STUART INVESTMENT
MANAGEMENT LIMITED

Economic and Market Update – April 4, 2011

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Summary

Over the past month, the consensus for first quarter growth has been revised down to near 2.5% from 4%. My forecast of 3-4% remains the same, but as indicated in the growth section, the range of possibilities is wider than usual. The first estimate, a very important statistic that can move markets, will be released on Thursday, April 28. I also forecast second quarter growth to be 3-4%, reflecting momentum from fiscal and monetary policy, but held back by recent events in the Middle-East and Japan that have had a negative impact on consumer confidence.

Jobless claims have been lower in the past few months, suggesting less willingness to lay off workers. However, despite the March 216,000 rise in payrolls, hiring remains weak. Moreover the fall in state and local jobs in the last few months is likely to continue. The labor force participation rate continues to be weak and, as a result, I expect the unemployment rate to remain in the 8.5-9.2% range in the second quarter, somewhat lower than my previous forecast.

QE2 is scheduled to be discontinued at the end of the second quarter. And I don't think it will have as negative an impact on Treasury rates as the consensus seems to assume. My bigger concern is about the fiscal situation. On one hand I expect an 11th hour agreement on cutting the current year's budget will occur. I also think the deficit ceiling will be raised before it has much of a negative impact on the economy and markets. My concern regards the fact that the focus on the current budget may preclude the grand bargain needed to deal with the more important longer-term deficit. Enacting near-term cuts without dealing with the longer-term problem may negatively impact the investment needed to broaden the tax base.

I expect problems in the Middle-East to continue to fester for months or longer. But, despite the human tragedies and uncertainty over whether the hopes of populations will win over the authoritarian governments, the market is mostly concerned with oil. Thus while a premium will continue to be built into the oil price, it is impossible (for me) to predict the outcome. Aside from oil, other markets appear to have become inured to Middle-East events.

Finally, I have raised my range on the Euro by a small amount to reflect interest rate and EU developments. Nevertheless, I think the Euro is near the top of its likely second quarter range. I also think the S&P is near the top of its second quarter range and will trade sideways to lower, as

investors realize margins have likely peaked and the Federal budget situation is not solved. However, continued healthy corporate profits will likely limit corrections in the stock market.

Economy

Growth: Fourth quarter growth was revised up by 0.3% to 3.1% reversing the 0.4% decline in the previous revision. Inventories remain lean, but the 3.27% contribution of net exports in the fourth quarter is not likely to be sustained. To the contrary, net exports may subtract a couple percent from first quarter growth. This subtraction, coupled with the effect of 'economy-reducing' weather in January, and a weaker-than-expected housing market, have caused most forecasters to lower their first quarter growth estimate to the mid-2% range.

Although I am sticking with my 3-4% estimate, I think the there is more downside than upside risk to my forecast. Moreover, I think the likely "error" potential is greater than normal. As previously mentioned, both the exceptional 3.27% contribution of net exports and the 3.42% subtraction from the inventory change were extreme outliers. Moreover, the recent crop report suggests that farm inventories continue to be drawn down at a rapid rate. Thus inventories may remain lean. And if the overall increase in non-farm inventories does not match the subtraction from net exports, then growth could be even lower than the 2.5% consensus. Conversely, if as I expect, the change in inventories reverses the fourth quarter decline by more than the subtraction from net exports, then growth could be well above the consensus. This is the primary reason my forecast is above the consensus.

A recent decline in consumer confidence introduces a downside risk to my 3-4% second quarter GDP growth forecast. At the same time, net exports will likely increase relative to imports due to the Japanese tragedy. Moreover, employment appears to be picking up and the recent rise in food prices may actually induce consumers to "buy ahead". Despite the abysmal housing activity, I think that second quarter is likely to see a pickup in housing and construction activity that is a bit above the seasonally-adjusted expectation.

My concern for growth is focused on the second half of 2011. It is likely that both monetary and fiscal stimulus will diminish. Moreover, if the rise in food and oil prices persists, this will eat into real consumer income at a time when wage increases remain negligible. I am sticking with my forecast for second half growth to slow to 2.5-3.5%, with some danger that it will(may?) be even weaker.

Recently, PIMCO's Mohamed El-Erian questioned how well the economy could growth on its own as the monetary and fiscal stimulus is withdrawn. His comment was that he was not sure the economy had reached "escape velocity". This is essentially a variation on PIMCO's "new normal" forecast to which I subscribe, namely, that the rebound will continue to be sub-par relative to the depth of the recession as the repair to the banking system and consumer balance sheets is a multi-year process that will inhibit growth for several years. In addition, the need to bring down the public deficit will also inhibit growth.

Employment: The 216,000 increase in payrolls is encouraging. I expect increases in the second quarter will remain near 200,000 per month. However, wage gains remain non-existent, a factor that will moderate income gains in coming months. Moreover, with food and energy prices increasing, consumer real income is not growing. Thus, it is not surprising that consumer confidence is weak.

Public sector jobs fell 14,000, while private sector jobs rose by 230,000. On balance I remain optimistic about job creation over the next few months. I expect the decline in public payrolls to continue at a 20,000 pace for months to come. And the increase in private payrolls is not likely to exceed the 200-250,000 level on average. In some respects it is good that the increase in private payrolls is increasing relative to jobs in the public sector. On the other hand, the mix of jobs appears to be such that lower wage jobs are increasing at the expense of higher-paying jobs. Hence I expect wage increases to continue weak.

Forward measures of the economy, including export orders and new domestic orders, are growing, but at a slowing pace. At the same time, manufacturing remains robust. Although profit margins may be peaking, I expect revenue growth and profits to continue to be strong enough for several more months to sustain my employment growth forecast. Keep in mind, however, that payrolls tend to be a lagging indicator, although not quite to the degree that inflation is. I am already seeing signs that growth may slow in the second half and cut into the monthly increases in job creation beyond mid-year.

Table 1: Economic Forecast 2011

	2nd qtr.	3rd qtr.	4th qtr.
Growth (%)	3.0-4.0%	2.5-3.5%	2.5-3.5%
Unemployment (%)	8.5-9.2%	8.2-8.8%	8.0-8.5%
Inflation (qtrly %)	4.0%	3.0%	2.5%
Core Inflation (%)	2.0%	2.2%	2.4%
Fed Funds	0-0.25%	0-0.25%	0.25-0.50%

Inflation and Monetary Policy: Chairman Bernanke has a dilemma. Last month I wrote "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."

Several of the more hawkish Fed officials have cited, correctly in my opinion, that price pressures are rising. Several retail outlets, Wall-Mart included, have indicated that rising input costs are forcing them to raise prices. Meanwhile, despite “coast-to-coast” planting intentions, food demand, driven by exports, and energy production that diverts cropland from food production to ethanol production, are driving basic crop inventories down to minimum levels. Thus, it seems likely that inflation is at least temporarily going to go higher than the Fed’s comfort level.

At the same time, wages for many workers, many from the lowest income families are stagnant or falling. The typical inflation situation has wages rising with prices, with those on fixed income and net creditors being the losers. However, for the first time that I have ever witnessed, workers are losing as well. My own interpretation is that it is a continuation of the fall in the standard of living. To fight inflation as some would do, will exacerbate the situation by slowing the economy and eroding the very tax base that is needed to help lower the deficit. But to fail to fight inflation is also not a good alternative.

In my opinion the above situation is the inevitable result of past policy mistakes that failed to keep the U.S. as competitive as needed to support an aging population. Thus, there is no good monetary solution. The Fed must allow some inflation so as to gradually lessen the burden of debtors. But this means that creditors take a haircut as their debts are repaid with cheaper dollars. Alternatively, if we don’t have inflation, the burden of the debt becomes heavier and defaults will increase (beyond the mortgage market).

Essentially then, although I have been an advocate of QE2, it is only a stopgap measure to maintain demand by inflating asset prices while the U.S. gets the debt situation under control. To some extent, the U.S. has made progress in gradually lowering private household debt although, given the continued fall in housing prices, household balance sheets still need further repair. But unless we make huge progress (see below) on a sharp but scheduled reduction in the public deficit while at the same time promoting investment and broadening the tax base, quantitative easing will go for naught.

Fiscal Policy: By April 8, Congress must arrive at an agreement for cutting the fiscal 2011 deficit or the government will likely be shut down. I suspect that an agreement will be hatched in the 12th hour and that Congress will then tackle the fiscal 2012 budget. Frankly, the 2011 budget dispute is “small potatoes”. The problem is to schedule a massive cut in the deficit without sending the economy into recession, and at the same time, broaden the tax base.

My concern is that, although the key Republican leaders have indicated a willingness to tackle the entitlement programs, there will be no grand bargain without revenue increases for upper income families. If there were a true willingness to work for the American people the Democrats would be offering to cut the growth in entitlement programs and the Republicans would be offering revenue solutions that allowed the pain of entitlement curbs in lower income families to be shared by higher income families. Instead the Republicans appear to be offering a huge cut in Medicaid and the burden of their proposal appears to fall on low income people. And to date, the Democrats have offered nothing and are only responding to Republican proposals.

I have previously maintained a “grand bargain” that would not have negative unintended consequences would

- Broaden the tax base by increasing public investment and maintaining or giving additional incentives to business to create jobs and simultaneously increase productivity to maintain competitiveness in the global market,
- Curb the growth in entitlement programs, and
- Raise revenue from higher-income and wealthier households in a manner that favors investment over consumption.

If these requirements appear to be a tall order, they are. Republican hands are tied by an emotional right, driven by anger rather than reason and that does not understand the subtlety of the economic arguments. And Democrats hands are tied by an emotional left that is equally driven by anger at the greed of high-profile personalities that took unfair advantage of their privileged position. While I am sympathetic to the frustrations of both sides, the unwillingness to compromise shows the kind of childishness that we normally see in the Middle-East where centuries of pent-up grievances preclude a solution.

Although I hope I am wrong, the logical solution is that, in the six remaining months of fiscal 2012, Congressional leaders will only be able to cobble together another stopgap measure to make modest near-term cuts that will not accomplish any of the three objectives listed above. The fallback will be to “kick-the-can-down-the-road” on a longer-term constructive deficit reduction and investment-boosting solution. But time is getting short and the short-term huge deficit make the longer-term deficit problem more onerous by leaving little “wiggle” room. Moreover surveys suggest the populace is less willing than even Congress to accept pain. Most responses indicate only a willingness to make cuts that hurt others.

I cannot predict how much time we have to solve our national dilemma. If I were more optimistic, I would certainly be more constructive on growth, job creation and the markets than indicated in my forecast. As indicated in the equities section, corporations are in reasonably good shape and earnings as robust as they ever have been. If I were not concerned about the external negatives, my growth and stock market forecast would be much rosier.

Markets

Interest Rates: One of the themes in the investing community is that Treasury rates will move up quickly after June when the Fed stops buying Treasuries. I would not be surprised to see rates move up into the end of QE2 in anticipation of this result. However, two factors suggest that, by the time QE2 is ended, the rise in rates may slow:

- I am already seeing signs that consumer demand and growth in the second half will not be swift enough to put further upward pressure on prices. This slowing of demand will partly result from the loss of household purchasing power as inflation, a lagging variable, outpaces wage gains.
- The ending of QE2 is a “risk-off” trade. Just as investors were surprised that Treasury rates went up as the Fed began buying them, they may be surprised by the absence of further upside pressure as private investors and sovereign funds take up the slack by switching into Treasuries from other fixed income and asset classes.

Specifically, my forecast is for the 10-year note to rise to the top end of my range, 3.85% by the end of the second quarter. However, I only expect a further rise of 25 basis points by the end of 2011. This remains consistent with my year-ahead forecast made last December.

Currencies: Two months ago I wrote "I expect a moderate rebound in the dollar over the remainder of the first half of 2011". Some positive budget developments and continued pickup in growth will be supportive. At the same time, the rebound is mostly because of the relative performance of the U.S. economy compared with Europe and Japan." To date the dollar has not rebounded and fell another 0.8% in the past month. Nevertheless I will stick with my forecast for a moderate rebound into mid-year. In the second half of 2011, I expect the dollar to hold onto its gains but to extend them very little.

Table 2: Market Forecast Ranges 2011

	2nd qtr.	3rd qtr.	4th qtr.
10 yr. Treasury Rate (%)	3.35-3.85%	3.40-4.00%	3.70-4.10%
Dollar Index (futures)	75-80	76-82	78-82
Euro (in U.S$)	1.32-1.46	1.28-1.46	1.30-1.48
Dollar/Yen	81-85	83-89	84-90
Canadian (in U.S.$)	1.00-1.04	1.01-106	1.02-1.06
S&P	1250-1350	1250-1350	1280-1380

Longer term I think the dollar will continue to fall. The trade deficit remains unsustainably high. Budget deficit reduction, whether it comes from intelligent legislation or is forced on the U.S. by crisis, will not prevent a further dollar decline. Although it will remain the reserve currency for years to come, the dollar will continue to lose dominance. Investors will continue to rebalance their holdings in a manner that will likely not allow continued financing of the sum of U.S. indebtedness and monthly trade deficit without further dollar depreciation. The trade deficit will shrink, but not fast enough to avoid this result.

The Chinese yuan is on a pace to decline 5% this year. I expect a continued persistent further decline. Increasingly the Chinese will reweight their foreign reserve holdings to achieve lower relative exposure to the U.S. dollar. By weighting their reserves to a market basket rather than disproportionately investing in the dollar, the result will be that the yuan will appreciate a bit faster against the dollar than against the weighted average of other currencies.

I am "tweaking" my range on the euro for the remainder of the year, raising the top end to 1.46 for the quarter and to 1.48 by year end. However, I foresee mostly range trading and still look for a move back to near the 1.30 level or a bit lower sometime in the next 3-4 months.

Prior to the Japanese earthquake, I looked for the dollar to exhibit a gradual upward trend against the yen in 2011. The Japanese tragedy does not change my forecast. However, the circumstances have changed somewhat. The immediate effect of the tragedy was a rise in the yen as speculators anticipated that $100s of billions would be repatriated to pay for insurance liabilities and reconstruction. G7 nations made it clear that a rapid rise in the yen was unacceptable. And at this point, traders appear to anticipating that the Japanese trade surplus will turn to a deficit as imports increase to facilitate the reconstruction and as Japanese exports are temporarily curtailed by the damage on Japanese infrastructure.
Perhaps more important, despite the burgeoning debt, the immediate slowdown in the Japanese economy will keep its rate at zero at a time when rates in many other parts of the world are rising. Overseas investment opportunities also remain attractive. Thus, I expect borrowing in yen to continue as investors look to reap returns outside of Japan. As a result, I expect the yen to remain weak for several months, perhaps for the rest of the year.

The Canadian dollar remains in a distinct upward trend. Prospects for a fall in the current minority government and, more importantly the effect of the economic disruption from the Japanese earthquake were responsible for the sharp test of the par level in mid March. Since then, however, the Canadian has rebounded, oblivious to the prospect that an early May election will still likely leave the parliament with a minority government.

The mix of policy in Canada remains the most favorable among the major industrial nations. And the election is not likely to change that. Still, many in Canada are concerned with the rapid inflow of capital and the takeover by foreign entities of Canadian companies. Historically, Canada has been the repository of huge foreign capital inflows. And unlike the U.S. those capital inflows were used for investment rather than domestic consumption purposes. Thus, Canada is able to maintain a trade balance and even surplus that pays for any potential capital outflow that represents the foreign return on their investments in Canada. The concern is that, to some extent, capital flows are driving up the price of housing and, at some point, may deprive domestic entities of a reasonable rate of return.

Because the foreign capital flows has become an issue that has potential negative as well as positive implications, the Canadian dollar could, from time to time, result in sharp setbacks such as the one that occurred in mid-March. Thus I allow for the Canadian to correct back to the par level. And if an unexpected slowdown in the U.S. or world economy occurs, the resulting downward correction in commodity prices would likely cause me to revise my forecast down for the Canadian dollar. But absent such a development I expect a gradual continued rise in the Canadian dollar.

Stocks: Over the next few weeks and months I expect equity prices to be whipsawed by external fiscal policy developments. An agreement on the 2010 fiscal budget in the coming week may result in a rally. At the same time, I think traders and investors will take such a rally as an opportunity to sell stock on the premise that the agreement does nothing to solve the longer-term problem. Moreover, with the end of QE2 in sight, I would not be surprised to see a second quarter correction as a powerful support for the market is eliminated. And later in the year, it may take a deeper correction to make it clear to Congress that they not only have to come up with a deficit-reduction strategy, but it must be one that does not undercut the fragile economic growth.

For the moment, investors appear to be ignoring Middle-East developments. Absent a negative surprise, then, I see limited near-term downside in stock prices. Thus, my lower bound is consistent with the recent corrective low. My 1250-1350 range assumes that stocks will trade in a narrow range in the second quarter with no clear trend.

I see the main risk to my forecast as being one last thrust to the upside, say, to 1380 if investors conclude that both sides of the aisle are ready to move to a compromise that achieves the objectives I have laid out in my discussion of fiscal policy. However, given the politics I foresee disappointment as regards getting over the finish line on long-term deficit reduction in this Congress.