



Economic and Market Update – July, 2011

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Summary

I expect second quarter growth, to be reported on Friday, July 29, to come in near 2.5%, in the middle of my previously forecast 2-3%. While this would be greater than the 1.9% growth reported in the first quarter, it is less than I and others expected just 6 months ago. Many forecasters regard the weaker-than-expected growth in the first half as a temporary soft patch. They cite bad weather and the Japanese earthquake and the spike in gas and food prices as factors that are going away in the second half and look for growth to pick up in the second half. The most recent June data is mixed. Production is growing, but few jobs are being created. I remain less optimistic about growth than the consensus.

The primary risk to growth could come if a deal to cut the budget deficit that front loads spending cuts and revenue increases. As the impact of monetary fiscal stimulus fades, growth will be less than would otherwise be the case. Moreover gas prices, which have receded recently, may have exhausted the downside for now as the crude oil price is rebounding. My forecast for the second half is for 2.5-3% growth. The negative impact of policy increases the growth risk for 2012. In addition, overseas growth in Europe and Asia is slowing.

The employment report was shockingly weak. With only 18,000 new payroll jobs created, the net change from the previously reported jobs, given a downward revision of 33,000 jobs in the previous two months, was a negative 15,000 jobs. Another 39,000 jobs were lost in the public sector, while only 57,000 jobs were created in the private sector. Wage pressures were non-existent. Despite continuing high gas and food prices, inflation should ease in the second half.

I have adjusted my second half forecasts for market prices a bit. I continue to expect Treasury rates to rise, but not quite as much as previously, given that a credible budget reduction plan appears to be in the works. If a credible deal is struck, the dollar should get a multi-month boost. I remain negative on the dollar longer term.

I have raised the top end of my S&P range because earnings are likely to hold up in the second half. If a budget agreement is reached, investors will likely be willing to put a higher multiple on those earnings. Nevertheless, my forecast for a 1425 high for the year remains below more optimistic forecasts that have a target of 1450-1500. If, as looks likely, Republicans agree to the elimination of some tax breaks for business, this is negative for earnings. On the other hand, if the overall corporate tax rate is lowered as part of the agreement, I will raise my target for the S&P.

Economy

Growth: I expect second quarter growth, to be reported on Friday, July 29, to come in near 2.5%, in the middle of my previously forecast 2-3%. While this would be greater than the 1.9% growth reported in the first quarter, it is less than I and others expected just 6 months ago. Weather, the Japanese earthquake, and higher gas prices mitigated whatever boost the economy got from QE2 and the year-end deal to extend the Bush tax cuts and the period for collecting unemployment benefits, to cut payroll taxes, and to give the investment tax break to corporations. Were it not for the unanticipated negative factors, growth in the first half would likely have been a percent higher.

June data on economic activity support this idea that the soft patch in the first half is ending. However, employment gains continue to be very weak and household spending will likely remain restrained. If recent hopes that Congress and the administration will reach a compromise deal to make a credible cut in future budget deficits are realized, this should have a beneficial impact on household and business confidence. At the same time, scheduling of spending cuts and revenue enhancements will have a major impact on economic activity and on my forecast for growth, especially in 2012. As a result of these opposing factors I am more cautious about second half growth than the consensus.

Near-term, the primary risk to growth stems from the risk that gasoline prices rebound and that overseas growth, especially in Europe and Asia is slowing. Although the U.S. ISM index rose to 55.7 from 53.5, away from outside of the U.S., manufacturing indicators tell a different story. There was a May rebound in Japan's indicator, from 45.7 to 51.3. But it slipped back to 50.7 in June, suggesting little growth momentum. The European index also slipped to 52 from 54.6 in June, indicating a loss in growth momentum as well. Moreover, the ECB hiked rates 25 basis points on Thursday, July 7. With China still raising rates, world growth momentum appears to be slowing despite the statements of the new IMF director Christine Lagarde and Fed chairman Bernanke that growth momentum will pick up in the second half. The weaker dollar will help U.S. competitiveness and positively impact the trade deficit, but world demand for U.S. products could be dampened if the slowdown abroad offset the positive impact of the lower dollar.

Housing activity continues to be weak. Despite the one month rise in home prices in May, it will continue to take many months to work off excess inventory in housing, resulting from the overbuilding in the years following 2000. The impact of distressed housing owners that continue to have trouble meeting their mortgage commitments adds to the problem. Nevertheless housing activity may be bottoming, and should be a neutral to slightly positive in the second half.

Manufacturing is doing well in the U.S. and should continue to do so. As indicated above, the June ISM index rose to two points to 55.7. The lower dollar and good productivity gains are helping. But the sector is much smaller than the service sector where the non-manufacturing index eased to 53.3 from 54.6. In addition, some of the strength in manufacturing is due to the interruption of supply from Japan, especially in the auto sector. It remains to be seen if the domestic-produced autos can continue to grow in the second half. South Korean auto companies, Hyundai and Kia, are taking share from other companies.

On balance, I expect second half growth will be a bit stronger than growth in the first half, but not quite as high as the 3-4% forecast by those looking for a robust rebound from the first half. Specifically, I look for growth to be 2.5-3% in both the third and fourth quarter.

Longer term, the impact of a less accommodative monetary policy and fiscal consolidation will mitigate growth. Measures to ease the U.S. budget deficit will help build consumer and business confidence, but curb demand coming from the public sector. Jobs will continue to be lost at the state and local level as much of the Federal aid to these government entities ends. And unless corporate tax rates are lowered, earnings will be negatively impacted if corporate tax loopholes are reduced as part of a budget agreement. Curbs in entitlement growth and outright cuts in government spending will negatively impact jobs and demand.

The tax and spending package to reduce the deficit that the Clinton administration and the Republican Congress agreed to in 1995 resulted in both healthy growth and a budget surplus. However, the current situation is much different. In particular, the Fed was able to counter the impact of the agreement by a more accommodative monetary policy.

Table 1: Economic Forecast 2011

	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	2.5%	2.5-3.0%	2.5-3.0%
Unemployment (%)	8.6-9.1%	8.6-9.0%	8.5-8.9%
Inflation (qtrly %)	3.6%	3.0%	2.5%
Core Inflation (%)	2.1%	2.2%	2.4%
Fed Funds	0-0.25%	0-0.25%	0.25-0.50%

Employment and Inflation: The employment report was shockingly weak. With only 18,000 new payroll jobs created, the net change from the previously reported jobs, given a downward revision of 33,000 jobs in the previous two months, was a negative 15,000 jobs. Another 39,000 jobs were lost in the public sector, while only 57,000 jobs were created in the private sector. Wage pressures were non-existent.

Recent job gains in manufacturing are a positive but the small fraction that manufacturing represents of overall GDP suggests that the positive impact has to be put in perspective. There is also a skill matching problem. A number of companies have reported that, despite high unemployment, they cannot find the skilled workers they need. Continued outsourcing and continuing investment in labor-enhancing technology will limit job gains in the manufacturing sector. The latter two factors also limit employment growth in the service sector.

Inflation pressures will likely ease somewhat in the second half. Even if gas prices rise, they are not likely to rise as quickly as in the first half. Food prices are also not likely to rise as quickly as the supply response to higher prices will likely lead to greater supplies of staples, despite the flooding problems that delayed planting in some areas. Finally, the continuing high unemployment rate will keep a lid on wages, leading to difficulty for businesses to pass along input cost increases as household income is growing very slowly. My forecast for headline inflation in the second half remains at 2.5-3% and I expect core inflation to remain in the 2-2.4% range. Admittedly, I underestimated inflation in the first half of 2011 as non-core gas and food prices rose far more than I forecast.

Europe, the Euro and Sovereign Debt: Once again the euro-zone countries were able to finesse the Greek sovereign debt situation, delaying the day of reckoning. Despite passing legislation that implements still more fiscal austerity and authorizes the sale of public assets, the debt situation will still, in my opinion, result in private debt-holders having to take a haircut. The ultimate solution may involve some grants to Greece from other countries and the rolling over of debt at unfavorable terms to both private and public holders of Greek debt.

One of the problems facing Greece is that austerity has a negative impact on Greek GDP and previous measures have resulted in lower tax collections. As has happened in the U.K. and could happen in the U.S. if debt reduction attempts are too front-loaded, growth slows and economies could go into or stay in, (as is the case of Greece), recession.

One benefit of the Greek bailout, even if temporary, is that it gives European banks, big holders of sovereign debt, the opportunity to shore up their balance sheets. It also gives other countries with debt problems such as Ireland, Portugal, Spain, and, to some extent, Italy, time to get their fiscal situations in better order. This would contain the contagion effect once Greek debt-holders take a haircut. Moody's 4 notch downgrade of Portugal debt once the Greek situation was finessed indicates the potential for contagion.

Monetary and Fiscal Policy: QE2 has ended and the politics both inside and outside the Fed will make it difficult for Chairman Bernanke to pursue further balance sheet growth to "push" monetary fuel into the system. Further, if growth and employment are as forecast, it is unlikely that the Fed will feel the need to hike their balance sheet further. The only chance I see of a QEIII being implemented before next year is if the July 29th release of second quarter GDP comes in under 2%. And even then, implementation will depend on how front-loaded any fiscal agreement is.

Last month I indicated that, while I expected a budget agreement in time to hike the debt ceiling before the "drop-dead" deadline, I was increasingly pessimistic about the scope and credibility of the agreement. It appeared, then, that both tax revenue hikes and entitlement programs would not be part of the agreement. I also cited that prospects were for an agreement could be as low as \$2 trillion, less that the amount I consider credible.

It now appears that Congressional leaders and the administration are talking seriously behind semi-closed doors about a \$4-5 trillion 10-year debt reduction agreement that would include "revenue enhancements (read corporate subsidy cuts)" and curbs in medical costs and the growth

in Medicare and Social Security benefits. These possibilities are very dangerous politically. However, recent statements by key Republican leaders and officials the Obama administration, including Obama himself, suggest they understand that delaying decisions on these “third-rail” issues to beyond the 2012 election might result in another financial crisis that could lead to recession and further tax revenue losses.

Although I am more optimistic about the fiscal situation, there is a very real danger that, during the tough bargaining, negotiations will break down. The Demographic left, led by Nancy Pelosi, is still unwilling to consider entitlement programs as part of the negotiation and those representing Tea Party advocates are demanding spending cuts that are either unrealistic or would be detrimental to the economy. And the need for revenue enhancements may require more than can be agreed-upon by the negotiators. Clearly lobbies will be geared up to resist the elimination of subsidies that affect their constituents. Thus my optimism is tempered by the realization that interest rate, currency and equity markets may be volatile as prospects for the agreement ebb and flow in the days leading up to the date (sometime in August) by which the debt ceiling needs to be raised.

Other than getting a credible agreement, my other concern is the scheduling of deficit reduction. Just as the components of the health care plan were phased in, I expect spending cuts and revenue increases to be gradually phased in. In addition, once an agreement is reached, politicians of all stripes will distance themselves from the agreement and position for the November, 2012 presidential and Congressional election. Investors and business leaders will take a hard look at the agreement to see how it affects their investments and earnings. And economists will immediately revise their forecasts to reflect demand shifts and declines.

Many observers, including myself, would like to see more spending in the near term in areas that would improve U.S. competitiveness. It will be very difficult for Congress to devise a deficit reduction plan that increases spending in some areas near term while curtailing spending and raising revenue over the longer run. To the extent that the agreement negatively impacts current growth, tax revenues will be impacted and could negate a portion of the revenue enhancements. Such has been the experience in Greece and the U.K.

Markets

Interest Rates: My interest rate views remain the same as in the past few months. The 10-year note has likely seen its low and will trend up slowly in the second half. However, I have lowered the top of my range to 3.85% for the 10-year note from 4% given that I think that Congress and the Administration will do just enough to maintain the U.S. Treasury as the world “riskless” standard. At the same time I think that continuing European debt problems and mediocre investment opportunities at home and abroad will keep Treasuries well bid.

My long-standing forecast that the fed funds rate will begin to creep up in the fourth quarter looks less likely. Thus, I think the movement in Treasuries will be a bit more muted than I previously thought.

Currencies: My views on the dollar also remain the same as in my June report. My caution on the dollar has been reinforced by the weakness of dollar/yen, which has remained in the upper

end of my 80-84. Dollar/yen briefly broke the 80 level but came nowhere near the 78 level that represents the bottom of my range. Meanwhile, on the back of an interim European agreement to continue supporting Greece, the euro is at the upper end of my third quarter range.

Table 2: Market Forecast Ranges 2011

	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	3.10-3.50%	3.35-3.85%
Dollar Index (futures)	72-78	76-80
Euro (in U.S\$)	1.28-1.44	1.30-1.48
Dollar/Yen	78-84	80-85
Canadian (in U.S.\$)	99-1.04	1.01-1.06
S&P	1280-1400	1300-1425

I continue to think that the dollar will rally once a deficit agreement is reached and the debt ceiling is raised. At the same time, I think the dollar has further to fall longer term as the U.S. continues to deal with the limits of domestic policies to reduce job losses. Over the next few years, I think the U.S. must eliminate its trade deficit in order to keep its external debt from appreciating to the point that it will be overly onerous to support the servicing of this debt. In my opinion, the continued rise in the U.S. external debt has more negative implications for the U.S., economy and the standard of living than the domestic debt.

Specifically, the debt agreement that I envision will allow the dollar index to rally back to the 76 to 80 level in the second half of the year. But the prospects for problems in an election year, in which foreign observers may well observe that proposed solutions are either not realistic or have negative social and economic implications, are likely to cause investors to exit the dollar in 2012.

Given continuing problems with European debt and the risk, although I do not think it will be realized, of contagion, I think the euro will decline once a U.S. deficit agreement is reached. My first downside objective is the 1.36-1.39 area that I think will be achieved in August, with a further decline to retest the 1.28 level before the euro stabilizes. If dollar/yen does not fall below the 80 level in July, I think that prospects for a U.S. deficit agreement will allow it to retest the high end of my 78-84 range by the end of the third quarter. To date the Japanese recovery has been lackluster and that lessens the risk of dollar/yen moving to the bottom of my range.

The recent Canadian dollar rally to near the top of my 99-104 third quarter range lessens the chance that the Canadian dollar will break the buck. However, I am not ready to raise my range because I think continued Chinese monetary policy and the fact that I am less optimistic about world growth than the consensus will keep a lid on a further rise in the Canadian dollar.

Moreover the Canadian government does not want to see further appreciation of the C-dollar as manufacturing in Canada is in an intermediate-term competitive decline. Housing and housing prices in Canada continue to be vibrant and the rise in the Canadian dollar probably contributes to this given the foreign interest in Canada.

Finally, the Chinese currency continues on a relentless, very slow appreciation path. It has not met my expectation for a more rapid appreciation that I thought would be a part of the Chinese policy effort to slow down inflation in China.

Stocks: I am not as bullish as many forecasters who look for the S&P to move up to the 1450-1500 level based on better second-half growth and continuing upward earnings momentum. I agree that earnings will hold up well, but see continuing economic and debt problems (not with corporations, though) as limiting the price that investors will put on those earnings. I have, however, raised and widened my range for the S&P based on my agreement that earnings will hold up well despite my caution on economic growth.

Specifically, I think that, once a budget agreement is in sight, the S&P could rise as high as 1400 as the previous high near 1370 is breached. The near-term risk that budget negotiations temporarily break down could send the S&P down to retest the 1280 support area, or even move temporarily below that level, remains. Thus, I have widened the range. Because of my forecast that growth will not meet expectations, I think that, once investors react to a budget agreement, the S&P will have yet another moderate correction that could send it as low as 1300 or a bit below. But assuming that prospects for foreign earnings of U.S. companies continue to hold up well in 2012, the S&P will likely continue its upward move near year end. Thus, I have an upper bound of 1425 near year end.

Relative to earnings and historically low interest rates, the PE ratio is not high. Nor do I think it will be for some time to come. My reason is that I continue to be pessimistic about the U.S. ability to adopt policies that appropriately reduce the budget deficit while favoring investment over consumption. This is why my equity forecast is not as optimistic as many others with whose earnings forecast I agree. If a corporate tax rate cut is adopted to offset the elimination of corporate subsidies, I will raise my S&P target.

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