



Weekly Economic and Market Comment 12-11-11

The week ahead: The European Union economic summit was a qualified success in that all 17 of the Eurozone countries and 6 of the other 10 European Union members signed on to the stability pack. There are still many pitfalls ahead (see below). The important data releases this week are:

- Tuesday, December 13: November Retail Sales will be released at 8:30am EST and are expected to be up a moderate 0.5%, the same as in October.
- Tuesday, December 13: The Fed may lower the discount rate and cite the vulnerabilities emanating from Europe. But it is unlikely to signal a further expansion of the balance sheet (QE3).
- Thursday, December 15: November PPI will be released at 8:30am EST and likely rose 0.2% following a 0.3% decline in October. This number is not likely to move markets unless it deviates at least 0.2% from the consensus.
- Thursday, December 15: November Industrial Production will be released at 9:25am EST and is likely to have risen 0.2% following the solid 0.7% October rise. Capacity Utilization remains under 80% and there are no inflation pressures coming from the manufacturing sector.
- Thursday, December 15: The December regional Philadelphia Fed Survey of general business conditions will be released at 10:00am EST. It is expected to show a small increase to 5 from 3.6 in November (0 indicates no change and 5 would be a small increase).
- Friday, December 16: November CPI will be released at 8:30am EST. Along with retail sales CPI the most important release this week because it is the broadest measure of price changes. Headline is expected to rise a moderate 0.1% leaving the year-over-year level near 3.5% but declining (there is no recorded inflation the past three months). Core inflation is expected to be up 0.1% with year-over-year up 2%; near the level currently desired by the Fed.

The Budget: After much posturing, I expect Congress to extend the payroll tax cut by year-end. It will likely come at the last minute before Congress adjourns. There should be a very limited positive impact on the markets.

Europe: The proposed stability pact to move the members of the European Union to a sustainable debt and deficit path was approved by all 17 members of the Eurozone and most of

the members of the EU not in the Eurozone. The notable exception was Great Britain, but in terms of the need to restore confidence in the euro this is inconsequential. The pact represents the first credible progress, in my opinion, for solving the Eurozone debt crisis but pitfalls remain. Negotiations of specifics will take months if not years, but the positive is that all Eurozone members have indicated a commitment to meet deficit standards that are more stringent than the existing standards that have been previously ignored.

The main pitfall remaining is whether the ECB and IMF will be willing to supplement the ESFS fund by buying enough of the Eurozone debt to hold interest rates on sovereign debt down until private market participants are willing to step in and support the market at interest rates that will not unduly strap the vulnerable countries such as Spain and Italy. Both Spain and Italy have huge refunding needs as well as the need to issue new paper in the first quarter. Watch sovereign debt rates in January to see if the stability pact is providing enough of a basis for resolution to defuse the sovereign debt crisis. I remain cautiously optimistic.

A European banking crisis has accompanied the sovereign debt crisis. Although the ECB has warned that it will not stopgap the sovereign debt crisis, the coordinated move by key central banks, including the U.S. and ECB and the reinforcing signal of the ECB's rate reduction suggest that, although banks will take a "hit", a Lehman-style bankruptcy is not in the offing. Europe will almost certainly have an extended recessionary-slow growth period in 2012, but, in my opinion, the banking crisis is being defused.

Equities: Although the European debt situation may lead to periodic downdrafts in the market, I think the progress made by the central banks and at the EU summit will allow the current equity rally to continue through year-end. Still I think the rally will be limited as attention turns to the U.S. and to corporate earnings. Already some key businesses such as DuPont and Toyota are issuing earnings warnings for the fourth quarter. I expect the main shortcomings will come from those businesses with a high concentration of foreign earnings/revenues, especially European divisions that are cyclically oriented.

My range on the S&P into yearend is 1220-1300. Some further tax-related selling could evolve into a year-end rebound for select companies who fared poorly this year but whose prospects look better for 2012. However, most companies are likely to have a cautious outlook for the first half of 2012. Thus, although I am still moderately bullish, I see the S&P upside as limited to the 2011 high in early 2012. And I do not rule out another setback in the first quarter if European financing difficulties are worse than I currently expect and if the European recession and Chinese slowdown are deeper than I expect.

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