



Economic and Market Update – February 7, 2011

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Summary

Based on lean inventories at the end of the fourth quarter (a decline subtracted 3.4% from fourth quarter growth), I am raising my growth forecast for the first quarter by 1/2% to 3%-4% from 2.5%-3.5%. Were it not for severe winter weather throughout the mid-west and east and still lackluster employment gains, I would raise it more. Tailwinds from QE2, fiscal stimulus and healthy overseas growth will be maintained though the first half of 2011. I am not as optimistic about growth in the second half and I will revise my forecast for that period in the second quarter, based on monetary and budget policy decisions as well as developments in the Middle-East.

The January employment report was weaker than expected for the third month in a row. Moreover benchmark revisions lowered the numbers employed by over 400,000. And although the unemployment rate fell to 9.0%, that result was mostly the impact for the second month in a row, of fewer workers participating, as opposed to robust job gains. Weather distortions may also have distorted the rate and I think the rate will move up over the next few months.

The inflation outlook is deteriorating. I am not revising my 2011 estimates of 2.5% overall inflation and 1.8% core inflation, yet. However, the secular trend to higher food and energy prices is likely to continue, driven by increased demand in Asian markets and, to a more limited extent, some drought-related supply curtailments.

Fed Chairman Bernanke has made it clear that QE2 will remain in force until mid-year. Although the growth outlook has recently improved, the labor market remains much weaker than the overall growth pickup would suggest. Productivity continues to increase which allows businesses to produce more without aggressive hiring. Fiscal policy is a “wild card”. It is unclear whether the forces on the right and left will, in the end, prevent the types of compromises that are necessary to provide the near-term “fuel” to continue the expansion while curbing the rise in future entitlement payments needed to reduce the deficit. And although I don’t think instability in the Middle-East is an immediate economic problem for the U.S. or Europe, over time it could become one.

I have substantially revised my forecast for the euro based on what I believe is the realization by European leaders, especially Prime Minister Merkel of Germany, that in order to preserve the euro’s credibility, fiscal and regulatory standards have to be harmonized. This is a very positive development although it will be met with opposition. My new range for the year is 1.28-1.42, implying a steady euro/U.S. dollar relationship and up from my previous forecast of 1.08-1.36. I

view the risks as balanced and I will revise this forecast again for the second half when U.S. fiscal policy takes shape in the spring.

Three other revisions to my forecast are smaller adjustments. First, I have raised my 10-year interest rate range for the first quarter to 3.25-3.75% from my previous 3.10-3.50%. I was too conservative previously and growth is a bit higher as is headline inflation than I previously thought. I have also raised my forecast for headline inflation by 1.2% in the first quarter. Finally I have raised the lower end of my quarterly S&P range to 1350. Note, however, that I still see more downside risk if events in the middle-east threaten to affect oil deliveries or the precarious peace between Israel and its neighbors.

Economy

Growth: Fourth quarter growth came in at 3.2% led by a 4.4% increase in consumer spending, contributing 3.04% of the growth. And even spending on residential housing contributed a small 0.8% to that growth. Investment, not including the effect of the inventory change, also contributed 0.43% to growth, far less than the gains in the first three quarters of 2010. Government spending subtracted 0.11% from growth, almost all coming from curtailment in state and local spending.

The “head-scratching” estimates were the contribution of net exports, 3.44% and the subtraction, 3.70% from a reduction in inventory accumulation. These numbers are far too big but, coincidentally, tended to offset each other. It could be that weather considerations kept imports from being counted which would also account for the reduction in inventories. I suspect subsequent revisions will boost imports and scale back the inventory reductions.

Even if inventory reductions are reduced and imports increased, the combination of leaner inventories relative to sales and the improvement in trade bode well for first quarter growth. Thus I have raised my first quarter growth estimate range by a half a percent to 3-4%. That momentum will likely spill over into the second quarter, but I for now I am keeping my forecast at 3-4% as I already had a small growth increase built in. Table 1 below indicates my revised estimates for key economic indicators.

Table 1: Economic Forecast 2011

	1 st qtr.	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	3.0-4.0%	3.0-4.0%	2.5-3.5%	2.5-3.5%
Unemployment (%)	9.0-9.5%	9.0-9.4%	8.8-9.4%	8.6-9.2%
Inflation (qtrly %)	2.0%	2.0%	2.5%	2.5%
Core Inflation (%)	1.0%	1.2%	1.5%	1.8%

Fed Funds 10 yr. 0-0.25% 0-0.25% 0-0.25% 0.25-0.50%

Were it not for budget consolidations at the state and local level, my growth forecast would be even more positive. As indicated in my December forecast for 2011, I think the public sector will subtract about a half a percent from 2011 growth. It will take years for budgets at the state and local level to repair but, at least at the state level, progress is being made, most dramatically in New Jersey and Illinois, but also in most other states. The bulk of the negative impact of the downscaling at the state and local level will be felt in 2011 and 2012.

My current forecast is for growth to slow in the second half as the impact of QE2 and fiscal stimulus subsides. However, the outcome of budget negotiations between the two parties in Congress and the administration will be very important to whether growth is stronger or weaker than my forecast in the second half and in 2012 (see my policy discussion below). I will likely revise my second half, 2011 forecast in the second quarter when, hopefully, the path of fiscal policy becomes clearer.

Employment: For the third month in a row the increase in payrolls was weaker than expected. The absolute increase 36,000 also showed little improvement in the labor market. This contradicts recent anecdotal data that shows

- a gradual decline in jobless claims,
- an increase in the Consumer Confidence data stemming from the perception that jobs are easier to get and
- ISM indexes that indicate employment gains.

The report did revise up the previous two months by 40,000, but after benchmark revisions, overall employment is more than 400,000 less.

For the second month in a row the unemployment rate has dropped significantly, moving down another 4 tenths to 9%. Unfortunately, most of the drop is due to individuals leaving the labor force as opposed to increases in employment. Thus the drop in the unemployment rate does not bode well for household incomes.

The increase in manufacturing jobs of 39,000 accounts for more than the total hiring. Further, hourly earnings of those working increased by 0.4%. These are perhaps the only good signs in an otherwise discouraging report. Construction jobs continue to evaporate. Government jobs are down, a good sign for those who feel that there is a need for private jobs to substitute for public jobs and to cut public spending. But hours worked was down a tenth and, coupled with the slower growth in employment, signals weakness.

If I took the January employment report at face value, I would have cut rather than raised my first quarter growth estimate. However I think the anomalies in the report and the prospect that weather held down hours worked suggest that the report should be discounted. Nevertheless, with weather remaining a factor into early February, the employment report suggests that the upside risk that I referred to in the growth section is offset by a downside temporary risk to growth.

Inflation: In a recent press conference, Fed Chairman Bernanke maintained that inflation was still benign and said that the rise in commodity prices was mostly the result of fundamental factors including increased demand from emerging markets that are growing quickly. While I agree that is the main impetus for rising commodity prices, QE2 is likely exacerbating the move. You can't have it both ways. If the transmission mechanism of QE2 is to raise asset prices, then it almost has to be a factor in contributing to speculation in commodity prices. I can understand why the chairman is reluctant to "own up" to the role, but in failing to do so he risks credibility and gives ammunition to pundits whose rhetoric inflames the situation. There are negative unintended consequences to QE2, and that is one of them.

Unrest in the Middle East: I am not an expert on the Middle-East, but I feel it is necessary to take the developing situation there into account in addressing risks to my forecast. History has taught me that spontaneous eruptions of populations seeking more freedom and democracy fail. This was the case in 1917 in the revolt against the Czar, in the 1930s in Germany, in 1957 in Hungary, in 1962 on Cuba, and in Iran as well. I attribute the reason to the fact that spontaneous movements are driven by need, but are disorganized. It is often the case, there is a small group that has been organizing, is often ruthless, but knows how to gain power.

Many of the groups that ultimately come to power have a good amount of popular support and do not reveal their intentions to the fullest. A good example is Fidel Castro, who was initially acceptable to the U.S. which had a good deal of influence in Cuba, for better or worse, during the deposing of Batista. But once Castro consolidated his power, he became ruthlessly repressive and his dictatorship has not been unlike the previous rule. The history of Russia during the Tsar's overthrow is similar.

The Muslim brotherhood is the obvious group to benefit from developments in Egypt. It is in a better position to organize infrastructure and is likely to gain in popularity as a result. Look, for example at how Hamas gained credibility in Gaza by providing medical care and other services badly needed by Palestinians. The discipline and organization of the Brotherhood as it pertains to Egypt is not necessarily a negative. But its objectives and willingness to be tolerant and accept diversity is potentially a problem, much as has been the case in other countries in the Middle-East, and in Venezuela.

If my concern is warranted, the danger to oil flow, and of an increase in hostilities toward Israel is not immediate. Thus, the fears that arose on Friday, January 28 will not materialize in the short run. Rather, the danger comes later and may in fact coincide with my concern that an overly restrictive attempt to reign in the budget may have the same sort of negative consequences that are being played out in the U.K.

Fiscal and Monetary Policy: Following this paragraph are excerpts from last month's comments on fiscal policy. Not much has changed. The president's speech was general and the Republican speech offered nothing new. What will be most important is that members of Congress with very different views compromise, and that the compromises offer reasonable solutions. For the next two to three months most of what will come out of Congress is posturing. The real negotiation will likely come in late spring and extend into the summer. Despite earlier deadlines, it is not unusual for the tax and spending framework to be decided in July and August.

From my January monthly: “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 and, in some cases lower entitlement program liabilities,
- provide increased tax revenues from consumption, and
- reduce tax rates that restrict investment.

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 they 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.

Finally, I am not 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

Interest Rates: In my previous monthlies I described QE2 as a “risk on” policy. Thus, the spread on corporate and other riskier instruments narrowed relative to Treasury rates. Recently, events in the middle-east resulted in a flight to safety that temporarily benefitted Treasuries and reversed the ‘risk on’ trade. However, as it appeared that the implications of the protests in Egypt and prospects of protests elsewhere were mostly internal and were not likely to affect oil delivery or Israel in the near term, the flight to safety reversed and Treasury rates resumed their climb.

More as a result of the pickup in food prices again raising inflation fears and somewhat better near-term growth than I previously estimated, I am raising my 10-year note range to 3.25-3.75% from 3.10-3.50%. If it were not for what I consider to be the potential longer-term negative effects of events in the Middle-East I would raise the bottom of my range a bit more. For now I am not raising my range in subsequent quarters. Table 2 indicates my quarterly forecasts for the 10-year note rate and other market ranges.

Table 2: Market Forecast Ranges 2011

	1 st qtr.	2 nd qtr.	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	3.25-3.75%	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\$)	1.28-1.42	1.28-1.42	1.28-1.42	1.28-1.42
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	1235-1320	1235-1380	1250-1350	1280-1380

Currencies: I am maintaining my long-term negative forecast for the U.S. dollar primarily against Asian currencies. The exception is the dollar/yen where my view has been that the 2010 rise in the yen was a bit too quick and the yen would lose some of its strength. Specifically, I

have a dollar/yen range of 82-90 for 2011. Dollar/yen is currently at the bottom of my range and has briefly flirted a bit below 82. However, I am maintaining my range for now. I will review the range in the coming month and the risk is for a moderately lower range, say, 80-86. Longer term, further erosion of dollar/yen is likely.

I am making a major change to my euro forecast. Previously I had the euro falling in 2011 and my lower boundary was 1.08. My high was 1.36 which I thought would be achieved early in the year. In fact we exceeded that range by 2.5 cents as the euro hit an early February high of 1.38 and ½. My new range is 1.28-1.42, subject to revision either up or down in the second quarter depending on the outcome of U.S. budget and fiscal negotiations and European progress toward harmonizing regulation, tax and fiscal policy.

Previously, the primary threats to the euro were:

- Sovereign debt issues in several countries, and
- Prospects that Germany would abandon the euro or, at a minimum, refuse to underwrite the debt of other euro nations, raising the prospect of default.

Through most of 2010, the euro-based countries were behind the curve in reacting to the debt problems, causing periodic sharp falls in the euro value. In particular, Germany, the powerhouse in the group, only reluctantly agreed to raise the limits of support, and did so only after rising rates in the more vulnerable countries, Greece, Ireland, Portugal and Spain, threatened to undermine the euro. The main problem that euro-skeptics have with whether the euro is workable is the lack of coordination of sovereign fiscal policy and the lack of discipline some countries had in meeting fiscal guidelines.

What has changed? Recently, the German government has moved from being euro-skeptic to being more supportive. Loan guarantees are becoming more credible and financing is forthcoming. In the coming week, German Prime Minister Angela Merkel will propose a series of regulatory and fiscal changes that will move to harmonize work and fiscal standards within the euro-community. The outcome of these efforts is not guaranteed, but Germany's leadership and apparent strong commitment to the euro is a positive.

I continue to expect the Canadian dollar and the Chinese yuan to appreciate moderately in 2011. I am maintaining my 96-106 range for the Canadian and expect the Chinese yuan to appreciate at least 5%.

Stocks: Federal Reserve Chairman Bernanke has been more forthright about the positive impact of QE2 on stocks. Although he maintains the purpose of the policy is to boost the economy and support a rise in employment, he acknowledges that the transmission mechanism for achieving this result is by boosting asset prices. Given his commitment to continue QE2 through mid-year, I am raising the bottom of my S&P range in the first quarter from 1220 to 1235, a small adjustment. Were it not for the potential negative effect of Middle-East developments I would have raised the lower bound a bit more. At the same time, I am not raising the upper bound because I think much of the positive impact of QE2 is in the market. Relative to earnings and risks, I see the market at fair value.

I have also “tweaked” my ranges for the second through fourth quarters of 2011 to reflect the following. Although I expect earnings to be supportive of stock prices throughout 2011 (S&P earnings are likely to be between \$88-96), I see four negatives as keeping a lid on the P/E ratio.

- State and Local budget contractions will weigh on sales to that sector, e.g., Cisco has reported a huge drop in orders to governments.
- QE2 is unlikely to extend beyond mid-year given my growth and inflation forecast.
- I remain somewhat pessimistic that a rational fiscal policy can be agreed upon within Congress and between Congress and the administration.
- Later in the year, developments in the Middle-East could weigh on the markets as it appears that an even more hostile environment toward Israel and the West develops.

If my assumptions are correct, the market will have a setback in the second quarter in anticipation of the end of QE2 and as the outcome of fiscal policy negotiations looks pessimistic. In the end, however, I expect some form of budget to be adopted and for the fiscal situation to look a bit better, if only because tax revenues related to growth rise. Absent a crisis, the S&P should end the year near the top of the range. Moreover, if I am too pessimistic about the success of fiscal negotiations and if the income tax rate is reduced for corporations without an undue removal of tax incentives for investment, the market will move higher than my forecast.

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