



Economic and Market Update – September 6, 2011

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Summary: Second quarter growth was revised down to 1% from 1.3%. The stock market volatility and decent will exacerbate an already shaky consumer and erode investor, business and consumer confidence. Even if we do not have a recession, it is already feeling like one. I revised my growth forecast down significantly last month so I am not revising it further. But the recession risk continues to rise. Despite my cautious outlook, below, regarding fiscal and monetary policy, the situation is critical enough that I think a coordinated multi-country “rescue” policy may be adopted at the G20-IMF meetings in Washington on September 23-25. In particular look for an end and possible reversal of the Chinese tightening policy

Last month, I suggested that even though the employment report is very important, coming early in the month, employment is a lagging indicator. Thus, I regarded last month’s increase in jobs as being overshadowed by more forward-looking indicators. The zero increase in August payrolls confirms this notion. And in the current circumstances, hiring is likely to come to a halt for several months.

Is policy coming to the rescue? It will take a coordinated mix of fiscal and monetary policy to foster a return to more vibrant growth. And the Fed does not have a lot of options. In his Jackson Hole speech, Chairman Bernanke implied that fiscal and regulatory developments will have to bear the principle responsibility for putting the economy on a better long term track. Within and outside the Fed, there is “push back” on further monetary accommodation, although Bernanke has indicated several further measures that could be taken, if needed. It seems clear from Bernanke’s remarks at Jackson Hole (excerpted in the monetary policy section) that politics is trumping the sound implementation of economic policy as regards the future.

Despite the failure of politicians to make necessary fiscal adjustments, I think there is the potential for a positive fiscal response if done between now and the end of the year. The very negative voter and market response to the early August budget agreement may well “soften” positions for the extremes. My oft-repeated position is that, to offset the negatives, the Federal government needs to spend more on investment in the short run while dramatically tamping down the growth in spending over the next decade. And, in my opinion, there is no good alternative to raising revenue and implementing tax reforms that incentivize investment and businesses while curbing relative consumption growth.

Europe remains a huge obstacle to world economic growth. The EU desperately needs to harmonize fiscal policies to preserve the euro and this will take a long time. Moreover the task of reducing debt to manageable proportions without unduly impacting growth will take years, not months. A credible solution and prospects for it being implemented are needed in the short run. Meanwhile, given the problems in the U.S., the euro is likely to remain higher than otherwise would be the case.

I remain positive on Asian currencies although the Chinese yuan and the Japanese yen will continue to be “managed”. Appreciation of the yuan, which has been rising at a 3% rate the past year, may rise a bit faster, say, at a 5% rate. The yen continues to seek all-time new highs. In my opinion, Japanese monetary officials, with the help of their U.S. and European counterparts will not stop the rise in the yen, but will smooth and slow its tendency to rise. Meanwhile, prospects for slowing world economic growth, the rising probability that the U.S. will fall back into recession, and prospects for the fed extending its asset duration will keep interest rates lower than I previously forecast.

Finally, I remain cautious on the S&P. I think the S&P will retest the 1080-1120 level in September and then, if it appears that a more beneficial fiscal policy will be adopted, will rally back to the 1300-1350 level by year-end. If the G20-IMF meeting fails to adopt a stimulative position, I think the S&P will drift lower toward the 1000 level. I have also adjusted my interest rate and currency forecasts. Treasury rates are likely to stay lower for longer than I previously thought. If the U.S. adopts a more favorable fiscal policy in the fourth quarter, the dollar will likely rally. But given the continued rapid rise in the U.S. external debt, I remain negative on the dollar longer term.

The Economy

Growth: The downward revision to 1% from 1.3% in second quarter growth contained a bit of good news. The downward adjustment resulted in part from a lower accumulation of inventories (partly from the shortage of autos), which will buffer businesses from having to reduce production in the face of sluggish consumer spending. But that is the only good news. The trade component of the deficit remains problematic as the slowdown in the world economy will slow and possibly even reverse the growth in exports.

I look for fourth quarter growth to be close to flat, between 0 and 1.5%. I do not rule out a slightly negative quarter. Housing is faring less well than I earlier expected. Export growth is on hold and state and local governments continue to slash budget deficits and make job cuts. Consumer confidence indicates a possible recession although demand has held up better than the confidence numbers suggest. Investment remains a positive and the quality of business balance sheets, the exception being banks, is high.

I will issue a tentative first report on 2012 growth in my next monthly and following the September 23-25th G20-IMF meetings. If these meetings fail to adopt policies to counter the slowdown in world growth, it may take a “market-inducing” further pullback to indicate the need to act. By this I mean an undercutting of the recent stock market lows and the unfolding of a more substantial bear market. My forecast will also be contingent on the U.S. making

meaningful progress in adopting a fiscal policy that is more stimulative and business friendly in the short run, but curbs deficits in the long run. The outcome of the fall negotiations between the administration and Congress will not be known until late in the fourth quarter.

Employment: The August employment report was as ugly as the July report was encouraging. Not only was there zero growth in jobs, but last month's gains were revised down to 85,000 from 117,000 and the June job gain was revised down to just 20,000 from 46,000. Thus the net jobs from last month's reported number actually fell by 58,000. Hourly earnings declined by a tenth after last month's revised 0.5% gain. The average weekly hours worked declined a tenth. These numbers are consistent with no growth, especially since productivity has been lagging lately.

Private payrolls increased by a weak 17,000 although the increase would have been 62,000 if the 45,000 striking Verizon workers had not been subtracted. These workers are not back on the job and will contribute to next month's private sector jobs. On the other hand, government jobs declined by 17,000 but would have declined by 37,000 if the 20,000 furloughed Minnesota public workers had not been added as they got back on the job.

Looking forward, it is difficult to see jobs growing much for the balance of the year. Thus, even though the unemployment rate held at 9.1%, I see it rising a tenth or two in next month's report.

Table 1: Economic Forecast 2011

	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	1.0%	0.0-1.5%	1.0-2.5%
Unemployment (%)	8.6-9.1%	9.1-9.3%	9.2-9.5%
Inflation (qtrly %)	3.6%	3.0%	2.0%
Core Inflation (%)	2.1%	2.3%	2.0%
Fed Funds	0-0.25%	0-0.25%	0-0.25%

Coordinating Monetary and Fiscal Policy: Chairman Bernanke “came out swinging” as regards the appropriate policies for dealing with the cyclical and structural problems facing the U.S. economy. Rather than being timid, following the ill-conceived remarks of Texas governor, Perry regarding the Fed, Bernanke indicated that it is the failure of fiscal policy that needs to be addressed. Specifically, he said “... perhaps most challenging, the country would be well served by a better process for making fiscal decisions. The negotiations that took place over the summer disrupted financial markets and probably the economy as well, and similar events in the future could, over time, seriously jeopardize the willingness of investors around the world to hold U.S. financial assets or to make direct investments in job-creating U.S. businesses.”

Fed chiefs are usually cautious about commenting on the deficit and Bernanke's message did not take sides with Republican, Democrat or administration views. Rather, he pointed out the critical

importance of fiscal policy and admonished politicians for exacerbating the problem with hostile, entrenched attitudes. Although he stands ready to take additional measures, he notes that monetary policy has limited ability to positively affect the economy without negative unintended consequences. Moreover, although there is a strong contingent on the FOMC committee that is ready to take additional actions, there is also a vocal minority against additional monetary stimulus.

Despite my endorsement of QE2 and belief that more monetary action may be needed, I agree with the Chairman that it is not the preferred way of countering the “new normal” effect of the financial crisis (that is now 3 years old). I disagree with the Chairman’s and, more recently, Chicago Fed president Evans, who maintain that the commodity price rise is not affected by the policy. The way quantitative easing is supposed to work is to increase asset prices and, therefore, spending as households and businesses feel better off. I agree that the underlying cause of commodity price rises is the secular emergence of Asian and other developing economies demand for more resources to support growth. But there is also accumulation of commodities as an asset class as well as equities. In my opinion the Fed loses credibility by denying this unintended consequence.

The recent stock market rally following the Chairman’s speech is likely in part the result of investor and speculator expectation that the Fed will, in the light of the weakening economy, adopt future measures to support asset prices. My view is that Chairman Bernanke will operate behind the scenes to strike a deal with the administration and key Congressional leaders to adopt more accommodative policies in a coordinated way with additional budget progress. If I am correct, this will take time and an accommodation policy will not come as soon as many investors expect. Rather it may be contingent of budget progress.

In my opinion, a credible agreement would include the following elements:

- Tax reform to reduce uncertainty in tax policy along the lines that Republican presidential candidate Huntsman suggests, i.e. eliminating tax loopholes for business but lowering the tax rate.
- Agreement to temporarily lower tax rates on funds repatriated from overseas. The argument against doing this has been that the money was not used to create jobs in a previous such arrangement. I would point out, however, that if the companies use the money to invest or increase dividends it stimulates demand from both businesses and households.
- Additional measures to support household income and create jobs including an extension of the payroll tax cut that Obama is proposing.
- More spending on infrastructure, which would not only enhance productivity and competitiveness, but would create jobs quickly. And to those who argue against any further government spending, I point out that the jobs created are mostly in the private sector that gets contracted to do the work.
- More stringent curbs in the growth in entitlement programs that are considerably bolder than the ones adopted in the recent August 2nd budget agreement.

Although I am hopeful that a new, more rational budget agreement will be made, the probability of success is, at best, 75%-25%. The reason I give it that much chance is that members Congress

got an earful from when they went home for the summer break. The negatives are still that a number of candidates are stumping purely on the notion of inciting a vote against Obama and a lot of their arguments do not make good economic sense.

The Bowles-Simpson report offers a template for what can be done and may come back into play as both sides realize that a major budget initiative is needed, and needed quickly. Many observers have cited that the Senators and Representatives selected for the 12-member panel to advise Congress on a budget deal are not known for their cooperative stance. My thinking is that it is these members that need to be “co-opted” in order for a deal to be “sold” to enough of the extreme members of Congress on both the left and right.

Europe: Are European leaders “fiddling” while Rome and the rest of Europe burn? Europe is facing the dual problem of debt risk and slowing growth as deficit-ridden countries tighten their fiscal belts. That is inevitable. But, as in the U.S., negotiating parties cannot seem to reach a deal that holds. Italy agrees to austerity measures, but then does not live up to them. German leaders, trying to protect their own banks, agree to help big time but the conditions are very unpopular with their voters. Finland, a model of prudence wants special conditions. And every European country, regardless of size and contribution has veto power.

Eventually, Europeans will be faced with the same “shared sacrifice” proposition that faces the U.S. In the case of Europe this means that

- Taxpayers in more fiscally responsible countries will and already are subsidizing the more heavily indebted countries,
- Austerity is negatively impacting growth in the heavily indebted countries and their citizens are at last feeling the downside of past excesses
- Private investors, including heavily involved banks in all European countries and, less so, in the U.S., and elsewhere, will take a haircut.

To date the first two results are underway and only now are the public officials beginning to shift some of the burden to the private sector.

As with the U.S., the time it is taking to understand the full extent of the problem and the delay in implementing solutions is worsening and extending the problem. Ideological fever is not as important in Europe as in the U.S. (extreme views are present in Europe, but are generally exhibited in minority parties rather than a part of the main parties as is the case with the Democratic and Republican parties in the U.S.). However, the fact that anyone of 15 members of the Euro Zone has a veto power is problematic. Still, the struggle to determine how to share the burden does seem, to me, to be more rationally discussed, if not agreed upon, than in the U.S.

The bottom line is that, as in the U.S., Europe is facing an extended period of slow growth while it unwinds its debt problem. There is no “silver bullet” in either area that will quickly eliminate the debt or joblessness. Meanwhile, however, non-bank businesses, especially huge multi-nationals in both Europe and the U.S. have good balance sheets and are better prepared for what is to come than households in Europe or the U.S.

Markets

Interest Rates: Friday's ugly employment rate and the possibility of a more accommodative Fed, will keep interest rates lower than I previously thought. In the short run, there is a greater probability that the 10-year note will fall below the bottom of my range than rise above it. Away from Treasuries, rates on the most highly-rated securities will likely fall in line with Treasuries as investors seek higher, but still very safe yields. However, the spread between "safe" securities and less highly-rated securities should widen as the fundamentals and balance sheets of riskier companies deteriorate.

Table 2: Market Forecast Ranges 2011

	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	1.90-2.25%	2.00-2.60%
Dollar Index (futures)	70-75	70 -75
Euro (in U.S\$)	1.36-1.48	1.36-1.48
Dollar/Yen	76-80	75-81
Canadian (in U.S.\$)	1.00-1.05	1.00 -1.05
S&P	1080-1250	*-1320

*I have not put in a bottom to my range in the fourth quarter for the following reason. If the G20-IMF meetings result in a coordinated effort to boost world growth led by a reversal of the Chinese tightening policy, I think the market will bottom late in the 3rd quarter and the bottom of my fourth quarter range will be, say, 1160. If the G20-IMF meeting fails to reach a policy of stimulation, the market will likely break the 1080 range and move closer to the 1000-1020 area in October before rallying.

The Dollar: Despite the political and demographic problems in Japan that led to yet another leadership change, I expect that the Japanese yen will hold up well against the dollar and will have a greater tendency to appreciate than to fall. The Japanese will continue to try to control any rise and as long as the world financial system remains in a quasi-crisis mode, other G7 members will probably work behind the scenes to keep relative values fairly stable. Thus, I see the yen as remaining in the 76-80 range. If my more optimistic scenario for a U.S. budget agreement is reached, even partially, the dollar will likely rebound some against the yen in the fourth quarter.

Recently the Chinese yuan appeared to appreciate at a faster rate than the 3% that was its central tendency. However, it may just be that the greater "allowable" daily moves will lead to a more fluctuations around a central tendency that remains at 3%. I do not have a strong opinion on whether the rate of appreciation will rise, but do feel confident that the yuan will continue to appreciate.

Ongoing debt problems in the euro zone have led many observers to forecast a lower euro against the dollar. I too have been in this camp but have recently modified my view. It now appears to me that, despite the possibility of a private sector “haircut” on Greek debt, foreign investors, especially sovereign funds will continue to diversify into the safer euro zone debt at a rate that will maintain the euro at a higher level than I previously forecast. Still, I don’t think the euro will rise much, especially in this period of uncertainty and crisis. If the euro is going to fall back below the 138 level it is likely to happen later in the year and result from a more favorable U.S. outlook if a credible stimulative but deficit reducing agreement, is reached.

The Canadian dollar remains vulnerable to the slowdown in U.S. growth and would likely fall below the buck if the U.S. goes into recession. But Canada continues to diversify its investment and trade relationships and fiscal policies remain relatively positive. Thus I am maintaining a range on the Canadian dollar of \$1.00-1.04, with the caveat that, near-term, there is more downside risk.

Stocks: In contrast to my usual practice, I have not given a lower bound to my S&P forecast this month. As indicated in the summary, I think the lower end of the range depends critically on the policy developments leading up to and agreed upon at the September 23-25th G20-IMF meetings. The most critical are:

- The outcome of final negotiations for the intermediate-term Greek bailout. This will determine whether the current terms hold and the extent to which a haircut to debt holders is accepted. While the Finnish demand for collateral as a requirement for their participation, it is probably a negotiating tactic to insure that current debt-holders take enough of a haircut to bolster the chances that those European countries taking on new debt, e.g., the Finns, as a result of the bailout are more likely to get their money back.
- Will the Chinese reverse their policy of putting the brakes on their economy and become relatively more stimulative? While this may appear to be a long-shot, they have a history, in the most recent financial crisis and in the wake of the 1998 Asian financial crisis, of acting quickly to spur the economy (note that the Chinese market bottomed in the fall of 2008 and “led” the recovery equity rally, whereas the U.S. market bottomed in early March 2009).
- Putting, at least in writing, a strongly-worded statement of agreement that the U.S. needs to do more to curb the federal budget deficit in the long-run, but needs to insure that it does not undertake measures to undercut demand in the short run. Also, a general agreement that Europe in particular, and emerging markets in general need to bolster their economies by keeping rates low and fostering imports to reduce trade imbalances. In particular will the ECB chairman signal an easing, and will Italian officials implement their fiscal austerity agreement without further backsliding.

At best, U.S. fiscal policy progress will not be done until late this year, but between now and the end of the month, there should be some evidence that the administration will commit itself to solutions that have a possibility of co-opting enough of the extreme right and left to have chance of passage. Thus, an agreement is not part of my thinking as regards the market performance over the next few weeks. Rather, economic data regarding whether or not the economy will avoid recession and the outcome of the G20-IMF meeting will dominate. With regard to the economic data, we really won’t learn much until the first estimate of third quarter GDP is

released at the end of October. Meanwhile, more forecasters are raising their probabilities of recession, although the consensus remains for slow growth.

One of my themes over the past few months and the reason why I have not embraced a more favorable forecast for stocks is that, because of looming economic and policy problems, investors would put a lower value on admittedly-solid profits than would otherwise be the case. In the past month, I adjusted this thinking a bit, suggesting that profit forecasts would begin to come down (which they have), but that hopes for some end-of-year positive developments on the fiscal front and the possibility of further Fed accommodation would be supportive in that investors would be willing to put a bit higher value on the reduced earnings.

So what are the positives and negatives on where investors will perceive value? Positives are:

- Interest rates are low and will continue to be low. The opportunity cost of buying other assets offers little competition to equities.
- PE ratios are already low. Yes, but with a caveat. Many erroneously compare PE levels with too short a time period. PE ratios throughout the late 1990's and early 2000 were far too high (35 on the S&P at the height of the market in 2000). This was the "bubble of all bubbles" resulting from an overshoot to the excellent fundamentals that developed for equities following the supply-side tax cuts, peak positives from demographics, and the peace dividend of the 1980's and 1990's. Also, while long-term debt problems loomed, the intermediate-term fiscal situation was "as good as it gets" following the bipartisan agreement between the Clinton administration and the Republican Congress in 1995. A more reasonable comparison would be a PE ratio of 15-18 in a period of normal interest rate and profit increases.

If times were "normal" and given current interest rates an appropriate PE ratio would be, say, 18-22, which would put the S&P at a much higher level, 1700 to 2100. And this is why so many of the sell side stock analysts view the market as "cheap".

Unfortunately, times are not normal and are in fact, quite poor. Profits are likely to remain healthy relative to the state of the economy, but the future is not good. The negatives are:

- Interest rates are low for the wrong reason, lack of demand.
- Lack of demand does not hurt profitability but it does hurt profits relative to their potential. We will not see a rapid return to full employment and rising household wealth or a willingness to take on debt (a recent estimate suggested that up to 40% of the growth following the Reagan tax cuts was due to the willingness of consumers to take on more debt and the easing of loan covenants and standards).
- There is a risk to corporate profits from future policy. When a famous bank-robber, Willie Sutton, was asked why he robbed banks, he replied "That's where the money is". The need to raise revenue as well as curb spending will likely lead to some form of tax reform that will, at best, be revenue-neutral to corporations and, more likely, impose a net tax on companies. Republican presidential hopeful John Huntsman is one of many proponents who would like, for example, to eliminate corporate tax loopholes in exchange for lowering the tax rate on corporations. While he is unlikely to be the Republican candidate, a compromise of his view and the Democrat's view that some revenues have to be raised is likely to be the only result that might pass Congress in time to benefit the economy before late in 2013. Moreover, the prospect of a "tea party"

Republican vs. Obama in the 2012 election is, in my opinion, a huge negative for stocks. To repeat profits are where the money is.

- Finally, regardless of policy developments, slow growth will likely persist until both the private and public balance sheets are in better shape and, perhaps more important, the road to reducing the rapid growth in consumption-driven external debt unfolds. Just as PE ratios remained extremely high for an extended period following the 2000 peak in the market, they will likely remain stubbornly low in the next two to three years.

In my opinion, the negatives will likely persist well beyond the 2012 presidential election, regardless of who is elected. There is a historical precedent for PE ratios to persist in the 7-10 range for years. While this may be overly pessimistic, I do think the ratio will remain well below the level consistent with normal times.

Following are two “policy contingent” extreme scenarios. If the Administration fails to reach any further budget agreement with Congress this year, effectively “kicking the problem out beyond the presidential election, I think that profits in 2012 will fall to, say, \$75-80 level and the PE ratio will likely be, say, 10-12, implying a central tendency for the S&P between 750-960, well below current levels. I deem the probability of this outcome and equity price level as low, say, 20%.

The positive extreme is a budget agreement that hikes public investment and private investment incentives and, at the same time, significantly lowers the growth in entitlement programs and future budget deficits (to the tune of at least \$3 billion more than what has already been agreed to). In this case 2012 S&P profits will likely hold up better and be, say, \$85-95, and the PE ratio will be closer to, say, 16-18. This would put the central tendency at 1360-1700. This is my most optimistic forecast and also has a low probability at 20%.

The most likely outcome is a budget agreement, akin to last years, that offers some stimulation and some further debt reduction but puts off the big changes needed in entitlement and tax reform off to beyond the next election. I put the probability of this outcome at 60%. The S&P range in this case would probably be somewhere in the 1000-1450 range over the next year. This is likely to be my initial range when I make my initial 2012 forecast.

Near term, I see the biggest risk to the market as the need for another sharp fall to give some of the more extreme members of Congress the incentive they need to reach a compromise agreement. A positive outcome in the G20-IMF meeting would likely be supportive for a few weeks. But if words are not followed up with credible and timely action, the market will be vulnerable in the October-November period. And current economic data could send the market down to a test of recent lows before we get a sense of what may be achieved the September 23-25th meetings.

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