



## **Economic and Market Update – June 6, 2011**

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### **Summary**

Although I expect second quarter growth to be 2.0-3.0%, above the 1.8% growth in the first quarter, recent economic data suggest that the U.S. economy will enter the second half of the year on a weak note. Several economists that I respect are interpreting the current weaker data as resulting from supply disruptions in Japan due to the earthquake. They not only expect that the economy will pick up as Japan rebuilds, but also suggest that an improvement in net trade will support better growth in the second half due to the weaker dollar. I disagree, and in the Tables below, I have revised my growth, employment, interest rate and stock market forecasts accordingly.

While I agree with their assessment of the positives, I do not think they will overcome the following negatives. World growth, in China and Europe especially, will likely slow enough to counter the positive impact of a weaker dollar. Housing is not recovering as I expected and will likely not contribute to growth in the second half. State and local finances continue to be repairing and I expect this sector to contract further in the second half. Finally, both monetary and fiscal policy will likely contribute less to growth in the third quarter as QE2 ends and as fiscal stimulus measures give way to relatively slower Federal government spending growth.

The weak employment growth reinforces the notion that growth will be slow. With housing prices still falling, household income growth will be an even more important driver of consumer demand that is normally the case in a recovery. Slow wage growth is impeding income growth and reinforces the slow growth that I am forecasting. The risk to my forecast is to the downside.

Many observers are now forecasting that worse-than-forecast growth will likely lead to the Fed adopting a QE3, continuing to buy not only Treasuries but perhaps mortgages as well. While I agree that a QE3 may be both needed and adopted, the bar for such a policy is high. It would not begin at the end of QE2 and would likely require the Fed to conclude that the economy is headed for a double dip, i.e. a couple quarters of negative growth. Despite the recent growth slowdown, a double dip is not currently their forecast. Moreover, the latest IMF forecast is for the current recovery to be reinforced. In my opinion, that is a very questionable forecast.

The recent fall in the Treasury rates (in contrast to many forecasts just 2-3 months ago, the 10-year note rate is hovering about 3%) should be moderately stimulative. At the same time, it is a signal of the slowdown in U.S. growth and, to some extent, a flight to safety as investors

concerns run from European and U.S. debt, to rising rates in emerging markets and rising commodity prices (despite the recent correction in oil and several other key commodity prices).

I have lowered, again this month, my Treasury rate forecast, and still think the risk is for lower rates than called for by the consensus. My dollar forecast remains the same. While I think sluggish U.S. economic data and prospects for more quantitative easing later in the second quarter are dollar negative, the failure of European countries to make as much progress on solving the Greek and other debt problems suggests that the Euro is not a good alternative to the dollar. Moreover, the Japanese yen will probably continue to be stabilized by G7 countries until the domestic rebuilding program gains steam. Nevertheless I have revised my forecast for dollar/yen to reflect a moderately stronger yen than I previously forecast.

The prospects for further quantitative easing later in the year plus continuing healthy profits will likely continue to support the S&P. However, I expect the correction now underway to continue into the summer and until it is clear that Congress and the Administration pass a spending cut bill and raise the debt ceiling. Nevertheless, as indicated in my section on fiscal policy, Congress may well agree on a deficit reduction number but, increasingly it appears that the specifics of how to obtain the result may not be agreed upon until after the 2012 election. I doubt that the markets will wait that long. Thus, there is a non-trivial risk that the S&P will drop more sharply than my forecast if foreign and domestic investors seek more safety.

## **Economy**

**Growth:** I expect second quarter growth, to be reported at the end of July, to be 2.0-3.0%, above the 1.8% growth in the first quarter. Recent economic data suggest that the U.S. economy will enter the second half of the year on a weak note. Employment gains are slowing. Wage gains are not keeping up with inflation. And fiscal policy is likely to be less stimulative. While many observers are beginning to expect the Fed to implement a third round of quantitative easing, the political environment both in and outside the Fed suggests that it is premature to expect more help from the Fed.

Several economists that I respect are interpreting the current weaker data as resulting from supply disruptions in Japan due to the earthquake. They not only expect that the economy will pick up as Japan rebuilds, but also suggest that an improvement in net trade will support better growth in the second half due to the weaker dollar. While I agree with their assessment of the positives, I do not think they will overcome emerging negatives.

World growth, especially in China and Europe, will likely slow enough to counter the positive impact of a weaker dollar. Housing is not recovering as I expected and will likely not contribute to growth in the second half. Moreover housing prices continue to fall, and this will mitigate household confidence and hold back growth in consumer spending. State and local finances continue to be repaired. Despite some encouraging news on the growth in tax revenues, I expect the state and local government sector to contract further in the second half. Finally, both monetary and fiscal policy will likely contribute less to growth in the third quarter as QE2 ends and as fiscal stimulus measures give way to relatively slower Federal government spending growth.

As a result of my less optimistic outlook, I have lowered my second growth forecast by 1/2% and my forecast for third quarter growth by a full percent to 1.5-2.0%. I do not expect a recession but growth will be far too slow to reemploy the unused resources in the economy. This will also have a somewhat negative impact on business investment as well.

**Table 1: Economic Forecast 2011**

	2 <sup>nd</sup> qtr.	3 <sup>rd</sup> qtr.	4 <sup>th</sup> qtr.
Growth (%)	2.0-3.0%	1.5-2.5%	2.5-3.5%
Unemployment (%)	8.6-9.1%	8.6-9.0%	8.4-8.8%
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 weak 54,000 in May, boosted by an 83,000 increase in private payrolls, but held back by a 29,000 drop in public employees. Downward revisions of 39,000 to the two previous months lowered the net increase to just 15,000 jobs. And the unemployment rate ticked up to 9.1% as many more individuals entered the labor market than got jobs.

Although wages increased by 0.3% in the month, the year-to-date increases do not offset the impact of inflation. Coupled with the further erosion in house prices, this outcome will continue to dampen the growth in household consumption.

Some economists maintain job growth will pick up in the second half to 200,000 a month. It is not clear to me where the growth will come from. Congress is wrestling with ways to cut the budget deficit and the climate does not bode well for further fiscal pump priming. Nevertheless, if GDP growth and the growth in employment continue to be as sluggish, as I expect, the Administration and Congress may yet decide to fund near-term spending in infrastructure and other investment projects. However this is not likely to come before mid-summer at the earliest.

**Europe, the Euro and Sovereign Debt:** Following a correction, the Euro is again strengthening as an agreement has been reached to continue funding the Greek debt. Greece has undertaken an austerity program and will make further spending cuts. But the measures have thrown Greece into recession and a fall in tax revenues is mitigating progress in reducing the deficit.

A substantial privatization of Greek assets and businesses would put Greece on a better fiscal path, but politics may prevent the amount of sales that are needed. Thus, the extension of further Greek debt purchases does not eliminate the prospect for some type of debt restructuring down

the road. Thus, I consider the current agreement as merely putting off a more viable solution. Moreover, European growth is likely to continue slowing and, at best, be a neutral for the world economic recovery.

**Monetary Policy:** The political and, to some degree, economic climate for continuing quantitative easing is very negative. Nevertheless, I have described it as the only game in town absent a fiscal stimulus which simultaneously boosts confidence by scheduling budget deficit reductions and increasing near-term investment spending. Given my pessimism concerning fiscal agreement (see below), the Federal Reserve may well end up reluctantly adopting a QE3 program. However it will not come easily or soon, certainly not before the deficit ceiling is raised and some form of budget agreement is reached. At the same time, it would be dangerous for the Fed to decide to let assets on their balance sheet roll off without replacing them. Thus, I think monetary policy will be on hold for the next couple months, probably longer.

If policy does change following a budget agreement, it will be toward some form of monetary easing. For example, the Fed may decide to broaden their asset purchases beyond Treasuries and further increase their balance sheet. As of now, however, such a development would be very unpopular and is only likely to be undertaken if the Fed feared a double dip recession or(?) another financial crisis. Moreover, monetary options are more restrained than was the case when Fed Chairman Greenspan lowered rates in exchange for the surplus-producing fiscal agreement between President Clinton and the Republican crisis. Business and the private sector “took off” after that historic agreement.

**Fiscal Policy:** My forecast for the fiscal outcome is pessimistic. Last month I wrote “In my opinion, 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 [market response] 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.”

I have become more pessimistic for two reasons. Although I think that the Congress will put some teeth into any budget agreement, i.e., they will build in mandatory across-the-board future spending cuts if goals are not met, I think the size of any agreement to cut the deficit is likely to be \$2-4 trillion, or less than the \$4-5 trillion that I previously forecast. Second, there is increasing chatter out from Washington that specifics concerning cuts that have to be made in

entitlement programs and revenue hikes will be put off until after the 2012 election. I have previously stated that, if this is the case, investors in the financial markets may not be satisfied and the negative impact on the markets could be considerable.

## Markets

**Interest Rates:** I have lowered the bottom of my second quarter range to 2.90% on the 10-year Treasury note. At the same time, I think Treasury rates are near their secular low. Despite my forecast that Congress and the administration will agree to a \$2-4 trillion deficit cut over the next decade, I think the lack of specifics and the prospect for investors moving away from Treasuries will lead to gradually-rising rates. Nevertheless, given some need for safety, I do not see Treasury rates rising as much as I previously forecast. Thus, I have lowered my ranges for the second half as well.

**Table 2: Market Forecast Ranges 2011**

	2 <sup>nd</sup> qtr.	3 <sup>rd</sup> qtr.	4 <sup>th</sup> qtr.
10 yr. Treasury Rate (%)	2.90-3.30%	3.10-3.60%	3.50-4.00%
Dollar Index (futures)	70-75	72-78	76-82
Euro (in U.S\$)	1.36-1.48	1.28-1.44	1.30-1.48
Dollar/Yen	80-85	78-84	80-85
Canadian (in U.S.\$)	1.01-1.06	99-1.04	1.01-1.06
S&P	1250-1370	1250-1350	1340-1400

**Currencies:** I am not as optimistic about the dollar as previously. Although I expect a rebound in the dollar in the second half, I do not expect it to be as strong as I previously thought and it will likely begin from a lower level. The economic data at this point do not support a rebound. A credible deficit solution would be a positive but if, as I expect, there are insufficient specifics as to how to achieve the goal, a dollar rally would be mitigated. I lowered my quarterly ranges for the dollar index by a couple points.

I have not changed my range on the Euro. Given the poor U.S. economic data, the euro has remained stronger than I previously expected. At the same time, despite the ability of the European Union to “paper over” the Greek debt problem, I think European debt problems will continue to be an issue weighing on the Euro.

I lowered my third quarter range on the Canadian dollar to \$0.99-1.04 based on my thinking that sluggish U.S. economic data will extend the commodity price correction and could also have a direct negative impact on the Canadian economy. I remain bullish on the Canadian dollar longer term. I lowered my forecast on dollar/yen looking for it to fall though the 80 level. G7 nations will likely limit the yen rise and the speed of adjustment but investment will likely flow into Japan as rebuilding gets going in earnest. In times of stress the Chinese tend to keep their currency stable. Nevertheless I expect continued slow appreciation of 3-5% annually.

**Stocks:** I previously lowered the bottom of my S&P and am not lowering it further at this time. However, I have lowered the top of my range. I think the slowdown in the U.S. economy coupled with concern that the U.S. is not solving its debt problem or promoting investment enough will facilitate further profit growth. Relative to my previous monthly I think there is more risk to the downside. We have already hit the top of my second quarter range and I think the S&P will remain below the 1330 level for the rest of June.

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