



Economic and Market Update – November 7, 2011

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Summary: Based on the composition and third quarter growth, I have raised my forecast for fourth quarter growth to 2-3% from 1-2%. Consumer confidence remains very low but, to date, that has not impeded consumer spending as much as I would have expected. The October employment report supports the rise in my fourth quarter growth forecast.

Longer-term structural problems will continue to limit both growth and equity appreciation in the coming year. Despite progress in dealing with debt problems, European growth will be a net negative to world and U.S. growth. In particular the recent rise in Italian sovereign interest rates is ominous. More important for the U.S. will be the outcome of year-end budget negotiations.

Following a moderate rally, the dollar has returned to its downward trajectory. Based on the European agreement I have established a range for the euro in the first half of 2012. I have also raised my forecast for the Japanese yen.

My range for the S&P up in the current quarter is 1150-1320. I forecast the “central tendency” in the first half to be 1250 to 1400 with a move outside that range dependent on the outcome of fiscal policy developments later this quarter. I think the low is in for stock prices for the next 2-3 quarters, but I continue to see prices held back by ineffective and misguided fiscal policy. Profits will remain near their post WW2 highs as a percent of GDP, but I expect PE ratios to remain below the historical norm, corrected for continuing low interest rates and the generally stock-favorable opportunity cost.

I will change my mind and forecast if Congress and the Administration can “snatch victory from the jaws of defeat” regarding the need to stimulate in the near term while significantly curbing the deficit longer term. The lower dollar and what I think will be a soft landing in China are supportive.

Economy: I have raised my forecast for fourth quarter growth by a percent to 2-3%. The inventory build in the third quarter did not keep up with the increase in consumer spending and this will help to buffer any slowing in the growth of production even if consumer spending continues to grow in the restrained 2-2.5% range that I expect. The lagged effect of lower gas

prices and the rebound in stock prices should also positively impact consumer spending in the current quarter.

Investment was more robust than I anticipated in the third quarter. While substitution of capital investments for jobs is negative for employment in the short run, longer run it is a positive in that it makes the U.S. more productive and competitive. With the appropriate fiscal and regulatory policies, the potential for job creation and wages is improved in the longer run by a more intensive use of capital. Near-term, however, job creation will continue to lag the potential new entrants and I expect the unemployment rate to stay near or above 9%.

Despite the positive developments, growth will be below what it needs to be to restore full resource utilization for several more years. The consumer will continue to deleverage even as we attempt to reign in public debt creation. And, as usual, I am most concerned that the continued build in external debt for consumption rather than investment purposes will continue to erode the U.S. standard of living. This problem is being corrected very slowly. Thus, despite recent better growth, I am keeping my forecast for first half, 2012 growth at a very sluggish 1-2%.

Regarding inflation, we continue to have “stagnation”, i.e. the level of inflation exceeds what one would normally expect given the high level of unemployment and capacity under-utilization. I continue to expect inflation to ease in coming quarters, but continued growth in energy and food consumption in Asia will likely prevent these non-core items from contributing much to the easing.

Europe: The agreement on a framework for Greek debt restructuring, private bank capitalization, and the ESFS emergency funding, including the attempt to leverage the fund, while not perfect, is a step forward in resolving the European debt crisis. However, pitfalls remain and the “workout” period will take years. The first hurdle is, of course, whether the Greek government can reform and accept the terms of the agreement. More important at this point is whether contagion can be prevented. The near 50 basis point rise in Italian rates since agreement on the structure of debt resolution is not encouraging (see chart following the tables). The failure of the G20 to ratify the framework by pledging the capital needed to leverage the euro zone ESFS fund is also not encouraging.

If contagion is averted, European growth will remain sluggish at least through 2012, probably longer. However, the euro will likely retain its value if the agreement attracts capital to Europe. Supporting this will be the general weakness of the dollar as the focus turns to the U.S. deficit problem and the politics surrounding it. At the same time, there will be periodic “downdrafts” in the euro. In particular, Italy has to roll over more than \$50 billion in debt in February and that may be the focus of the next setback for the euro.

Both Italy and Spain continue to have significant debt and deficit problems. The hope is that the willingness of the ECB and European Union to provide an intermediate-term bridge for financing this debt and holding sovereign debt interest rates down in these countries will tide them over as they get their financial houses in order. To date Italy has made more promises than progress in reigning in budget deficits and it has agreed to have its fiscal situation monitored by

the IMF. Meanwhile the private banks in Spain are faced with an ongoing housing-price problem, not unlike that faced by banks in the U.S.

U.S. Policy: As indicated in last month's report, moderate growth in the second half of 2011 and the predisposition of many within and outside the Fed to resist further monetary accommodation has stayed 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 until the outcome of Congressional fiscal negotiations is determined. 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 although the recent turmoil in Europe may give negotiators a better incentive to come up with a solution more in line with my "hope" expressed in last month's report. Paraphrasing my thoughts from that report:

- 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.

My economic and market forecasts are based on the second case. If, as I hope, Congress and the Administration are able to enact a bolder solution along the Bowles-Simpson line, investors will undoubtedly "smell this out" and the market will rally before I can adjust my forecast.

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

- Interest rates: I continue to expect U.S. treasury rates to stay in their present range. The low for the cycle is probably in, but I do not see a meaningful rise for some time to come.

The 10-year note's recent return down to the 2% level is a risk-off flight to Treasuries resulting from the continued chaos in European sovereign debt. Meanwhile growth in the U.S. and the U.S. fiscal situation argue for higher rates. Near term, European developments will continue to dominate U.S. treasury rates.

- Currencies: I am negative on the U.S. dollar. Despite Japanese yen intervention, I have raised my range on the yen and expect it to test or fall below the 70 yen per dollar level by mid-2012. The fate of the Euro will be determined by whether the framework for resolving the debt crisis can be implemented and contagion can be stemmed. If so, capital will flow into Europe and the euro will hold its value (my forecast). Alternatively, if contagion spreads, the Euro will fall as capital flows out.

In light of the focus on Europe, the statement in the November 4 G20 communiqué that countries will move toward more flexibility in letting their currencies reflect market forces has not received much attention. Without naming China, the reference is clear and is one reason, along with the more dynamic growth, that I remain relatively bullish on Asian currencies.

In contrast to the U.S. employment report, the Canadian report indicated a huge drop of 72,000 (54,000 net when the 18,000 increase in part-time jobs is included). It appears that Canada is being negatively affected by the slowdown in world growth and commodity consumption. I am maintaining my previous forecast for the Canadian dollar. However, I expect it to rally in the first half of 2012 as part of my expectation that the dollar will weaken further.

- Stocks: I raised my 4th quarter range on the S&P to 1150-1320 from 1080-1250 based on both the progress made in developing a framework for dealing with European sovereign and banking debt and also the better-than-expected improvement in U.S. economic growth. However I maintained my range for the first half of 2012 based on two factors. First, the poor response to the European framework suggests that the situation will remain a restraining factor on world economies and markets. Second, I continue pessimistic about the ability of Congress and the Administration to make the necessary fiscal progress.

If, by year-end, Congress is willing to compromise along the lines of what I think should be done (see the U.S. policy section above), I will raise my forecast. If, on the other hand, no progress is made, I will lower my forecast range. Over the rest of November, I think the market will be weighed down by the apparent inability of Congressional negotiators to make progress.

I continue to think that the micro-situation for stocks, earnings, cash and businesses keeping a tight rein on costs is supportive. The macro-environment is a negative and will continue to keep a lid on the PE ratios that would normally be realized in the context of robust earnings and low interest rates.

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

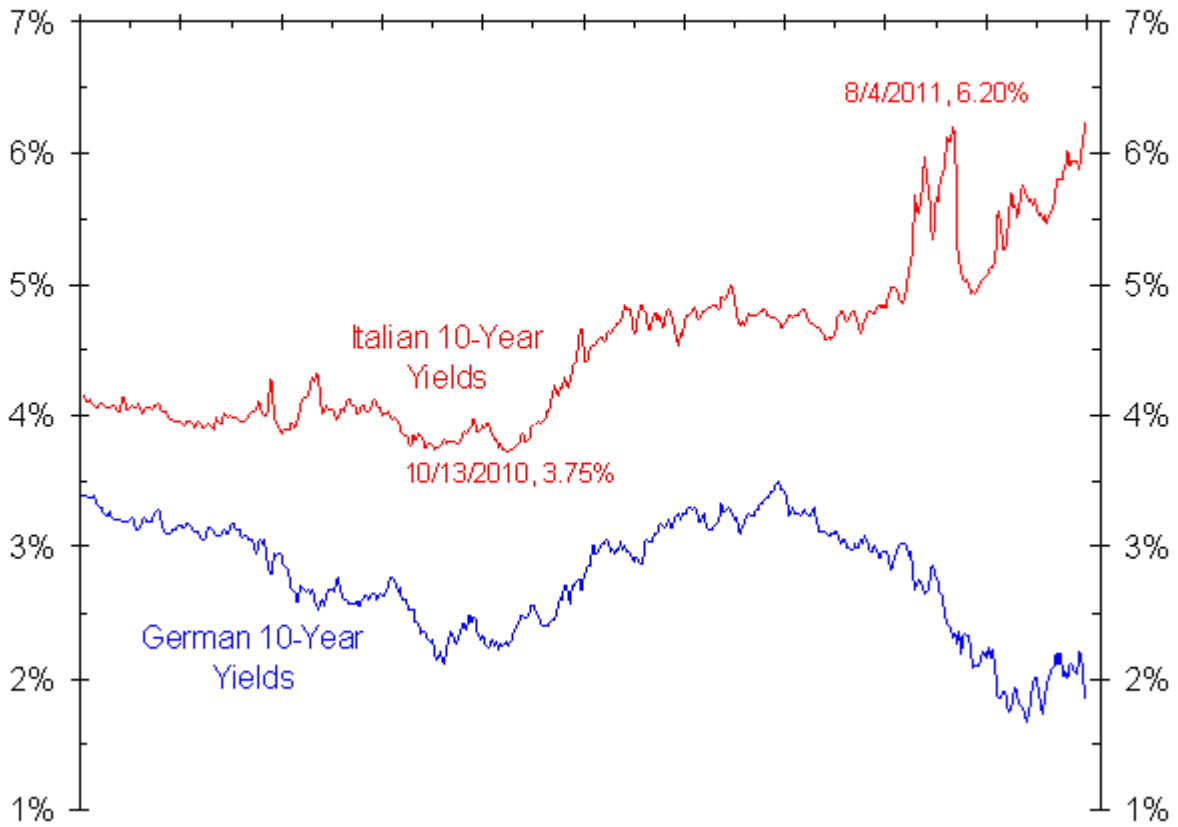
	3 nd qtr.	4 rd qtr.	1 st qtr.	2 nd qtr.
Growth (%)	2.5%	2-3%	1-2%*	1-2%*
Unemployment (%)	9.1%	9.0-9.2%	9.0-9.1%	8.8-9.0%
Inflation (qtrly %)	3.6%	3.2%	2.8%	2.5%
Core Inflation (%)	2.5%	2.4%	2.2%	2.0%
Fed Funds	0-0.25%	0-0.25%	0-0.25%	0-0.25%

*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).

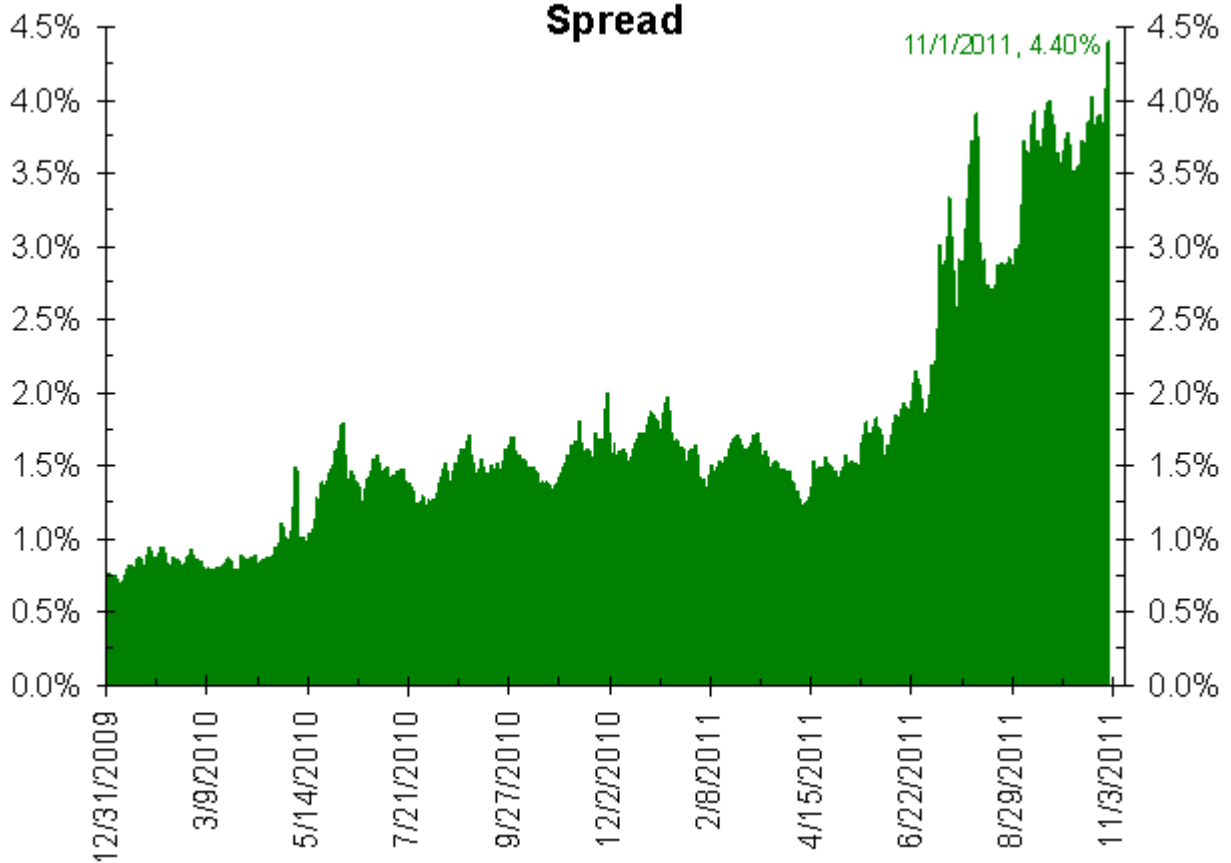
Table 2: Market Forecast Ranges 2011- First Half 2012

	4 th qtr.	1 st qtr.	2 nd qtr.
10 yr. Treasury Rate (%)	1.90-2.35%	2.20-2.50%	2.20-2.60%
Dollar Index (futures)	72-77	68 -75	68-74
Euro (in U.S\$)	1.32-1.44	1.32-1.44	1.32-1.44
Dollar/Yen	74-80	72-76	68-74
Canadian (in U.S.\$)	0.96-1.02	1.00 -1.04	1.03-1.06
S&P	1150-1320	1220-1380	1250-1400

Italian 10-Year Yields vs. German 10-Year Yields



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