



Economic and Market Update – May 9, 2011

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Summary

At 1.8%, first quarter growth came in lower than my forecast, but right on the consensus. Government spending subtracted 1.09% while commercial real estate subtracted another 0.63%. Much of the Federal government's subtraction, or 0.63%, was from growth due to reduced defense spending, which is likely to be recaptured in the second quarter. My forecast for second quarter growth is 2.5-3.5%, 1/2 % lower than my previous estimate. My estimate for the second half remains at 2.5-3.5% and assumes that the lower dollar will lower the net export deficit, offsetting the negative impact of the end of QE2 and some reduction in the government deficit. But world growth is also likely to slow and the risk to my forecast is to the downside.

Payrolls increased a very healthy 244,000 in April, despite the continuing drop of 24,000 in government employment. Moreover, payrolls in the previous two months were revised up 46,000 bringing hiring more into line with previous thinking that job growth was rising faster than the data indicated. Even the rise in the unemployment rate is a good sign given that it was caused by new entrants into the market rather than discouraged workers who were no longer looking for work. Tempering the positive report is the recent rise in new jobless claims and very sluggish wage growth. The increase in jobless claims is a more timely indicator of the future than the monthly report, which tends to be a coincident or even lagging indicator.

Inflation continues to pick up and has many forecasters concerned that the rise will become embedded in the expectations for future inflation. Although I previously raised my forecast for inflation this year, I still assume that it is transitory. My greater concern is that, with wages rising very slowly, the decline in real income could reduce household spending, dampening growth.

In the most recent FOMC communiqué and Chairman Bernanke's follow-up press conference, it became clear that, while QE3 will end as scheduled at the end of June, the Fed has no current plan to reduce the balance sheet by letting maturing Treasuries "roll off" without replacing them. I view QE2 as a stopgap measure to support the economy while the damage from the previous credit crisis is unwound and until progress can be made in reducing the budget deficit. As such, if an eventual agreement to lower the budget deficit is reached, the impact on the economy, which could be either positive or negative, will determine how fast the balance sheet will be allowed to decline or, alternatively, if a QE3 is needed.

My best guess is that, in order to pass a rise in the Federal debt ceiling, Congress and the Administration will agree on the amount of budget deficit, but will not be able to agree, yet, on how to achieve the necessary result. It appears the amount will be \$4-5 trillion over a 10-12 year period. My assessment is that, if an agreement as to how to cut the deficit is put off entirely until after the next presidential election, the markets, including the dollar and longer-dated Treasuries, and even stocks will likely sell off in the third quarter.

My market forecast assumes that a target for deficit reduction will be agreed upon and enough progress on how to reduce the deficit will be made to allow Congress and the Administration to agree to raise the debt ceiling. But the agreement will not come for two to three months and will not include specifics as to how to meet the objective. In the interim, Treasury rates will likely climb 25-35 basis points, but continued sluggish growth will keep them from rising dramatically.

Deficit reduction will tend to lower rates. Thus, rates in the second half will depend on the relative importance of the withdrawal of the Fed vs. the degree of deficit reduction. The strength of the economy and lending in the private sector will also be very important. Based on slower-than-expected current growth, I have lowered my 2nd quarter forecast for the 10-year Treasury note to 3.15-3.65%. I have kept my forecast for the second half, 2011, the same.

Fed Chairman Bernanke's dollar comments indicate he thinks it is much more important to have a healthy economy and low inflation than to raise rates prematurely and risk a further domestic economic slowdown. This was a near-term negative for the dollar but likely mitigates the speed of a dollar drop that would occur if the U.S. economy fell back into recession. As a result I have lowered my 2nd quarter dollar forecast, but still expect a counter-trend dollar rally.

Assuming that a further drop in the dollar, if any, is orderly, the positive impact on earnings, both from increased competitiveness and earnings translations, will benefit stock prices. At the same time, the U.S. continues to face headwinds from prospects for the end of QE2, slowing government demand from budget cuts and some slowing in world growth as other countries, especially among emerging markets fight inflation by raising rates. Thus I expect it will be difficult for the market to rise further this quarter and look for at least one 10% correction as the budget debate drags on.

Economy

Growth: At 1.8%, first quarter growth came in lower than my forecast, but right on the consensus. Government spending subtracted 1.09% while commercial real estate subtracted another 0.63%. Meanwhile, inventory accumulation added 0.93% to growth reversing the 3.4% subtraction from the fourth quarter. Away from the above subtractions and contribution, the remaining demand-driven categories resulted in growth of 2.6% led by a 1.8% contribution from household demand and a 0.8% contribution from investment in equipment and software.

The 0.78% drop in government expenditures due to the Federal government was the result of what is probably a temporary drop in defense expenditures. Much of this drop will probably be reversed in the second quarter, leading the Federal government to contribute, say, a half a percent

to growth. On the other hand, State and Local spending will likely continue to be curtailed subtracting a few tenths. Household spending on goods and services will likely continue to add 1.5-2.0% to growth, while investment will add another 0.6-1.0%. Assuming the drop in commercial real estate will be minimal and that a further inventory build will offset any trade deterioration, I estimate second quarter growth at 2.5-3.5%, a half percent lower than my previous range.

I am maintaining my second half growth forecast at 2.5-3.5%. While this would be reasonably healthy in a fully-employed economy, it is not sufficient to reduce the unemployment rate much further, or to boost tax revenues to the extent that most recoveries do. Consumers continue to repair their balance sheets and will likely continue to contribute a moderate 1.5-2.0% to growth, including personal consumption and housing expenditures in the second half. Investment will contribute another 1-1.5% including some further build in inventories. But the government will likely subtract a half percent.

The path of the U.S. trade deficit will determine whether this forecast is optimistic or pessimistic. The recent sustained drop in the dollar will help U.S. competitiveness, boosting exports and, possibly, limiting the growth in imports. On the other hand, emerging markets are raising rates to curb inflation and growth in Asia and South America may slow. Growth in countries such as China, India and Brazil, have been driving an increasing proportion of world trade in recent years and a slowdown in these countries could curb the improvement in U.S. net trade.

Table 1: Economic Forecast 2011

	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	2.5-3.5%	2.5-3.5%	2.5-3.5%
Unemployment (%)	8.6-9.0%	8.4-8.8%	8.2-8.5%
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%

Employment: Payrolls increased a very healthy 244,000 in April, despite the continuing drop of 24,000 in government employment. Moreover, payrolls in the previous two months were revised up by 46,000 bringing hiring more into line with previous thinking that job growth was rising faster than the data indicated. Even the rise in the unemployment rate is a good sign given that it was caused by new entrants into the market rather than discouraged workers who were no longer looking for work.

The recent rise in new jobless claims and very sluggish wage growth temper the positive monthly employment report. Weekly claims, 470,000 for the most recent week, rose sharply from the 392,000 level just three weeks ago. This data is a bit more timely and forward looking

than the monthly report. And while there may be some distortion from the timing of the Easter holiday, it now appears that job-gain momentum is slowing.

Wage growth remains very slow and the concern is not so much about a rising level of inflation, but rather that households will be unable to keep up with the inflation that exists. This could put a damper on second-half household demand and is every bit as negative as a higher rate of inflation that is accompanied by rising wages.

One longer-term bright spot is the continuing productivity gain, especially in manufacturing. Although unit labor costs rose a percent in the first quarter, productivity rose 1.6%, exceeding unit labor costs. Manufacturing productivity was even higher and unit labor costs in manufacturing fell one percent. Near-term this may be holding back the job gains in manufacturing as capital improvements replace labor needed to produce a given level of production. But longer term, this is a positive development because it improves U.S. competitiveness and will lead to future job growth as demand increases.

Inflation, Real Incomes and Monetary Policy: Inflation continues to pick up and has many forecasters concerned that the rise will become embedded in the expectations for future inflation. Although I have raised my forecast for inflation this year, I still assume that it is transitory. And core inflation in the first quarter was in line with my 2% annualized forecast. I expect some further gain to an annualized rate of 2.4% by year end. But my greater concern is that, with wages growing so slowly, the decline in real income could reduce household spending, dampening growth.

In the most recent FOMC communiqué and Chairman Bernanke's follow-up press conference, it became clear that, while QE2 will end as scheduled at the end of June, the Fed has no current plan to reduce the balance sheet by letting maturing Treasuries "roll off" without replacing them. I view QE2 as a stopgap measure to support the economy while the damage from the previous credit crisis is unwound and until progress can be made in reducing the budget deficit. As such, if an eventual agreement to lower the budget deficit is reached, the impact on the economy, which could be either positive or negative, will determine how fast the balance sheet will be allowed to decline or, alternatively, if a QE3 is needed.

Fiscal Policy: Be careful what you wish for. I have previously written about the importance of boosting investment and maintaining demand in a period of deficit reduction. Some economists that I respect even advocate that is premature to reduce the budget deficit at all for fear of slowing growth too much in the near-term. Such appears to be the case in the U.K. And there is limited evidence that, even in the U.S., the decline in state, local, and Federal government defense spending may be mitigating near-term growth.

Conversely, those looking at the longer term maintain that if we do not implement a policy to reduce the budget deficit significantly over the next few years, the economy will be undermined as foreign and domestic investment will dry up as interest rates rise and as the U.S. bond rating deteriorates.

A more extreme position held by some of the candidates recently elected suggests we should roll back government spending now, by a huge amount to indicate the country's seriousness about

reducing government spending. But with state and local governments already cutting sharply and with the economy still recovering from the credit crisis and the deepest recession since WW2, this would be a grave mistake and would, in my opinion, send the economy back into recession and undermine the tax base, worsening the deficit.

In my opinion, both the case for limiting the degree of near-term public demand decline and the case for a “legally binding” Congressional agreement to reduce the budget deficit significantly over the longer term are both important. And, given that Congress should be careful about implementing cuts too quickly, an agreement that has “teeth” is crucial.

My market forecast assumes that a target for deficit reduction will be agreed upon, probably \$4-5 trillion over 10-12 years. And progress will be made on how to reduce the deficit while maintaining investment incentives and infrastructure spending in the coming fiscal year. These agreements will be sufficient to get the Congressional votes necessary to raise the budget deficit ceiling. But the agreement will not come soon. Nor will it include specifics beyond the coming fiscal year on how to achieve the desired result. Thus, there is a danger that, following an initial positive investor response, the positive will be eroded as a failure to agree leads to skepticism on whether the target will be reached. Moreover if an agreement is not reached by late July, investors are likely to get very concerned and a market selloff like that which occurred when the first vote on TARP failed may be necessary to spur Congress and allow more responsible members to prevail.

More on the budget: Recently, a good friend, a very well-read more academically-inclined economist, asked a very legitimate question “why do you think the U.S. can't get out of the budget problem as easily as happened in 1995 when the Clinton administration and a Republican Congress reached an historic agreement that resulted in budget surpluses”. Some economists that I respect think this is possible.

I am more pessimistic for several reasons. A potential structural deficit crisis has been developing over several decades. Demographics related to the “baby boom” are leading to a situation in which the numbers of the working population relative to retirees (if the age of retirement does not change) may not be sufficient to support our building entitlement program obligations. I date the potential crisis as roughly in a 2015-2020 time framework. That is when baby boomer retirements begin to draw more money out of Social Security and Medicare than is being put in. And the net withdrawal increases at a faster rate for several decades.

The Clinton/Republican compromise put the budget on solid footing and let to the possibility that the Government would enter the period of structural debt from a position of strength, i.e., there would be little public debt. But it did not eliminate the longer-term structural problem. Then in the early 2000's, the Bush Administration, with the consent of both Democrats and Republicans in Congress reversed the progress that had been made by allowing the budget deficits that ensued from the shallow 2000-2001 recession to continue long after the point where they should have been offset. Thus 15 years later the country not only enters the potential crisis period from a position of weakness, but, in the interim, we have done nothing to offset the structural deficit. Moreover the recent concern and curbing of immigration over the past few years likely makes

the problem a bit worse by lowering the worker/retiree ratio relative to what would otherwise be the case.

The Japanese faced a similar, but even more dramatic, demographic situation in which the population is both aging and declining about 15 years in advance of the U.S. This is in part, the reason for the very sluggish growth and the rapid rise in the Japanese public debt to a level that is -far and away the highest among the G7 countries. Also, there is almost no immigration into Japan, a country that admittedly has less land availability than the U.S. But what Japan has that the U.S. lacks, is a huge external surplus. Admittedly the Japanese public debt is much larger as a percent of GDP than is the U.S. debt load, but Japan has a huge pool of private savings, both internal and external to draw upon. That is why I have consistently indicated that aggressive private and public investment is needed to improve U.S. competitiveness. It is also needed to offset the curbing of consumption growth and to broaden the tax base in order to minimize the tax rate rise that will be necessary to close the public deficit without undermining the economy.

Finally, a popular argument is that the near trillion dollar stimulus program was bad policy and was a failure because it did not create jobs. - It is quite true that the result did not come close to the Administration's rosy prediction. However, the reason was not because the stimulus was unneeded, but rather because the financial crisis and the economic damage went far beyond anything that was anticipated. A study done by two reputable economists, Mark Zandi, a "Wall Street" economist who advised Republican candidate, John McCain, and Alan Blinder, a Princeton economist, and formerly a Democratically-appointed vice chair of the Federal Reserve, concluded that the combination of monetary and fiscal response to the crisis saved three million jobs. If correct, 11 million jobs would have been lost and the unemployment rate would be far higher without the stimulus and complimentary monetary policy actions.

A more legitimate criticism of the stimulus is, in my opinion, how the money was spent. As with the health bill, the legislation was cobbled together by politicians, and produced a solution that was far less than optimal, even though the rationale for enacting the policy was sound. In the long term, the impact of a multi-year agreement to reduce the budget deficit on the health of the economy will depend as much on the specifics of the agreement as on its size. As I have written the past three months, investors should assess an agreement based on whether it:

- Increases public spending on investments in infrastructure to support the continued growth in productivity and, simultaneously maintains current incentives to business to become more competitive and, thus, create job opportunities,
- Curbs the growth in entitlement programs in a rational way that does not weaken the health of the nation,
- Raises revenue from higher income and net worth households in order to share the unavoidable pain of reducing consumption growth and allow for more investment.

Over the past year, despite all the concern expressed in the financial media, corporations have increased productivity, become more competitive, and increased profits so that they represent the highest fraction of GDP in the post WWII period, and tax revenues are increasing. We need to intelligently decrease the budget deficit without undermining this development.

Markets

Interest Rates: As indicated last month, I would not be surprised to see rates move up into the end of QE2 in anticipation of this result. I also indicated that I was not as pessimistic about the rise in rates as the consensus due to the possibility that household purchasing power and the need to further repair their balance sheets would slow the rise in rates.

As it turns out, rates have fallen as the economy in the first half has been weaker than originally forecast. Thus I have lowered my second quarter range to 3.15-3.65%. I expect the low in rates is being put in this month and that rates will rise slowly into the end of the quarter.

For now I am retaining my previous forecast of mildly rising Treasury rates in the second half. I will adjust it according to the outcome of budget negotiations. A more aggressive reduction in government spending than I expect near term would allow me to lower my second half range in line with the second quarter reduction of 20 basis points. Failure to reach a credible agreement for lowering the deficit will cause me to hike my range. Such a failure could also result in a downgrade of U.S. debt and lead to considerably higher rates than my forecast.

Currencies: Given recent erratic and sharp euro and yen movements, it is difficult to say whether this is a turning point in the dollar drop or a correction. As with rates, the fate of the dollar beyond the second quarter will likely depend on the ability of Congress and the Administration to reach a credible deficit-reduction agreement. I am lowering my forecast for the dollar index (futures) by 3 points in the second quarter based on Chairman Bernanke's unwillingness to change his domestic economic game plan to temporarily support the dollar. The counter-trend rally that I expected over the past two months did not materialize, in my opinion, because the U.S. economy has been weaker than either I or the consensus expected. But I still expect a correction and the most recent week's activity suggests that we may already be experiencing it.

Table 2: Market Forecast Ranges 2011

	2 nd qtr.	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	3.15-3.65%	3.40-4.00%	3.70-4.10%
Dollar Index (futures)	72-78	75-80	77-83
Euro (in U.S\$)	1.36-1.48	1.28-1.44	1.30-1.48
Dollar/Yen	80-85	82-86	84-90
Canadian (in U.S.\$)	1.01-1.06	1.01-1.06	1.01-1.06
S&P	1250-1380	1250-1420	1340-1420

If I am correct and Bernanke's resistance to hiking rates is the appropriate strategy for preserving the longer-run value of the dollar and, **if Congress and the Administration agree on credible**

interim deficit reduction in the next 90 days, I think the dollar will have a substantial second half rally.

Recently, Chinese policymakers have been more aggressive in hiking rates and raising some reserve requirements in order to slow inflation. A reasonable corollary to this would be to allow somewhat faster Yuan appreciation. Thus I expect the recent pace of appreciation, 5%, to be a floor for appreciation. I would not be surprised to see the pace of appreciation rise 2-3 percent to the 7-8 percent level for a couple quarters.

Last month I hiked the upper end of my range for the euro by 2 cents to \$1.48. That was not enough. We are undergoing a sharp correction as this is written so I am going to maintain the 148 upper bound although we temporarily exceeded it in the past week. While I continue to expect a retest of the \$1.28 in the second half, I have raised the bottom of my range for the current quarter to \$1.36.

The yen has in turn rallied and corrected as risk-taking has ebbed and flowed. I expect this to continue. The G7 will likely be willing to counter a rapid move below 80 yen per dollar, but may not be willing to “draw a line in the sand” at that level. However, at this point I am holding my dollar/yen range at 80-85, despite the quick and, I think, temporary move below 80. Aside from the break to the 77 level following the earthquake the 80-85 range has held for 6 months.

The Canadian dollar continued to rally into the May 2nd Election, won decisively by the Conservative Party. That rally was not so much anticipation of that result as it was the general rally of commodity-based currencies and general fall in the U.S. dollar. Thus with commodities correcting and world growth expectations being revised down a bit, the Canadian dollar is probably set up for a 3-5 cent correction. My forecast is for the Canadian dollar to remain above parity, but trade in a range near present levels for several months. The risk is that, if the U.S. economy slows more than expected, the Canadian dollar would temporarily move back below parity for a few months. Longer term, I remain bullish on Canadian fundamentals and the Canadian dollar, however, the rise over the past six months has captured the positive fundamentals and a period of consolidation is in order.

Stocks: Although I have raised the top of my S&P range for this quarter, to 1380 from 1350, this reflects the fact that the “Bernanke and Bin Laden” rally took the nearby S&P futures to 1373.50 on Sunday evening, May 1. I have also widened my range for the quarter by maintaining my lower bound at 1250. Despite the fact that corporate profits continue to grow, the recent anecdotal data on possible slowing of economic growth and the sharp liquidation in key commodities could presage and even deeper near-term correction to, say, the 1200 level as budget negotiations get more nasty before an agreement is reached. Indeed, the stock market may have to play a role as “messenger” that tells Congress how important it is for them to reach a credible agreement.

Longer term, once an agreement is reached, probably in late July or August, the stock market rally will likely continue and its extent will depend on continued gains in U.S. competitiveness and the credibility of the agreement. Meanwhile corporate earnings will likely continue to

increase but at a much slower rate than in the past 18 months. In my opinion, the “name of the game” over the next few months will be how to value earnings, not the earnings themselves.

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