bid up asset prices (which is also a “risk-on” trade). Thus commodity prices are, even if as an inadvertent consequences, going to rise in the process. However, I would agree with Bernanke that the relative increase in commodity demand is the primary source of the rise. For example, the same rationale that argues for a rise in commodity and stock prices would suggest a rise in housing prices that is not happening, yet.

Given my above thinking, I interpret the recent rise in Treasury rates as both an inflation and real growth response to the Fed policy. If both inflation and growth are poised to rise in 2011, then Treasury rates should be going up. Moreover, the end-of-year economic and tax legislation will at least temporarily increase the budget deficit over the next few quarters.

As a result of the faster pickup in rates that I anticipated, I raised my forecast ranges on the 10-year note for the first two quarters of 2011. And while I remain concerned about Congress’s ability to put us on a sustained path to decrease the deficit without unduly putting a brake on the economy, the lagged impact of first quarter growth on broadening price increases to the core will likely keep Treasury rates up in the second half, even if the unemployment rate remains high.

**Table 2: Market Forecast Ranges 2011**

|                          | <b>1<sup>st</sup> Qtr.</b> | <b>2<sup>nd</sup> Qtr.</b> | <b>3<sup>rd</sup> Qtr.</b> | <b>4<sup>th</sup> Qtr.</b> |
|--------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| 10 yr. Treasury Rate (%) | 3.10-3.50%                 | 3.25-3.75%                 | 3.40-4.00%                 | 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                  | 1.18-1.32                  | 1.08-1.24                  |
| Dollar/Yen               | 82-86                      | 84-88                      | 85-90                      | 85-90                      |
| Canadian (in U.S.\$)     | .96-1.04                   | .96-1.04                   | .98-1.06                   | 1.00-1.06                  |
| S&P                      | 1220-1320                  | 1250-1350                  | 1300-1380                  | 1280-1350                  |

**The Dollar:** In my year-ahead outlook I continued to expect that, while quantitative easing may have had a negative near-term effect on the dollar, it helps to strengthen the economy. And the economic strength is supportive of the dollar. Thus I have the dollar appreciating against the euro and yen in 2011. At the same time, I continue negative on the dollar longer term, especially against Asian currencies and currencies of resource-rich countries. In particular, I expect the Canadian dollar and Chinese yuan to appreciate in 2011.

My view on the euro and yen has not changed in the past month so I repeat my previous thoughts. I expect the euro will remain 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 worth 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 Deutchemark) would rise and the euro would fall, probably dramatically.

Other than periodic “runs” on European sovereign and banking securities and a slowdown in growth, I 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. 1.26 to 1.28 is very near-term support and I would not be surprised to see a bounce back to test the 1.34 range in the next month.

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 continues to recover.

Over the past few years, the Canadian dollar has benefitted from a beneficial combination of fiscal and monetary policy and because Canada is a reliable source of commodities. I expect that trend to continue. As a result, I think the Canadian dollar will appreciate on balance against the U.S. dollar over the course of 2011. The 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.

A recently reported “wikileaks” maintains that a Chinese official told the U.S. administration to expect a 5% appreciation of the yuan in 2011. I regard this as a minimum. Still, the yuan is appreciating more slowly than I earlier forecast. It has risen 3 percent in the 6 months since the Chinese announce they would allow more flexibility.

My reason for expecting more than a 5% increase in 2011 is that it is in the Chinese interest to allow the yuan to appreciate a bit faster, as one means to counter inflation and, at the same time, appease Chinese trading partners. In my opinion, this is preferable to the alternative of raising rates more quickly that would be the case if the Chinese hold the currency steady.

**Stocks:** The S&P continued to rally in the fourth quarter, gaining 11%. My forecast top for the quarter is 1320 and I have a yearly top of 1380 that I think will be achieved in the third quarter. Were it not for my concerns over Congressional attempts to fix the longer-term deficit problems,

I would probably have a higher target. Economic growth in the coming year is likely to produce S&P earnings of \$85-90 and a reasonable PE ratio for this, assuming a further increase in the next year, would put the S&P in the 1400 to 1500 range or near its all time high. But given the uncertainty of the legislative outcome, I think I will have plenty of time to adjust my second half range while the S&P is still in my near to intermediate-term forecast range.

A correction at any time would not surprise me. State and local debt problems and European debt problems will continue to be negative factors that will, from time to time, produce headline risk. However, barring a negative surprise such as a flare up in the middle-east, I anticipate that 3-6% corrections will be buying opportunities. The bottom of my forecast range in the first quarter is 1220. This represents a bit less than a 5% correction from the early January high achieved as this is written. This would be consistent with the small correction that occurred simultaneously with the release of fourth quarter earnings a year ago. I note, however, that over the past year, my upside targets have generally been met or exceeded a bit, while the market has not corrected to the bottom of my forecast range. Still I do not foresee a move to the top of my range without first having a 3-6% correction.

### **Third Party Research Disclosure**

This third party publication is not prepared or approved by Stuart Investment Management Limited and therefore does not meet Canadian research disclosure requirements applicable to Stuart Investment Management Limited. The opinions, estimates and projections contained in the publication are those of the author alone as of the date indicated and are subject to change without notice. Stuart Investment Management Limited makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors or omissions which may be contained therein and accepts no liability whatsoever for any loss arising from any use of or reliance on the report or its contents. The provision of this publication is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities.

Stuart Investment Management Limited, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities of issuers mentioned in this publication, related securities, or options, futures or other derivative instruments based thereon.