



Economic and Market Update – August 8, 2011 (Abbreviated Report)

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Second quarter growth came in at 1.3%, considerably lower than my 2.5% forecast and, more importantly, below the 1.9% consensus. Very sluggish consumer spending and a further sharp fall in government spending at the state and local level were the main culprits. Even more troubling was the sharp (almost unprecedented) downward revision of first quarter GDP to 0.4% from 1.9%. Moreover benchmark revisions for the past two years indicated the depth of the recession was worse than expected.

I am lowering my second half growth forecast to 0-1.5% from 2.5-3% in the third quarter and 1-2.5% in the fourth quarter. The recent fall in consumer confidence confirms, in part, the negative impact of the recent political crisis. And despite the prospect for improved Japanese growth as the negative impact of the earthquake is reversed, the deficit cutting in the U.S. plus the inability of Congress to come up with a robust plan that balances the need to reinforce the recovery with the need to aggressively reduce the budget deficit will continue to mitigate potential growth. State and local governments will also continue to reduce spending.

On balance, I see little in the way of policy, either monetary or fiscal, that will offset the slowdown. Moreover, the speed of the stock market correction and the continuing debt “crisis” in Europe will likely erode business and consumer confidence more than otherwise would have been the case. Thus, while I am not forecasting recession, I don’t see the ingredients for a growth pickup that will create jobs and boost profits further. The “new normal” continues, probably well into 2012.

Although the 117,000 increase in employment (168,000 including the upward revisions of 51,000 in the previous two months) was a relief to the markets following the Thursday, April 4th drop in the S&P, the detail on the report suggests weakness in employment in coming months. The seasonal adjustment called for over a million drop in teachers (meaning that over a million jobs were added to adjust for the seasonal drop). In a normal situation, these teachers would be rehired in late summer. In this case, some of the decline will not be recovered as layoffs are occurring to repair state and local balance sheets. Unless another stimulus program is passed to save these jobs, public sector jobs will continue to drop disproportionately in coming months.

The budget agreement, providing about \$2.5 trillion in savings over a decade is less than the \$4+ trillion that I expected in last month's report, but a bit better than the \$2 trillion that represented my more pessimistic risk forecast. A problem with the agreement is that much of the cut is front loaded and, therefore, comes at a time when the economy still needs to be stimulated. A lot of the uncertainty remains since all but \$917 billion of the cuts are still to be determined. Add to that the fact that the reduction in growth indicated by recent data suggests that lower-than-forecast tax receipts will likely more than offset the budget cuts, and it may be the case that CBO will increase, not decrease the forecast deficits over the next decade. Meanwhile, despite the disappointing growth data, monetary policy is likely to remain on hold.

Although progress was made on financing the Greek debt, the more general debt problem in Europe refuses to go away. Questions continue to rise over whether Spain and Italy, for example, are on a path to resolve their own debt problems. While Europe can rather easily finance Greek debt, it would be overly onerous, perhaps impossible, for Europe to underwrite the debt of economies the size of Spain or Italy. Meanwhile, the austerity measures being taken to curb deficits will result in very slow growth in Europe. Thus, both the dollar and euro remain under pressure. Gold and the yen appear to be the main beneficiaries of continued debt problems.

Given my downward revision of U.S. growth and the negative impact of the stock market correction on confidence, I have lowered my equity forecast significantly. My new range for the rest of the year is 1100 – 1350. Following the cathartic August 4-5 decline, I expect a moderate rally as European officials respond to the debt crisis. However, the damage that has been done is likely to have a negative economic impact. I expect the market to have a similar, but more muted response to the current crisis as happened in the fall of 2008 and first quarter of 2009. Then the S&P rallied into yearend following the credit crisis, but then fell to new lows as the economic deterioration was “built” into market prices. A similar reaction would result in an S&P that rallies to the 1250-1260 area into, say, mid August and then falls back to the 1100-1150 range into October.

With some progress having been made on reducing future deficits and growth below forecasts, Treasury rates will likely stay lower than I (and most other forecasters) had predicted. I have lowered my 10-year note range for the remainder of the year to 2.25-3.50%.

Following are my forecast tables. Table 1 indicates the economic variables and Table II the market ranges. The accompanying graph indicates the path of Federal Receipts Current Expenditures (Red) and tax collections (Blue). Read it and weep!

Table 1: Economic Forecast 2011

	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	1.3%	0.0-1.5%	1.0-2.5%
Unemployment (%)	8.6-9.1%	8.9-9.4%	9.0-9.5%
Inflation (qtrly %)	3.6%	2.4%	1.8%
Core Inflation (%)	2.1%	2.2%	2.0%
Fed Funds	0-0.25%	0-0.25%	0-0.25%

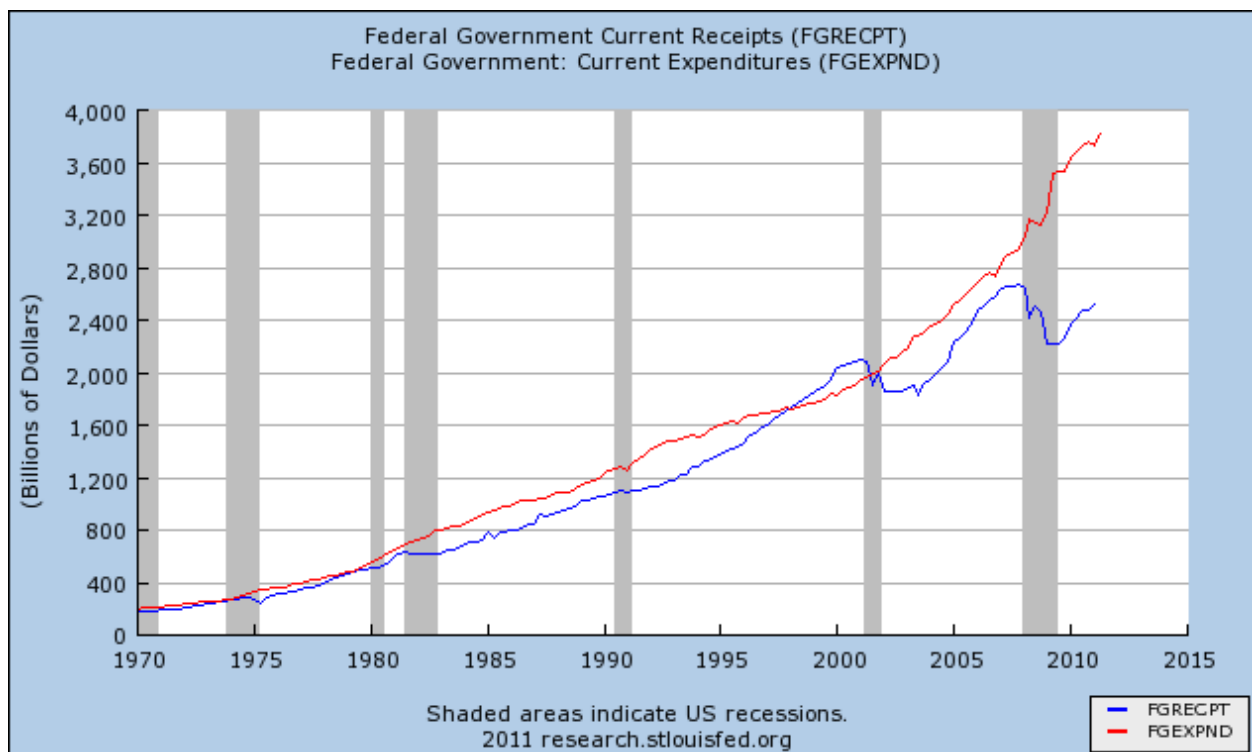


Table 2: Market Forecast Ranges 2011

	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	2.25-3.10%	3.00-3.50%
Dollar Index (futures)	72-77	74-78
Euro (in U.S\$)	1.28-1.44	1.30-1.45
Dollar/Yen	76-82	76-84
Canadian (in U.S.\$)	1.02-1.05	1.03-1.06
S&P	1125-1320	1200-1350

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