



Economic and Market Update – October 10, 2011

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Summary: I expect the economy grew 1.5-2.0% in the third quarter. The number will be released on Thursday, October 27. The relatively strong September employment report bodes well for some growth in the fourth quarter but forward looking indicators suggest layoffs this quarter will limit momentum. My fourth quarter growth forecast is 1-2%. The tables at the end of the report indicate my new forecast for the first half of 2012.

The economic and market forecasts are based on a monetary and fiscal policy mix outlined below. Longer-term structural problems will continue to limit both growth and equity appreciation in the coming year. Europe remains a particular problem although the recent move to acknowledge the need to recapitalize the banking system is a positive step.

As the market section suggests, I see range trading for currencies and equities over the next month and I think the yearly highs and lows for the S&P will not be breached. In particular, my range for the S&P for the next 4-6 weeks is 1050-1080 on the downside and 1200-1240 on the upside.

Economy: Third quarter growth was likely between 1.5-2%. While this is better than many of the earlier pessimistic reports forecasting a recession, I think that some of the growth resulted from the temporary inability to satisfy demand in the first half. In particular, the first quarter and early part of the second quarter were held back by weather-related problems while second quarter growth was dampened by the negative impact on supplies of the Japanese earthquake.

Despite the pickup in growth from a first quarter low of 0.4% to the third quarter estimate of 1.5-2%, longer-term persistent problems including debt problems in Europe, continuing deleveraging of U.S. households, and the move to reign in deficits at the state and local level will prevent the economy from gaining much traction. My forecast for fourth quarter growth is 1-2%, boosted by some residual rebound from first-half disruptions but held back by the longer-term problems cited above.

My growth forecast of 1-2% for the first half of 2012 (see Table 1) is based on the mix of monetary and fiscal policy discussed below. I note two risk cases based on an assumption that some fiscal progress will be made on reducing the drag from expiring stimulus and in further

cutting the long term deficit. Housing should begin to add to growth in the next 4 quarters but household income gains will remain sub-standard relative to other post WW2 recoveries. Fiscal policy at all government levels will make a neutral to negative contribution, business investment will continue to contribute but will not increase in momentum, and net trade will be a small contributor. As discussed below, the main negative coming from external sources will be the ongoing debt problems in Europe.

Despite the much-stronger-than-expected September employment report (in addition to 117,000 increase in payrolls, 97,000 jobs were also added in the previous two months' numbers and the workweek increased), job growth prospects remain weak. A forward looking indicator, the Challenger report indicated 110,000 layoffs announcements in September, far and away the highest in over a year. Earnings growth is not keeping up with inflation and, along with the loss in housing equity, this will hold back the real growth in consumer spending.

The recent correction in commodity prices coupled with slow wage growth will continue to keep a lid on inflation. The 3-4% headline rise in CPI that is occurring in 2011 should, absent a supply-side shock, give way to a gradual decline back to the 2% area beginning in the current quarter.

Europe: In my opinion, the most likely scenario in Europe is that the degree of sovereign default will increase and individual countries in Europe will instead concentrate on shoring up capital in their own private banking systems. This both recognizes the scope of the sovereign debt problem and allows the populations in each country to move away from the notion that they are supporting the excesses of other countries.

If I am correct, the implication of a strategy to "tolerate" effective default will be negative for bank stocks because it puts more of the burden on the private sector. Thus if the degree of non-payment of sovereign debt in Greece is, say 40% rather than the approximately 20% that was previously agreed, the implications for bank losses is considerable. And if a formula is adopted for less than full payment of other sovereign debt, say in Italy, the losses will mount.

The ECB and finance ministers will likely continue to provide support for Greece and other countries' sovereign debt for some time to come in an attempt to avoid too much contagion. This will involve providing bridge loans for some countries as they rationalize their fiscal policies. But the bulk of the subsidies will go to private banks in order to maintain the banking system and the capital needed in the system. As was the case with, for example, Citibank during the TARP program, the individual countries will likely impose a cost on the banks that need help. This cost will likely come in the form of equity dilution rather than nationalization (equity elimination).

I think the above solution is workable and a major step forward in both realizing the inevitable in terms of what has to be done, but also in placing more of the pain on the banks and other investors that took the risks. And although the U.S. banks and other financial entities in the U.S. and elsewhere have less exposure, it is more negative for them than would be the case if European taxpayers attempted to shoulder the entire burden of the debt.

U.S. Policy: Moderate growth in the second half of 2011 and the predisposition of many within and outside the Fed to resist further monetary accommodation will stay the Fed Chairman's

hand. Operation Twist is having a moderately positive impact on holding down longer-term treasury rates, but it is unlikely that this will be accompanied by a further fed-funds reduction or increase in the Fed's balance sheet. In recent testimony and speeches, the Fed Chairman urged Congress to deal with the structural problems facing the U.S. economy by enacting fiscal policy solutions on a timely basis.

The fiscal outlook remains cloudy. My forecasts regarding both the economy and markets are based on the assumption of what I think they will do, outlined below. I have also indicated two other possibilities and their implications.

- What they should do: In my opinion, Congress should agree to provide more stimulus in the near term, targeted to infrastructure and easing the negative job prospects for key service and education personnel at the state and local level. At the same time they should make a more meaningful cut in the longer term deficit along the lines of the Simpson-Bowles commission, accompanied by corporate tax reform. This would involve substantial cuts in future entitlement costs and revenue raising targeted at closing loopholes, reducing tax deductions for mortgages above a certain level, and increasing the marginal tax rate slightly on high incomes so as to balance the "pain-sharing" at all levels of income. The deficit cut if this set of alternatives is passed would be in excess of 4 trillion over the next decade.
- What they will do: My best guess is that Congress and the administration will compromise by extending tax cuts and benefits that would otherwise expire, thus neutralizing the negative fiscal impact in coming quarters of stimulus withdrawal. They may provide some additional infrastructure spending that is part of the President's jobs proposal. They will also make some cuts in the longer-term deficit to avoid the automatic cuts in defense and other programs that would take place if no further cuts are made. Major entitlement and tax reforms will be put off.
- What I hope they will not do: Kick the can entirely down the road.

Legislation that comes closer to what I think should be done would likely increase growth next year by as much as a half a percent and would give a sizeable boost to stock prices. If they do nothing the chances of a recession in the first half increase and the PE ratio on stocks would be negatively affected.

Markets: Following is summary discussion of my market interest rate, currency and U.S. equity forecasts.

- Interest rates: Operation twist already appears to have had some impact in flattening the yield curve. Some observers have said that the fact that the yield curve is not inverted indicates that there will be no recession. But since nominal rates are already near zero at the short end it is unlikely that the yield curve could give us a traditional recession signal. And with inflation above the Treasury rates and real rates in mortgages and corporate flat to negative, the accommodative stance will help avoid recession. Despite the recent moderate rise in rates in early October, it appears likely that both Treasury and private rates will remain in their current range.

- Currencies: I am not ready to make a currency forecast for the euro in the first half of 2012. But it seems likely that, if my assessment of how eurozone countries deal with their debt problems materializes, the euro is likely to remain in a range of 1.28-1.32 on the downside and 1.40-1.42 on the upside. The euro is supported by progress in solving the debt problem but held back by the fact that, near term, private debt purchases will be sluggish due to continued uncertainty over the pricing of private and sovereign debt. What is needed is to issue “new” debt that is “guaranteed” by the entire eurozone and this will take a long time to implement since effective coordination of fiscal policies among eurozone countries needs to be assured before this can happen.

Near term, the dollar will likely retain its value until the ingredients for faster world growth are in place. Thus I have raised my forecast range for the dollar index, admittedly belatedly. Longer term, I continue to think the value of the dollar will still erode and that the currencies of the BRIC countries, Japan and other Asian currencies will strengthen.

- Stocks: I think the recent inter-day low for the S&P (near 1070) will be a benchmark for the low in the current stock market decline. Near-term stocks could try to extend the early October rally as earnings season unfolds and despite the macro-economic problems. At the same time, I expect stocks to be weighed down by continuing European debt problems despite progress in decisions on how to distribute the costs between countries and between the private and public sectors. As indicated in the section on Europe, prices of equities in the financial sector will continue to be weighed down by potential dilution in European banks and write down of debt in other financial institutions, including those on the U.S. with some Greek and, perhaps, Italian debt.

Specifically, my forecast for the S&P for the next 4-6 weeks is 1050-1080 on the downside and 1200-1240 on the upside. Although earnings will remain solid, European problems and uncertainty over whether a meaningful fiscal compromise can be reached in the fourth quarter will result in continuing bouts of weakness. Moreover, despite the better-than-expected growth in the third quarter, guidance will likely be quite cautious as world growth continues to slow. If, however, China reverses its “braking” policy and a credible agreement is reached for solving European debt problems and reviving world growth can be reached at the early November meeting of finance ministers and central bank heads in Cannes, stocks could begin a year-end rally that exceeds my upper boundary later in the quarter.

Table 1: Economic Forecast second half 2011 – First Half 2012

	3 nd qtr.	4 rd qtr.	1 st qtr.	2 nd qtr.
Growth (%)	1.5-2%	1-2%	1-2%*	1-2%*
Unemployment (%)	9.1%	9.1-9.3%	9.1-9.3%	9.0-9.3%
Inflation (qtrly %)	3.6%	3.2%	2.8%	2.5%
Core Inflation (%)	2.5%	2.4%	2.2%	2.0%
Fed Funds	0-0.25%	0-0.25%	0-0.25%	0-0.25%

*Growth in the first half of 2012 depends on the degree of bipartisan cooperation to both stimulate the economy near term and reduce the deficit longer term (see text).

Table 2: Market Forecast Ranges 2011- First Half 2012

	4 th qtr.	1 st qtr.	2 nd qtr.
10 yr. Treasury Rate (%)	1.75-2.25%	2.00-2.40%	2.20-2.60%
Dollar Index (futures)	74-82	72 -80	72-82
Euro (in U.S\$)	1.30-1.44	*	*
Dollar/Yen	76-80	75-81	75-80
Canadian (in U.S.\$)	0.95-1.00	0.98 -1.04	1.00-1.06
S&P	1080-1250	1220-1350	1250-1400

* I am not ready to forecast the Euro. My forecast will depend on the method by which the Greek default and its consequences develop.

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